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How China Should Use Its Foreign Reserves: Enabling Privatization without Social Disorder

by Deepak Lal

China's remarkable economic performance during the last two decades has rightly been hailed as an economic miracle. The sources of this miracle are well known. The rise in rural incomes with the adoption of the household responsibility system (the shift away from collectivized farming) and the bonus from the demographic transition with a fall in the dependency ratio (the ratio of children and the old to workers) led to a marked rise in savings rates, while the creation of the special economic zones on China's southern rim fueled unparalleled export-led industrial growth through the development of nonstate enterprises.

That labor-intensive growth allowed the transfer of a vast amount of low-wage labor from both the rural sector and the declining state-owned enterprise (SOE) sector. That allowed China to grow by "walking on two legs": by keeping the SOE sector alive while the nonstate enterprise leg was growing stronger. It thus avoided the loss in output and employment and the attendant social disorder that had characterized other transition economies' move from plan to market.

But that strategy is now running into some serious obstacles, which, if not tackled, could lead to the erosion of the miracle. After briefly outlining those problems, I present a simple way in which China could avoid such problems by creative use of its large buildup of foreign exchange reserves and question the current trend in Chinese policy of using those reserves to convert some SOEs into world-class national champions by acquiring foreign companies and assets.

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The Fragility of the Financial System

The dangers to the continuation of the Chinese miracle all hinge on the fragility of China's financial system. That fragility is in large part due to the continuing direct and indirect subsidization of the SOE sector, which is still needed to prevent unemployment and the rescinding of the welfare system currently provided through the SOEs to their past and current employees. But the continuing subsidization of the SOEs to meet the "social burdens" imposed by the past development strategy based on promoting heavy industry through planning is leading to serious problems of economic management and inefficiencies in the allocation of investment. Such subsidization could also pose a threat to the high rate of household savings—the fuel of the Chinese economic miracle.

All those problems are linked to the common feature of a capital-intensive heavy-industry-biased development strategy, which is not in line with the comparative advantage of a labor-abundant and capital-poor developing country. This strategy, which China shares with India for example, requires for its implementation financial repression: the government has to monopolize the mobilization and deployment of savings in the economy.

Thus in China today nearly 90 percent of household savings are still held in deposits with the state-owned banks, in part because of the lack of alternative savings instruments. Alternatives like stocks in the productive and fast-growing small-scale "private" non-SOEs are obviously discouraged because they would prevent the deployment of household savings in the SOEs. Most of the deposits in the banks are loaned (directly or indirectly) to the SOEs. By contrast, most of the investment in the viable private non-SOE sector is either self-financed or dependent on foreign capital.[1] With few of these privately owned growth enterprises being willing or allowed to issue stocks, the stocks traded on the domestic stock exchanges are mainly those in the SOEs, whose nontransparent accounting practices and perceived unviability deters households from holding much of their savings in those stocks. Hence the thinness and volatility of the domestic stock markets.

Opaque Ownership and Financial Repression

Many of the supposedly large private enterprises are likely to be state controlled and have an ownership structure that is at best opaque. Thus *The Economist* noted that Huwaei, one of China's most dynamic and hi-tech companies, "was founded by Ren Zhengfei a [former] officer in the People's Liberation Army. . . . The company denies, but admits it cannot shake, speculation that it is really controlled by the military. . . . Yet its multi billion yuan campus, lavish marketing and relentless expansion overseas are hard to square with it being a private company that made just $300m of profits last year. Nor is it clear why Huwaei has not yet gone public [as some rivals have]."[2]

The PC maker Lenovo, which bought IBM's personal computer business, "is majority-owned by the Chinese Academy of Sciences."[3] Most of the other companies making global headlines are also part of the decision made by the government some years ago that "30–50 of its best state firms should be built into 'national champions' of 'globally competitive multinationals' by 2010."[4]

The truly private enterprises that are the descendants of the small-scale town and village enterprises, which began China's remarkable surge of labor-intensive industrialization after Deng's opening of the Chinese economy in the early 1980s and which are by and large outside government control, are not listed on the domestic stock market and depend more on self-financing and direct investment by the Chinese diaspora for their capital requirements. Ordinary Chinese investors cannot invest in stocks in this dynamic sector of the Chinese economy. They are at best left with the only option of holding their massive savings in deposits in the state-owned and state-controlled banks.

The lack of adequate savings vehicles and the low return households currently get from their savings in the state-owned banks pose a future threat to the maintenance of China's high savings rate. That is particularly so when taking into account the projected rise in the dependency ratio with the aging of the population after about 2010. But the state-owned banks cannot promote higher savings by raising their deposit rates without raising their lending rates to the unviable SOEs whose losses would increase, leading the banks to further increase their loans to cover those losses and thus to a further increase in the nonperforming loans in the banking system.

Those microeconomic difficulties in using the interest rate to stimulate savings and for the efficient sifting and deployment of investments are further compounded by the macroeconomic consequences of financial repression. As the interest rate cannot be used as an instrument for managing aggregate demand, heavy-handed administrative measures with all their inherent inefficiencies and limited effectiveness (given the self-financed nature of most private non-SOE investment) are needed to cool the economy. Furthermore, given the fragility of the banking system, fully opening up the capital account of the balance of payments followed by a move to a fully flexible exchange rate system is ruled out as it could lead to a serious financial crisis.

I do not think that China's export-led growth has depended, as many other observers believe, on maintaining an undervalued exchange rate. Since most Chinese manufactured exports are processed goods with little domestic value added, changes in the exchange rate would not markedly affect their profitability. A flexible exchange rate therefore would not hurt China's phenomenal export-led growth. The move to a fully flexible exchange rate is not only needed for a more efficient use of China's national savings but also to fend off the growing pressures for a revaluation of the yuan from both private speculators and China's major trading partners. (Such pressures have been mitigated but not removed by the recent move to a managed float of the yuan against an unknown basket of currencies, and the modest revaluation that has occurred.)

The Misuse of Chinese Reserves

Behind the prospective dangers currently facing the Chinese economy lie the "policy" and "social" burdens carried by the SOEs because of China's past planned development strategy. The answer must be to eliminate those burdens so that the viable SOEs can be privatized and prosper in a globally integrated market economy or are shut down without causing domestic disorder. Fortunately, China's large buildup of foreign exchange reserves provides the means to do so.

The Chinese government does seem to be using its foreign exchange reserves to deal with its SOE problem, but in a way that is likely to be highly wasteful. It is using the reserves as part of its strategy to create "globally competitive multinationals" from its best state firms, mainly in the natural resources sector, as well as in some consumer goods and high-tech industries where it hopes they will become global brands.

As regards the resource group companies, the recent binge by Chinese SOEs into big foreign acquisitions seems of dubious economic value. Most natural resources, like oil and iron ore, are now internationally traded bulk commodities. The true opportunity cost of the domestic use of those resources remains the fluctuating world price determined by global demand and supply. It is illogical to assume that, just because one owns a foreign iron ore mine or oil deposits, the cost of using those reserves in the home country will be lower than the world price at which they can be imported. Nor is it true, unless the Chinese are aiming to enforce their property rights in owning foreign assets by military might against any attempt at expropriation by local nationalist predatory elites, that such acquisitions create any greater security of supply than that provided by forward contracts in the world markets for those commodities. India too is making a similar mistake in using its own large buildup of foreign reserves to go on a global buying spree of foreign natural resource assets.

As regards the attempts to create world-class companies in consumer goods and high-tech industries out of SOEs, their efficiency and long-term viability is doubtful. *The Economist* noted that most of the first crop of potential champions a decade ago have collapsed. Thus, "D'Long, a conglomerate spanning food and financial services, was lauded as a smart operator that bought tired foreign brands for a song and cut costs by taking manufacturing to China—until last year when it collapsed with huge debts."[5] The problem remains that SOEs (however the extent of state control is disguised) retain the well-known problems of sclerotic management and inefficiencies arising from soft budget constraints. Worldwide experience tells us that the only solution for SOEs is privatization. Using the foreign exchange reserves to enable SOEs to acquire foreign assets is only throwing good money after bad. A better use of the reserves would be to deploy them to enable the privatization of the remaining SOEs without causing social disorder.

Using Reserves for Privatization without Social Disorder

China's foreign exchange reserves now stand at more than $711 billion, which in a roughly $1.6 trillion economy means they are about 44 percent of Chinese GDP. At the moment they are largely held in the form of U.S. Treasuries. Apart from the absurdity of a relatively capital-poor developing country making large unrequited capital transfers to a capital-rich country, China must have seen a loss in the real value of those assets. For since its peak in 2002 the U.S. dollar has depreciated by over 30 percent in trade-weighted terms against the major currencies, while in 2003 the Citigroup U.S. Treasury Index returned a modest 2.3 percent. The return on China's foreign exchange reserves (in trade-weighted terms) is likely to have been negative over the last few years. A small part of those reserves has been put into Chinese investments abroad (a record $5.5 billion in 2004 that is likely to continue growing with China's recent race to acquire foreign natural resource assets). Those foreign investments, for the reasons discussed above, are also not likely to yield large economic returns, if any, for the Chinese economy.

There is a much better way to deploy foreign exchange reserves. Only a small part—say $100 billion—is needed at best to fend off any speculative attack on the yuan and to maintain the chosen shifting peg to the unknown basket of currencies in its managed float. The rest, about $600 billion, as well as any future accruals, could be put into a Social Reconstruction Fund under the Central Bank. The SRF would be run like many public pension funds (for example, like those for the World Bank or the University of California employees to which I belong). Those pension funds are overseen by a committee from the institution that decides the broad sectoral distribution of the fund and the target rate of return (keeping the value of its capital intact) that it expects the fund's day-to-day mangers to beat. Thus the University of California pension fund, which is currently valued at $38 billion, is mandated by the Regents of the University to hold 53 percent U.S. equity, 7 percent non-U.S. equity, 30 percent fixed-income securities, 5 percent private equity, and 5 percent Treasury inflation-protected securities. In 2004 its total return (including capital appreciation) was 22 percent.

The World Bank's pension fund is valued at just over $10 billion, and the asset allocation laid down for it by bank management is 19 percent U.S. equities, 16 percent non-U.S. equities, hedge funds up to 12 percent, private equity up to 12 percent, real estate up to 8 percent, and 40 percent fixed-income securities. In 2003 its return was 18.4 percent. Over a 10-year period the return was about 8 percent. There is no reason why, if the day-to-day management is done by a reputable team drawn from around the world accountable to the Bank of China, the SRF should not be able to do as well. That would yield about $48 billion annually from the proposed fund of $600 billion. But, even if we are pessimistic and assume that it only achieves an average long-term return of 5 percent per annum (while keeping capital intact), that should yield at least $30 billion per annum. Thus, the SRF could earn 2–3 percent of current Chinese GDP as income each year.

The annual income from the SRF should initially be used to retire the existing "social" burdens carried by the SOEs. They could then be treated as normal commercial enterprises that could be privatized if viable and closed down if not. That would end the subsidies from the banking system that have led to its fragility, allow transparent accounting of privatized SOE stocks traded on the stock market, allow the banks to perform their primary intermediating function of efficiently mobilizing domestic savings and transferring them to high-yielding investment projects, and with the restoration of health to the financial system allow China to float the yuan.

In time, as the SOE problem disappears, the income from the SRF could become the basis for a fully funded pensions system for China's increasingly aging population. The SRF thus provides a means for China to move fully from plan to market by removing the sources of fragility in its financial system, while removing any danger of social disorder from the rescinding of the current "social" burdens borne by the SOEs or from the future need to provide pensions for an aging population.

Notes

This article is an expanded version of an op-ed that appeared in the *Financial Times*, December 29, 2004. It was based on a visit to China in October 2004 during which the author was visiting the China Center for Economic Research at Peking University in Beijing and the Department of Economics at Fudan University in Shanghai. The author would like to acknowledge useful discussions with Professors Justin Lin, Weisen Li, and Stephen Cheung without implicating them in any way in the conclusions of the paper.

1. In an important book, Yasheng Huang finds that most foreign investment in China is by the Chinese diaspora, and it goes to the nonstate enterprises. As those enterprises are denied access to capital from the banking system, this overseas Chinese capital has been an important means by which the nonstate enterprises have overcome this distortion in China's capital markets. The direct investment by foreign multinationals has by contrast gone mainly to state enterprises. Much of that investment has been misappropriated, though some has helped some state enterprises

to modernize. The multinationals retain ownership of nearly all technology. They also provide the marketing outlet for most of the industrial exports from the non-SOEs, which have in effect become the branch processing centers of multinational firms. See Yasheng Huang, *Selling China: Foreign Direct Investment during the Reform Era* (Cambridge: Cambridge University Press, 2003). For an enthralling account of how multinational investments to modernize state enterprises have failed, see Tom Crissold, *Mr. China* (London: Constable and Robinson, 2004).

2. "Special Report: China's Champions," *The Economist*, January 8, 2005, pp. 59–61.

3. Ibid., p. 60.

4. Ibid., p. 60.

5. Ibid., p. 61.

Other Relevant Studies from the Cato Institute

"U.S.-China Relations in the Wake of CNOOC," by James A. Dorn, Policy Analysis no. 553, November 2, 2005.

"Capital Flows, Overheating, and the Nominal Exchange Rate Regime in China," by Fred Hu, *Cato Journal* 25, no. 2 (Spring/Summer 2005).

"A Simple Solution to China's Pension Crisis," by David D. Li and Ling Li, *Cato Journal* 23, no. 2 (Fall 2003).

"Internal and External Reforms: Experiences and Lessons from China," by Yasheng Huang, *Cato Journal* 21, no. 1 (Spring/Summer 2001).