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Hearing on "Chinese State-Owned and State-Controlled Enterprises"

Panel II: The Competitive Challenges Posed by Chinese State Owned Enterprises

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I would like to thank the co-chairs and the other distinguished members of the Commission and its staff for the opportunity to speak to you today. It is an honor to be invited.

First, as is indicated in my biographical information, in addition to serving as an adjunct professor at the Georgetown University Law Center, where I teach courses on international securities regulation and China's financial markets, I hold the position of senior counsel in the Securities and Exchange Commission's Office of International Affairs. Before I begin my prepared remarks, I would like to emphasize that I am appearing here in my capacity as a Georgetown Law professor and that my comments today are mine and mine alone, and do not represent the views of the SEC, any individual SEC Commissioner or of the SEC staff.

I have been asked to speak on the topic of the competitive challenges posed by China's state-owned enterprises. I will focus my remarks on the advantage—some would argue unfair advantage—that China's state-owned enterprises have in the ability to raise capital at costs cheaper than that available to their foreign competitors. I would note, however, that this advantage in a low cost of capital does not exclusively come at the expense of foreign firms. The Chinese private sector competitors to these state-own enterprises are also often disadvantaged by the ability of state-owned enterprises to raise capital at significantly cheaper costs. The reason state-owned enterprises are able to obtain such cheap capital is result of the structure of China's financial markets.

China's Repressed Financial System

Over the past two decades, China has made truly significant advances in the transformation and development of its financial sector, a transformation that has witnessed the establishment of the Shanghai and Shenzhen stock exchanges, the restructuring and public listing of China's largest banks and the creation of a nascent corporate bond market. Also, China has adopted much of the institutional architecture required for well-functioning financial markets and market-based capital allocation—for example, the enactment of laws and regulations governing financial intermediaries, the adoption of international accounting standards, and the creation of ostensibly independent

market regulators, to just name a few. Despite these impressive achievements and important steps, however, China's financial markets suffer from significant financial repression. Financial repression describes an environment where financial markets remain undeveloped and government intervenes in the credit allocation process. In the case of China, financial repression is characterized by among other features:

- The virtual monopoly in capital allocation by a select number of state-owned commercial banks;
- Government control of interest rates that result in low to negative real rates of returns for deposit holders;
- Poorly developed debt and equity markets; and
- Strict capital controls.

Dominance of the Big Four Sate Banks in the Financial System

A study of how state-owned enterprises are able to obtain cheap capital begins with the fact that China's credit allocation system is dominated by the four largest state-owned commercial banks: Industrial and Commercial Bank of China (ICBC); Bank of China (BOC), China Construction Bank (CCB) and Agricultural Bank of China (ABC). In 2009, the big four banks alone accounted for more than 70 percent of the assets held by the state-controlled banking sector, which was 43 percent of China's total financial assets. When considering these figures, it is easy to see how these four state-owned banks are the true gatekeepers of the capital allocation in China and the overwhelming suppliers of capital to the state-owned sector. Also, despite recent figures that suggest that credit has become increasingly available to private sector firms as a result of the 2009-2010 stimulus-package-driven credit boom, the vast majority of the credit financed by the big four banks is sill directed to state-owned enterprises and at extremely low costs.

Government Controlled Deposit and Loan Interest Rates

Loans to state-owned enterprises are provided by the state-owned commercial banks at such low costs due to the government's control over interest rates. China's central bank, the Peoples Bank of China (PBC), sets interest rates for both deposits and loans, which for the past several years have been kept at very low levels. In fact, since 2003, the average real return on deposits has been negative once inflation is taken into account. Similarly, when adjusted for inflation, the real rate on bank lending has also often been negative. The spread between these two rates allows the banks to remain profitable despite the low lending rates. Simply, the banks are providing their principal customers—the state-owned enterprises—with virtually free capital at the expense of deposit holders.

The low interest rate policy serves as a tool for China's industrial policy, channeling the implicit tax collected from Chinese households through this negative return on their savings via the state-owned banks to selected investment projects and industries. Chinese government control over interest rates poses a competitive challenge to U.S. and other foreign firms as the negative real lending rates act as a subsidy to China's state-owned sector. This is particularly evident in the capital-intensive industries in which China's

state–owned firms are competing globally.

Lack of Alternative Options for Account Holders

One naturally asks why Chinese households would deposit their saving in banks if they are only going to lose their hard-earned money by doing so. The simple answer is that there is no viable alternative to the banking sector. This is the result of two additional characteristics of financial repression mentioned earlier: poorly developed debt and equity markets; and strict capital controls. A truly active bond market for retail investors has yet to develop in China and, despite all of the attention they have garnered over the past several years, the Shanghai and Shenzhen stock markets remain only small players in China's economy and have no significant role in capital formation. The stock markets are extremely volatile and have witnessed rapid increases in share values that are followed by precipitous price drops and then long periods of stagnation. In addition, there is a perception that insider trading, stock manipulation and reporting fraud are endemic in these markets. As such, the stock markets are viewed as barely better than a casino by the average investor. Consequently, Chinese households do not see the stock market as a viable alternative to banks for long-term savings.

Finally, because of the closed capital account, average Chinese households are unable to move their money abroad to access alternative offshore investment opportunities. I would note that the one possible alternative to placing their savings in loss-generating bank accounts for the average investor is to invest in residential real estate, which has led to the spectacular rise—many believe bubble—in Chinese housing.

The Impact of Financial Repression and Controlled Interest Rates

In summation, China's state-owned enterprises benefit from a distinct competitive advantage, having access to extremely low costs of capital as a result of the repression of China's financial markets and government control over interest rates. I will end by pointing out that, although these policies do benefit state-owned enterprises and industries vis-à-vis their foreign competitors, these policies do not come without significant cost to the Chinese economy. As I explained, the average Chinese household bears the brunt of financial repression and government controlled interest rates in the form of lost savings. The Result is a decline in purchasing power of Chinese households, which limits consumption spending. These policies also lead to the over investment in capital-intensive and export industries. Both of these factors significantly undermine the Chinese government's stated goal of transitioning to a growth path that relies less on investment and net exports and more on domestic consumption. Finally, it has led Chinese households to place more of their savings into the housing market, which has resulted in a potential housing bubble that has the potential for negative implications for China's future economic health.

Thank you and I look forward to answering any questions you may have.