World Bank tells China to reform state sector to ensure stability

A 400-page report calls the nation's economic model 'unsustainable' and calls on the Asian giant to boost market competition, support marginalized private enterprise and diminish the role of government-owned companies.

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Reporting from Beijing and Washington

The World Bank, taking aim at one of China's most entrenched interest groups, told the country's top leadership that it had to reform the nation's powerful state sector to ensure stability in the world's fastest growing major economy.

China's economic model was "unsustainable," the World Bank said, calling on the Asian giant to boost market competition, support marginalized private enterprise and diminish the role of government-owned companies.

"This is not the time just for muddling through," World Bank President Robert Zoellick said Monday at a conference attended by high-level officials in Beijing. "It's time to get ahead of events and to adapt to major changes in the world and national economies."

The World Bank's 400-page report outlined a host of recommendations, including reforming taxes and improving the rights of rural residents.

It comes as China continues to draw U.S. scrutiny for its economic policies, which some analysts see as a threat to the Chinese themselves as well as the global economy. As the world's second-largest economy, China's policies and development are increasingly influencing other countries, industries and markets around the world.

On Tuesday, the Information Technology and Innovation Foundation, a nonpartisan Washington think tank, plans to issue a new report detailing China's strategy to drive growth and innovation allegedly by setting up barriers to foreign firms and pressuring them to share technologies with Chinese partners.

Some aspects of the World Bank's study are consistent with the think tank's findings but don't go far enough, said Rob Atkinson, the foundation's president who co-chaired an informal White House-initiated U.S.-China innovation experts group.

The World Bank's report "doesn't repudiate China's export-led strategy," Atkinson said Monday. "It actually
calls for more of it."

The World Bank, based in Washington, gives financial and technical assistance to developing countries. It produced the China report to offer developmental strategies for the country in the coming two decades.

The report states that supporting the state sector hinders growth and needs to be recalibrated.

"This biased business environment can jeopardize fair competition, efficiency improvement and innovation, and be harmful for an economy to complete its industrialization and join in the club of high-income countries," it said.

China's transformation from a poor socialist state into an economic juggernaut was kick-started 30 years ago, in no small part by the unshackling of entrepreneurship.

Since then, however, the nation's economy has been carved up by what's popularly known as China Inc. — about 120 central government-owned corporations that dominate the biggest and most profitable areas of business, such as banking, telecommunications, transportation and energy.

Need a cellphone plan? Choose from the trio of state-owned giants: China Mobile, China Telecom and China Unicom. Looking to fly? You're most likely to take one of the three major state carriers: Air China, China Southern and China Eastern. Upset about gas prices? They're determined by a government duopoly of PetroChina and Sinopec.

Add in 150,000 smaller state-owned firms with their hands in everything from restaurants to real estate and tourism, and the public sector accounts for a total of about 30% of China's economy. The government-controlled system, analysts said, has contributed to China's excessive and unsustainable investments in residential property.

State dominance has become stronger since the 2008 financial crisis, when the country's official banks diverted stimulus cash to state-owned companies, mainly because the loans to those companies are likely to be guaranteed by the central government.

Meanwhile, many private enterprises have floundered for the last year as banks beset by soaring inflation tightened lending. The diminished access to loans is just one way non-state companies are squeezed. Government-run firms are often the first to get land, resources and word of policy changes that could benefit business.

In a world without meaningful competition, revenues of state-owned companies grew 21.5% last year to nearly $6 trillion.

The development has not gone unnoticed in Washington, where criticism of Chinese industrial policy has shifted from just talk of currency appreciation to unfair subsidies and market dominance of China's state-backed titans.

In theory, support of the state sector gives China the ability to catch up to the developed world by promoting globally competitive companies.

But critics said the system has achieved the opposite — massive monopolies prone to corruption unable to turn a profit without access to cheap credit from state banks.

The average return on equity for private companies is about 10% higher than for state-owned enterprises, according to the World Bank.
But breaking up the state oligopolies is politically untenable. Corporate leaders are handpicked by the communist party, often with the goal of placating different factions of the power elite, experts say.

"Many state-owned companies are controlled by princelings," said Hu Xingdou, an economist at the Beijing Institute of Technology, using the term given to the children of China's revolution-era leaders. "I'm not very confident that reform will take place very soon because it will require political reform and it threatens the interests of officials."

The World Bank suggested that China redefine its strategic sectors in which the state commands monopolies and restrict them to areas in which they offer public good, such as security, subsidized housing, and research and development.

The bank also recommended the establishment of independent asset management companies that could manage state-owned companies according to market needs.

"They could then, on behalf of government, gradually diversify the portfolio and scale back state ownership over time," the report said.

The research, co-written by the Development Research Center of China's State Council, an influential government think tank, could reverberate in the halls of power in Beijing. The project was conceived nearly two years ago by Zoellick and Vice Premier Li Keqiang, widely presumed to be China's next premier.

Whether the country's leaders will act on the recommendations remains to be seen. China is about to embark on a leadership transition this year that traditionally marks a period of policy stasis. However, weak financial conditions in Europe, Japan and the U.S. could force China to change tack sooner than expected.

"The case for reform is compelling because China has now reached a turning point in its development path," Zoellick said.

"Managing the transition from a middle-income to a high-income country will prove challenging," he said. "Add to this a global environment that will likely remain uncertain and volatile for the foreseeable future, and the need for change assumes even greater importance."


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