Finance and corporate governance in the Chinese NSI: macro and micro, national and international implications.

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1: Introduction: historical and global context.

Technological revolution; tendency to inadequate global investment; need for strong financial flows from aging to young populations, and from rich to poor.
Financial flows within Chinese economy – at both macro and micro level - are far from the pattern which would be optimal for the technological development of the country.

2: Macro situation.

- The poor are being squeezed rather than invested in.
- Net capital flows are out of rather than into China, not what should be expected in a fast-growing LDC.

3: Micro situation; effect of finance, corporate governance

- Flows into state-owned enterprises are largely going into subsidy to loss-makers, and to the extent that they are for investment this is more into moving 'sideways' to increase capacity in sectors where there is already too much of it, than into moving upmarket.
- Private and collective enterprises are largely unable to tap the financial system (i.e. banks) to fund their investments in technological upgrading and the overcapacity largely induced by the misdirection of SOEs reduces their capacity for self-financing.

1. Introduction

We are passing through a technological revolution.
A new techno-economic paradigm – the ICT paradigm, the fifth since the Industrial Revolution began – has appeared, but not yet been effectively exploited. Such delay is typical with new paradigms: it involves a tendency to under-invest, which

- reduces the rate of productivity increase, and
- threatens insufficient aggregate demand.

Crisis of under-investment visible in both DCs and LDCs.
In LDCs the main perceived challenge is to transfer established 'modern' technology from DCs. This requires high investment in

- physical capital, licenses etc.,
- education & training for a 'modern technology' workforce.

2 main LDC deficiencies:

1. Lack of finance for these twin requirements
2. Failure to develop and diffuse 'appropriate technology' – appropriate to 'factor endowment' of LDCs (mostly low-skilled labour, shortage of foreign exchange) and low initial technological capability.

Adequate levels of such investment will

- resolve problem of demand deficiency and
- release potential of new techno-economic paradigm.

Investment needed in LDCs, to be financed largely from DCs: complementary demographic positions –

- DC population bunched in high-saving age groups, 40-60;
- bunching of LDC population in low-saving age groups <30.

China has within itself many of world's imbalances.
The different types of under-investment within China are threats

- to its own continued economic expansion **and**
- to the equilibrium of the world economy.

2. The position of China

China is very large; and extremely heterogeneous in terms of economic and technological development.
Coastal provinces have clear locational advantage, increased with opening of economy (Figure 1).
Beijing, Shanghai and Guangdong are particularly fortunate: Beijing as capital, Shanghai as traditional hub, Guangdong as province bordering Hong Kong and first where restrictions on economic activity were loosened (Table 1 and Figure 2).
Cities' long, growing advantage over countryside (T.2, Fig.3).
Official figures: 'income ratio ca. 3:1'; unofficial, ca. 6:1
Gap between rural hinterland and top coastal cities larger still. (Including Hong Kong & Taiwan, gives 2 even wealthier areas.)
Same order as differences between developed and LDCs.
Related differences in technological development.
Relationship between more developed and less-developed China thus comparable with that between DCs and LDCs:
technology (imperfectly) transferred from D to LD,
migration from LD to D.

Demographic departure from LDC category: in 2000 census, 15-30 and 30-45 cohorts are about equal; larger than 0-15 cohort.
1-child policy since 1979; most effective in cities. But heavy migration caused doubling of proportion in cities. (Table 4).
This helps account for China's very high savings rate:

- High % are in age range which is saving for retirement, and
- they have relatively few children to provide for.

China however needs to create workplaces for:

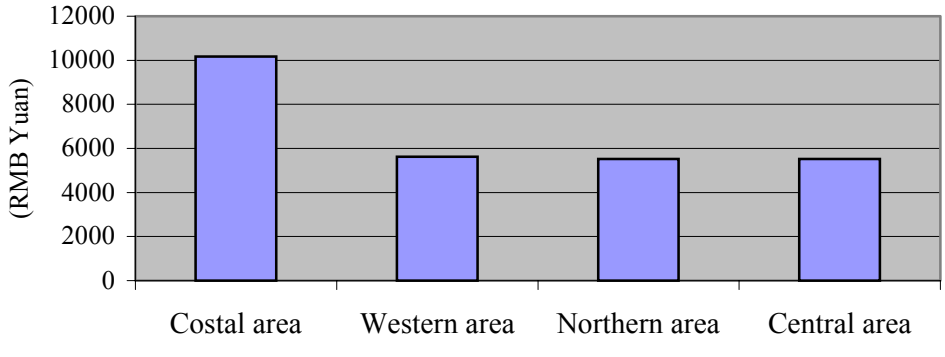
- ca.300 million surplus workers in rural areas alone
- surplus in state-owned enterprises,
- new entrants to the labour force,
- moving existing industry up-market.

Table 1: Per capita income of city-dwellers by region

Coastal Area	Annual Income (RMB Yuan)
Beijing	11577.78
Shanghai	12883.46
Zhejiang	10464.67
Guangdong	10415.19
Fujian	8313.08
Jiangsu	7375.1
Annual average income	10171.55
Western Area	
Qinhai	5853.72
Gansu	5382.91
Annual average income	5618.32
Northern Area	
Heilongjiang	5425.87
Jilin	5340.46
Liaoling	5797.01
Annual average income	5521.11
Central Area	
Shaanxi	5483.73
Ningxia	5544.17
Annual average income	5513.95

Source: China Statistical Year Book 2002: Table 10-15

Figure 1: Comparison of average city-dwellers income per capita by region



Source: China Statistical Year Book 2002: Table 10-15

Figure 3: A comparison of per capita annual income of urban and rural residents

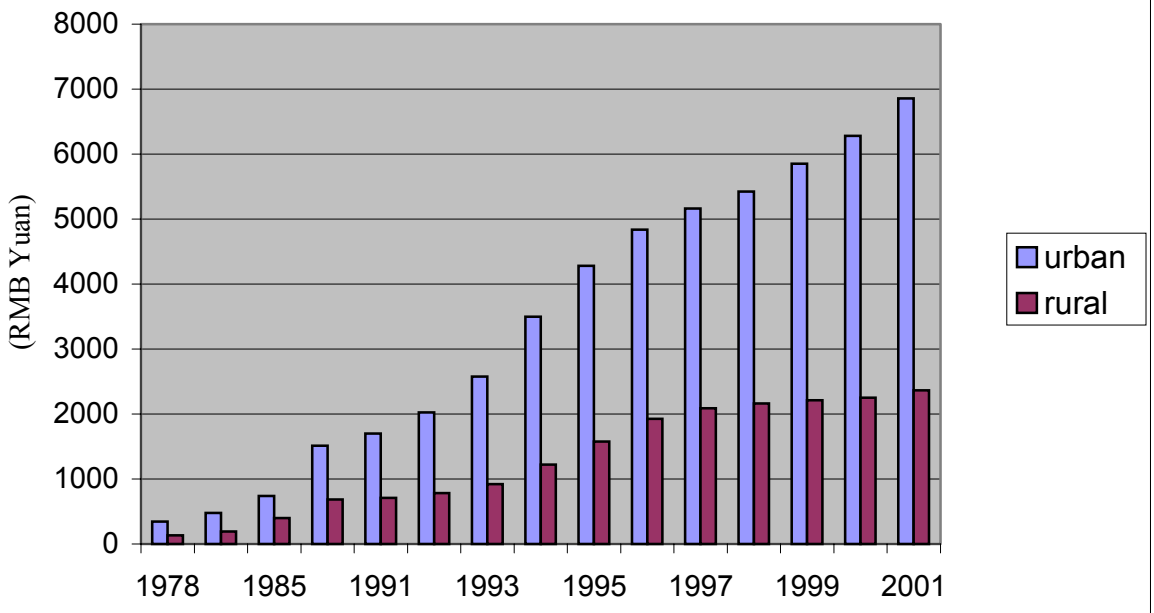


Table 3: Demographic data: population grouped by age

Age group	% of total population (1995)	% of total population (2000)
0-4	7.29	5.55
5-9	10.68	7.26
10-14	8.77	10.09
15-19	7.38	8.29
20-24	8.74	7.61
25-29	10.17	9.46
30-34	8.82	10.25
35-39	6.95	8.78
40-44	7.41	6.54
45-49	5.54	6.88
50-54	4.24	5.09
55-59	3.85	3.73
60-64	3.47	3.36
65-69	2.73	2.80
70-74	1.96	2.06
75-79	1.15	1.28

80-84	0.58	0.64
85-89	0.21	0.24
90-94	0.05	0.06
95-99	0.007	0.01

Notes: The data for 2000 are taken from the fifth national census of population (the other four were conducted in 1953, 1964, 1982, and 1990). The data for 1995 are from the sample survey in 1995. The sample proportion is 1.04%.
Source: China Statistical Year Book 1996: Table 3-5; China Statistical Year Book 2002: Table 4-5

Table 4: Demographic data: population and its composition

Year	Total population (unit:10,000)	% of urban residents	% of rural residents
1978	96259	17.92	82.08
1980	98705	19.39	80.61
1985	105851	23.71	76.29
1990	114333	26.41	73.59
1991	115823	26.94	73.06
1992	117171	27.46	72.54
1993	118517	27.99	72.01
1994	119850	28.51	71.49
1995	121121	29.04	70.96
1996	122389	30.48	69.52
1997	123626	31.91	68.09
1998	124761	33.35	66.65
1999	125786	34.78	65.22
2000	126743	36.22	63.78
2001	127627	37.66	62.34

Source: China Statistical Year Book 2002: Table 4-1

Investment demands divide into extensive and intensive growth.
1. Extensive growth and the absorption of surplus labour.
Most surplus is in the less-developed provinces.
Workplaces need to be created for them: ***either***

- through Appropriate Technology - technology appropriate to existing factor endowment of the country, and initial levels and type of expertise of the labour force.

Should blend ICT & other modern technologies with older.
AT is economically affordable and institutionally manageable.
And sustainable: can be engineered to strain 'sources and sinks' less.

- Or through *modern technology*. High capital cost per worker and high levels of skill and education.

Huge investment required – far beyond LD areas' and sectors' surplus. Massive effort of education and training in parallel – cf. current low education spend by government.
And what would they produce, and for whom?
Low per capita incomes of these areas constrain demand.

UNLESS one selects sectors which offer world competitive advantage to low-cost low-tech producers – e.g. textiles;
And those operations, like assembly, which do likewise.
(Foreign MNCs transfer their lower-tech operations to China.)
The cost per workplace is relatively low. Near coast, raw materials, components are turned into manufactures by young workers from hinterland with little education and training, on cheap equipment; mostly for export.
Spectacular rise in merchandise exports has resulted; such a strategy worked very well for Taiwan and S.Korea in 1960s, 70s.
But two crucial differences:

- Taiwan and SK were small. China can flood market.
- Taiwan and SK had v.equal income distribution of income, high mass education spend. Basis of fast ascent.

Nation-wide deficiency in financial flows.
Funds needed for education, training, employment of rural poor are not reaching them,

- partly because income transfers are going the wrong way,
- partly because conventional financial movements, ditto.

See next section.

2. Intensive growth and the move up-market.
Improvement in range, quality and sophistication of products, and the efficiency of processes – needed for real development.
China's advantages:
Huge home market

➔ optimum scale without high concn.,+ ecs of agglomeration.
➔ draws in foreign MNCs, to produce in China,

Huge output of graduate engineers and other key 'human capital'.

Evidence of under-investment in China:

- unemployed and underemployed labour, described already,
- balance of payments on current account. Should have
  $I > S$, $M > X$,

with an inflow of capital to make up the balance.
On the contrary: trade + $21.4bn, current account $35.4bn.
Its foreign reserves (helped by incoming FDI): $356.5bn.
So no balance of payments constraint on China's investment.

3. Finance and corporate governance: the key weakness in the Chinese national system of innovation.

Key constraint: ability/willingness of enterprises to invest, in physical capital, research and development, or training. Why?

4 main ownership types, each with own clearly-defined pattern of finance and corporate governance (that is, the structures and relationships by which they are controlled).

1. State-owned enterprises (100% and majority-).
2. Collective enterprises (township and village-owned).
3. Domestic privately-owned.
4. Foreign-owned (100% and majority-).

Collective and (particularly) private enterprises are mostly small and almost always simple in their corporate governance.
The main problem is simply finance. They are too young and small for stock market; and vice versa.
Little private equity or venture capital.
Banks prefer state-owned enterprises; are very weak financially; and have little experience in lending for technological development – a process which does not involve or generate suitable collateral, and therefore involves expert judgments.

So private and collective enterprises are trapped in low-tech activities, unless they can generate their own funds to move up.

In other 2 ownership types, problem is more corporate governance.
Foreign multinationals are not generally finance-constrained – or they would not have invested in China. Corporate governance:

- in joint ventures, loth to let technology leave their control.
- no incentive to locate more high-tech plants in China:

China is classic location for 'branch plants' which use established processes to make established products, so capability for learning and innovation does not need to be locally held. [This may still be partly true when R&D is done in China.]

In the state sector finance is a moderate and varying problem. Much investment, nonetheless, is financed. In 1999 SOEs carried out 53% of capital investment (28% of gross output). They invest largely in diversification on same technological level. The main pressure on many SOE managers is to maintain employment by whatever means they can, in the short and medium term. The simplest way of doing that is to enter a succession of established medium-low technology industries where they are confident of being able to master the technology quickly, and develop a more or less full product range. One way of mastering the necessary technology quickly is to buy a whole package of equipment and technology from abroad, even though this is an inferior strategy to largely-internal development of capability, from the point of view of long-run competence and indeed long run profit.

External sourcing of technology attracts all SOE managers. System of corporate governance operating in and over SOEs is unfavourable to *low-visibility* investment. A large discrete package is highly visible. A diverse collection of small investments in learning, training and second-hand equipment such as allowed Taiwanese and Japanese firms to move up-market on the cheap, is not.

Result, over-capacity. Disastrous effect on profitability of industry in general and private sector in particular.

Under different circumstances SOEs and the private/collective enterprises could be symbiotic. An SOE might lead into a higher technology sector, using its superior access to finance – and then being followed by private enterprises who perhaps reverse-engineered its products, poached some of its best employees, and had tighter management and sharper eye on the market.

Legend and most of the other high-tech successes, significantly belong to a fifth, small category of *minority* state ownership.

4. Conclusions and Policy Prescriptions

It is not only the Chinese who lose by the 'misdirection' we have described, and the imbalances with which it is connected: the effect is to increase competition and supply in low-technology manufacturing worldwide, thus weakening the weak in developed and less developed countries alike.

What should be done?

- Deregulation might lead to an increased outflow of capital.
- Wholesale privatisation? Politically excluded. And good thing too: earthquakes are undesirable for fragile structures.

Corporate governance of SOEs needs to be radically reformed to improve the quality of monitoring and to encourage low-visibility investment.
The loss-making SOEs in the inland provinces need special attention, with a redirection of subsidy towards the acquisition of real technological capability. But the position of these SOEs must be seen in context of their areas areas from which they should get their customers and their skilled workers. 'The lives of hundreds of millions of farmers in China's villages have been blighted by illegal taxes and fees they are forced to pay by town authorities charged with governing them.' (Kynge, 2003, p.14). Mr Wen Jiabao, who became premier in March 2003, 'in a recent speech to senior officials….singled out four areas in which China needed to pursue a more balanced growth strategy.. development needed to be better harmonised between towns and villages; different regions; the economy and society; and man and the environment'. Linked to power relationships. 'The question is, who whom?'. But the answer is certainly not Lenin's.