China Economic Quarterly

June 2016
Vol. 20 No. 2

The State Sector's New Clothes
Will the SOEs save China's economy or drag it down?

Policy Confusion
Lessons from an Authoritative Person

Oil Demand
The one commodity good-news story

China In Europe
New horizons in checkbook diplomacy

GavekalDragonomics
www.gavekal.com

China Economic Quarterly

Vol. 20 No. 2 June 2016

The Party Line

Making Sense Of The Economic Policy Mess 3
By Arthur Kroeber

The State Sector's New Clothes

Villains Or Victims? The Role Of SOEs In China's Economy 7
SOEs' poor performance results from their mandate to act as economic stabilizers.
By Andrew Batson

State Enterprise Reform: Missing In Action 15
The promise of bold SOE reform has dissolved into a conflicting jumble of vague objectives.
By Barry Naughton

Return Of The Line Ministries 22
Zhu Rongji broke up the big, unwieldy conglomerates. Xi Jinping wants to restore them.
By Michael Komesaroff

The Economy

Stability Above All 29

Beijing aims to keep GDP growth and the currency as stable as possible ahead of the 2017 Party Congress.

By Chen Long

Energy

The Future Of China's Oil Demand 34

Oil demand will grow but imports will be volatile, thanks to uncertainty over how the strategic reserve will be filled.

By Rosealea Yao

China Abroad

The Long March To Europe 40

Chinese investment in Europe is surging, bringing economic benefits and political risks.

By Philippe Le Corre and Alain Sepulchre

Books

Hope And Hard Work On A Shanghai Street 47

A review of Street of Eternal Happiness *by Rob Schmitz.*

By Arthur Kroeber

China Economic Quarterly (CEQ) is published by Gavekal Dragonomics, a unit of Gavekal Research Ltd.

Subscriptions are available only as part of the Gavekal Dragonomics research service. Contact sales@gavekal.com for details.

The trademarks "China Economic Quarterly," "CEQ" and "Dragonomics" are the property of Gavekal Research Ltd.

Editor
Arthur Kroeber

Editor-at-large
Tom Miller

Design & production
Big Brains

Gavekal Dragonomics
Suite 3101, Central Plaza,
18 Harbour Road,
Wanchai, Hong Kong
Tel +852 2869 8363
Fax +852 2869 8131

Suite 603,
Soho Nexus Center,
19A Dongsanhuan Beilu,
Beijing 100020, China
Tel +86 10 8454 9987
Fax +86 108454 9984

For more information:
www.gavekal.com

The Party Line

Making Sense Of The Economic Policy Mess

By Arthur Kroeber

Xi Jinping's economic policy seems like a mass of confusion. This is only because he has been coy about stating his true aim: to make the state sector as strong as possible.

Fears of an imminent economic meltdown or financial crisis, which ran high at the beginning of the year, have abated. But deep uncertainty about China's economic direction remains. At the heart of this uncertainty lie two unresolved contradictions in government policy.

First, do Xi Jinping and his colleagues favor a "decisive" role for markets, as they proclaimed in their Third Plenum reform agenda in November 2013? Or do they want a "dominant" role for the state, as they declared in that very same reform agenda? Second, is the main policy aim of the moment to sustain economic growth at its current rate, as the credit-and-infrastructure stimulus of the last several months would imply? Or is it to undertake much-needed structural reform, as recent official statements insist?

These contradictions have been simmering away for a year now. Until June 2015 it was possible to maintain with a straight face that Xi was trying to push through a complex and broadly market-oriented economic reform program, even if the obstacles were proving trickier than expected. Since then, however, we have seen: a massive intervention to prevent a much-needed stock market correction from running its course; a mishandled change in the exchange-rate regime; a tepid state-owned enterprise reform blueprint that basically abandoned all the boldest proposals for shaking up that troubled sector; and a powerful credit stimulus in the first quarter of 2016 that delivered a short-term boost to growth at the cost of increasing the risks in the financial system.

Arthur Kroeber is editor of the *China Economic Quarterly*.

On top of this we have seen the release of two long-term planning documents that suggest a statist and nationalist direction. The first was the Made In China 2025 industrial policy plan, which in essence is a set of targets for domestic companies' share of various manufacturing sectors. This sort of targeting is obviously inconsistent with a commitment to truly competitive markets. The second was the 13th Five-Year Plan, released in March 2016 and covering the period 2016-20. This too is very much an industrial policy document, naming 75 priority industries and with minimal emphasis on deregulation or market liberalization.

> The evidence suggests that Xi's long-run ambition is to build a bigger, more powerful state sector

The evidence thus suggests that Xi's long-run ambitions are to build a bigger and more powerful state sector, and forcibly increase Chinese firms' share of both domestic and international markets. The market-oriented reforms flagged in the Third Plenum decision have given way to a dirigiste vision. In the shorter term, he seems committed to ensuring that China's economy continues to grow by at least 6.5% a year, even if this can only be achieved with a vast expansion of debt-financed, low-return infrastructure projects.

The growth target is enshrined in the five-year plan, despite lobbying by some economic bureaucrats who rightly argue that such growth targets are now useless and perhaps even counterproductive. It stems not from a sober analysis of the nation's potential growth rate, but from politics. In 2010, the Party pledged to double per capita GDP by 2020. To acheive that target, the economy must grow by about 6.5% each year to the end of the decade.

Authoritative confusion

This apparently clear—if somewhat depressing—picture was thrown into confusion with the May 9 publication in the *People's Daily* of an interview with an unnamed "Authoritative Person," who declared that debt-fuelled growth was unsustainable, that the economy was experiencing an "L-shaped" recovery (i.e. that economic growth would flatten out at some lower than its historic pace, though whether that level would be the current talismanic 6.5% or a lower figure was left unspecified), and that structural reform was still a top priority.

This was the second appearance of the Authoritative Person this year; in January another *People's Daily* interview had introduced the slogan of "supply side reform." After a brief flurry of confused commentary, a further set of statements, attributed directly to Xi Jinping, clarified that Chinese "supply side reform" has nothing to do with Reagan/Thatcher style

deregulation. Rather, it is a set of mandates from the central government to reduce supply in sectors suffering from excess capacity (steel, cement, coal) and increase supply in strategically important sectors of the future (the technology industries specified in the various industrial plans).

At first, many commentators interpreted the Authoritative Person's reappearance as a sign of factional struggle between a "pro-reform" Party camp and an "anti-reform," pro-stimulus government camp, led by Premier Li Keqiang. But this is nonsensical. Premier Li has been a loud and consistent supporter of deregulation, and has repeatedly told interlocutors that he has no interest in GDP targets, only in productivity and employment growth. So the idea that he has led the charge for short-term stimulus, and must be slapped down in the pages of the Party paper for failure to live up to President Xi's bold reformist vision, cannot be right.

A more plausible explanation is that Xi's economic brain trust is simply trying to drive home some propaganda points about the overall direction of economic policy. Their message seems to be:

- Yes, we're stimulating growth in order to maintain economic and social stability; however
- This stimulus is not going to last that long, so don't make investment plans based on the assumption that easy credit is here forever; moreover
- While we are doing everything in our power to prevent economic growth from falling too much, there is nothing we can do to make growth accelerate again, so get used to the "new normal" of slower growth; and finally
- We are really serious about market-friendly reforms, despite the fact that we have done nothing to promote them so far. Really, truly, cross my heart and hope to die! Trust us on this—and don't believe the critics who say we've thrown in the towel on the market.

Wisdom from gadfly Gao

On the last point, it is perhaps significant that the Authoritative Person chose to bring down his tablets from the mountaintop a few weeks after some widely publicized and incendiary remarks by a prominent former official, Gao Xiqing, at the Council on Foreign Relations in New York. Gao, who holds a law degree from Duke University, was one of the architects of China's stock markets and held a string of senior positions at the China Securities Regulatory Commission, the National Social Security Fund, and the sovereign wealth fund CIC, where he was president from 2008 to 2014.

Now a professor at Tsinghua University, the famously plainspoken Gao told his New York audience that Beijing was "basically giving up what the

Party said at the 18th Party Congress, to let the market be the decisive force in allocating resources," and that "this government in economic terms is very much captured by different interest groups. The biggest interest group is the state-owned enterprises."

In other words: the claim of Xi and his advisers that they are pursuing a market-oriented agenda is fraudulent. Xi sees state-owned enterprises (SOEs) as essential instruments for management of economic cycles, and trusty agents of a national strategy to enhance China's technological base and share of global markets. The main game therefore is to strengthen the Party's control over the SOEs, and strengthen the position of SOEs so that they can more effectively execute Party policies. Embrace of the market means little more than imposing slightly more stringent financial discipline on firms that, because of their central policy role, can never be permitted to change ownership or go bankrupt.

The Authoritative Person's interview reads, in part, as a rebuttal of Gao and other critics. Our analysis of the state sector in this issue of the *China Economic Quarterly* suggests that Gao has hit the nail on the head. In the past three years proposals to introduce private shareholders to SOEs, and to subject SOE oligopolies to more intense competition, have been jettisoned. Core principles of Zhu Rongji's successful reforms of the late 1990s—that unwieldy SOE conglomerates should be broken up into smaller, more focused firms and forced to face stiffer competition—have been rejected. Instead, an effort is afoot to reassemble the old conglomerates, on the theory that bigger SOEs will be more formidable competitors in global markets.

Neither dramatic success nor dramatic failure

The real question, therefore, is not whether Xi is aiming for an adjustment in the roles of state and market in favor of the market. It is clear that he has placed his chips on a state-led development model. The question is whether this model will work, or if it will drive China's economy into a deep recession or financial crisis in the next few years.

Our answer is that the Xi model will fail to deliver the technological progress and productivity gains that its architect dreams of. But the immense financial resources of the state mean that economic or financial crisis can be forestalled indefinitely. The most likely future is a long, slow grind downward into lower growth, financed by ever rising debt. This will not be disastrous, and plenty of smart private firms will find a way to flourish along the way. Chinese capital will continue to play a larger role in cross-border investment. China is not, in any sense, going away. But its contribution to the world will fall well short of its potential.

The State Sector's New Clothes

Villains Or Victims? The Role of SOEs in China's Economy

By Andrew Batson

State-owned enterprises are often blamed for China's excess capacity, but private firms are the bigger culprits. The real problem is that the government now forces SOEs to act as economic stabilizers, at high cost. This makes them an ever-growing liability to the state.

As China's economic slowdown drags on and on, the role of the country's state-owned enterprises (SOEs) is getting much scrutiny. SOEs are now blamed for the current unpleasant aftermath to China's investment boom—but they are not in fact the villains of the piece. The boom and bust in housing and heavy industry was driven by private companies responding to market incentives of high prices and surging demand. After the boom ended, the government has repeatedly used SOEs to try to keep growth going.

This choice has killed off the idea that underpinned SOE reform from 1998-2007: that SOEs should be competitive, profit-seeking companies that just happen to be owned by the government. The SOE sector is instead increasingly being used to deliver investment and public services, and it is now taken for granted that SOEs should be instruments of government policy. But this mandate is not sustainable, as it requires SOEs to undertake activities that generate low public-sector returns while funding themselves at a high private-sector cost of capital. The role that SOEs have now been assigned in China's economy therefore points to a future of higher government debt (as the implicit liabilities of SOEs are taken on by the government) and lower interest rates (to allow SOEs to continue their low-return investments).

Andrew Batson is China research director at Gavekal Dragonomics.

The simplest way to summarize what has happened in the Chinese economy over the past decade-plus is that China had the world's biggest housing boom, and then it ended. Housing construction rose more or less without pause from around 2003 until 2011; depending on the measure, the volume of construction activity by 2011 was double or triple what it was at the start of the decade. Construction has bounced around a bit in the years since 2011, but its long growth spurt is clearly over. Growth ended because of a combination of overbuilding and high inventories in the short term, and the longer-term plateauing of fundamental demand.

China is now living through the consequences of the end of the world's biggest housing boom

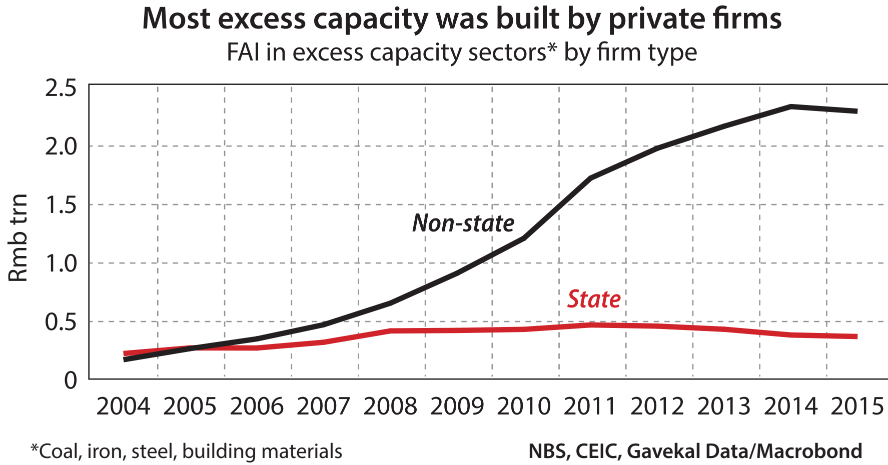
As a result, industries that had expanded rapidly to meet rising demand from construction have also stopped growing. As the new supply they had planned could not adjust quickly enough to the changing reality, prices of key commodities collapsed, taking profits with them. Since 2012, China has been stuck in a morass of weak growth, deflation in commodity prices, and weak private-sector investment, from which repeated government stimulus programs have so far provided only temporary relief.

Not so guilty

What role did SOEs play in this great boom-bust cycle? SOEs do have a big presence in the worst-hit industries, and are clearly suffering in the downturn. Much commentary treats this as the deserved result of their bad investments in the past. But the boom in housing and heavy industry investment was a massive economy-wide phenomenon in which SOEs played only a supporting role.

Of the Rmb40trn in real-estate investment over the 2004-13 decade, SOEs spent just Rmb6.4trn, or 16%. Of the Rmb13.4trn in investment in the excess-capacity sectors of coal, iron, steel and building materials, SOEs accounted for Rmb3.6trn, or 27%. SOEs clearly rode the boom, and handled its aftermath poorly, but they did not create it. The spark for the boom was in fact the privatization of urban housing, completed around 2003, which unleashed a lot of repressed demand.

This should not be surprising: as the US, Spain, and other countries have demonstrated in recent years, it is perfectly possible for economies that are primarily market- and private-sector driven to have huge booms, busts and excess capacity. Booms produce excess investment almost by definition: in an upcycle no one knows how long the increase in demand



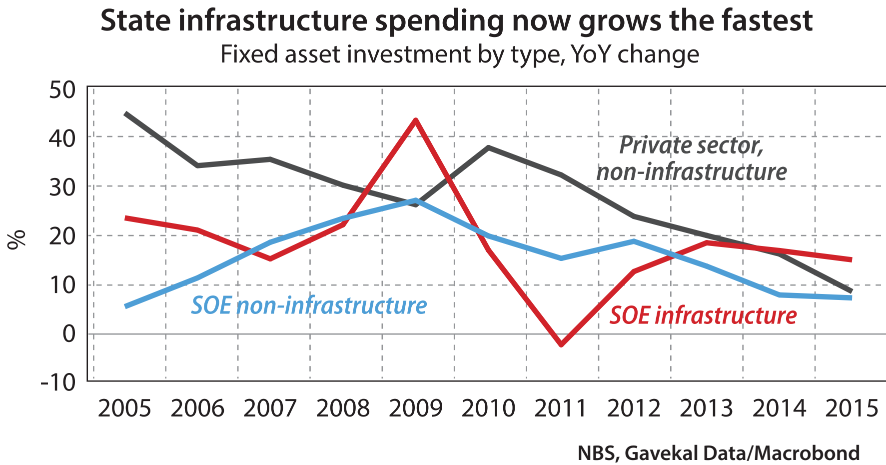
will last, but companies have strong incentives to invest anyway in order to not miss out on the gains.

The housing boom arguably had a more subtly malign effect on SOEs and their government overseers. The growth boom that started in 2003 clearly contributed to the improvement in SOE finances, with return on assets for the state sector rising from around 2% to a peak of 5% in 2007. The substantial turnaround from the depths of the previous downturn—the SOE return on assets was just 0.2% in 1998—led to a sense among policymakers that the SOE reforms since 1997 had been basically successful. And over the period 2003-06, a new administration put in markedly different policies for the SOEs: they ended management buyouts, put downsizing on hold, and set up a new agency to oversee SOEs.

Changed incentives

In short the goal of SOE policy was no longer to discipline enterprises to force them to improve performance (as it arguably was in 1997-2003), but to preserve and protect the state sector in its existing configuration. This meant that SOE managers no longer faced the threat of market exit in the event of poor performance. The resulting change in incentives contributed to the poor financial performance that returned after the global financial crisis in 2008. And by re-tightening the bonds between firms and government, the new policy laid the groundwork for the later use of SOEs as the main tool for supporting growth.

As housing construction peaked and started to decline in 2011-12, worries about the buildup of investment in heavy industry rose, and the government started cracking down on "excess capacity." SOEs, true to their nature, responded to this policy shift more quickly than the pri-



vate sector: SOE investment in the excess-capacity sectors declined 2% in 2012, and has fallen every year since. Yet private-sector investment in these heavy industry sectors grew 15% in 2012 (admittedly a slowdown from 43% growth in 2011), as prices were still high enough to make new investment profitable.

It was not until 2015 that private investment in the excess capacity sectors finally declined, as prices fell low enough to make new capacity clearly unprofitable. Many popular accounts blame the excess capacity and low prices of 2015 on SOEs using stimulus money to double down on investments in heavy industry. But the data show that the private sector's buildup of capacity was much larger, and its exuberance much more extended.

A new role: growth stabilizers

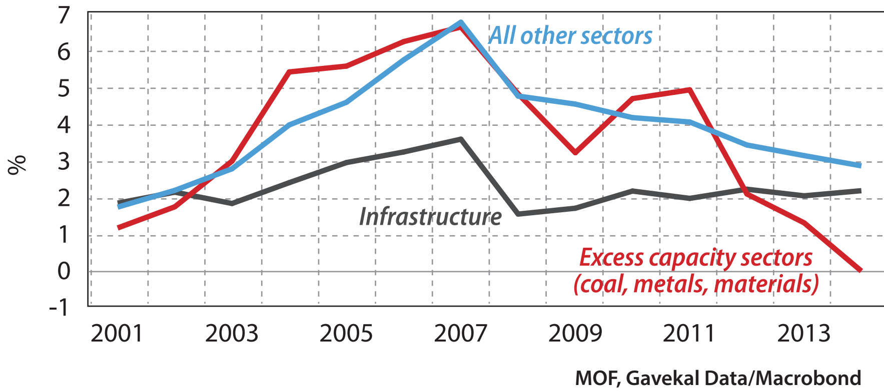
When the investment boom ended it was nonetheless the state sector that was called upon to keep the economy going. SOEs, primarily at the local level, were the main channels through which the government delivered the huge stimulus to counteract the 2008 global financial crisis: state firms' investment in infrastructure surged 43% in 2009. Initially that looked like a temporary response, as infrastructure investment by SOEs slowed in 2010, and then declined outright in 2011.

But the renewed growth slowdown in 2012 brought another wave of public-works spending that has yet to end. SOE investment in infrastructure rose 12% that year, and has grown about 15% a year since then. 2012 now looks like the turning point when SOEs became entrenched in their new role as the permanent provider of aggregate demand support.

Unlike previous epochal shifts in SOE policy, this one was not announced in high-level Communist Party documents and summarized

State firms' performance has been poor since 2008

Return on assets of non-financial SOEs



in catchy slogans. Nonetheless it is at least as significant as previous ones. The period when SOEs are expected to act as the default stimulus providers (so far, 2009-2016) has already gone on nearly as long as the previous period of SOE downsizing and reform (1997-2006), and may end up having even more economic impact.

One obvious effect of this new regime is a sharp deterioration in SOEs' financial performance. In the post-1997 reform period, SOEs served the government by maximizing profits (later remitting some of those profits to the budget). Now they serve the government by keeping up investment, with profitability a secondary consideration. Not surprisingly, profitability has eroded. Total profits of all nonfinancial SOEs declined outright in 2015, for the first time since 2008, pushing the return on assets down to 2.2% in 2015 from a peak of 5% in 2007.

The heavy industrial sectors with excess capacity accounted for about a quarter (0.74 pp) of the 2.8 pp decline. Although they account for only about 10% of total SOE assets, the decline in their profits was very severe. Infrastructure accounted for another quarter of the overall drop, possibly indicating that the increased provision of infrastructure is driving down the prices that can be charged. The remainder of the decline came from other industrial and commercial services sectors, caused by slower growth in general and the usual—and increasing—underperformance of state firms relative to private firms.

The longer-term impact of the new role for SOEs has been to shift the composition of investment and assets across the economy. The change is most visible in state firms' share of fixed-asset investment spending, a fairly reliable high-frequency indicator of SOEs' overall economic impact. (The definition of SOEs used for these statistics is a broad definition based

on control rather than a narrow one based on registration status.) The long-term trend has been for SOEs' share of investment spending—and implicitly of the economy as a whole—to gradually decline. This trend is not mainly driven by liberalizing policies, but simply by the fact that private-sector firms are more profitable and faster-growing than SOEs, and so their share of economic aggregates tends to increase over time.

This decline was interrupted briefly during the 2009 stimulus, resumed in 2010-11—and then went on hold starting in 2012. Since then, there has been essentially no further drop in the state share of investment. In fact SOEs' share of nationwide fixed asset investment rose slightly in 2015, to 32.4% from 32.2%. Not a huge move, to be sure, but it was the first such increase since the huge stimulus of 2009.

Shrinking returns to infrastructure

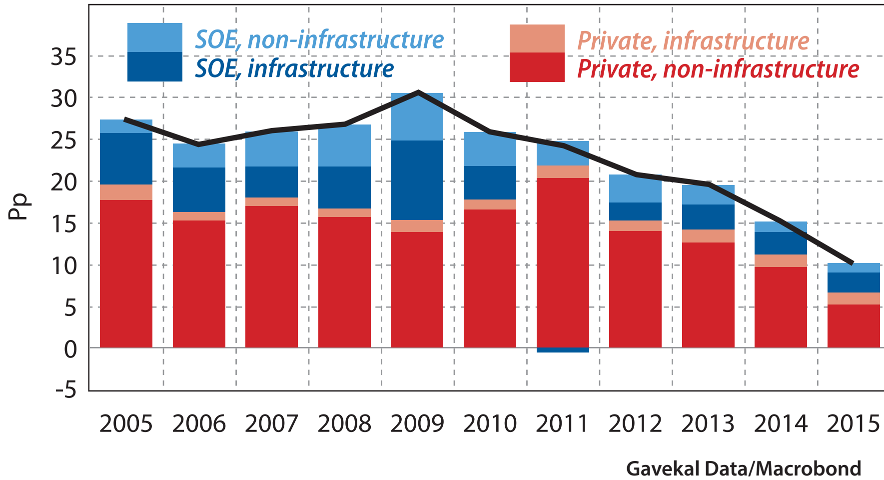
This "advance" of the state sector and "retreat" of the private sector is precisely a result of the increase in infrastructure investment and the continued slowdown in other private-sector investment. The good news is that SOEs do not on the whole seem to be going on wasteful investment splurges in most sectors. Outside of infrastructure, the cyclical pattern of SOE investment is quite similar to private-sector investment, and its growth is generally slower—and as we have seen, in excess capacity sectors SOEs retrenched earlier than the private sector.

The bad news is that infrastructure investment by SOEs generates very low returns, and has actually had a limited impact on overall growth. SOE spending on infrastructure has added 2-3 percentage points to nationwide fixed-asset investment growth since 2012. This is not negligible, but it's also not been nearly enough to offset the continuous slowdown in the private sector's much larger investment spending since 2010. Total fixed-asset investment growth still fell to around 10% in 2015, from around 25% in 2010. So the surge in infrastructure spending by SOEs since 2012 has not in fact "primed the pump" or catalyzed renewed growth in private-sector investment. Rather it seems to have a low multiplier: the infrastructure investment does itself add to GDP, but does not generate much additional GDP elsewhere.

The heavy use of SOEs to finance public works spending means that these low-return assets account for an increasing share of the stock of total assets. Infrastructure and public services now dominate the SOE sector, accounting for a combined 65% of all SOE assets at the end of 2014, up from 56% a decade ago; in addition to the well-publicized infrastructure spending surge, SOEs have increased their delivery of social services in

SOE investment has a low multiplier

Contribution to FAI growth



recent years. SOEs in the infrastructure sectors (power, water, transport, communication and other utilities) have made a return on assets of about 2% in recent years, while SOEs in social services, health, and government have made a return of assets of just barely over 1%. As Richard Herd recently demonstrated (see "The Fall Of Productivity And The Rise Of Debt," *CEQ*, March 2016, pp. 17-26), the decline in China's economy-wide productivity and return on capital since 2008 is largely driven by the increase in infrastructure and other low-return assets in the national capital stock, rather than a dramatic deterioration in performance by all businesses.

Deeper into the quagmire

The pattern of investment under the new SOE policy regime thus weighs on China's longer-term growth potential, but it also creates other problems. SOEs may be acting as government policy instruments, but they are still enterprises rather than government departments. This means they have to fund themselves through the financial system rather than through the government budget. And the funding costs for even state-owned firms are higher than for the government itself.

The financial statements of state-controlled firms listed on the Shanghai and Shenzhen stock exchanges show that they have paid an average annual interest rate of 4.5-5% on their debts over the past couple of years. These rates are not systematically lower than what listed private-sector firms have to pay, and more important they are well above the low rates of return that SOEs generate. In other words, the SOEs are paying mar-

ket rates of interest to fund activities that generate below-market rates of return. Therefore they are systematically eroding their own profitability and equity, on a trajectory that makes them likely to become liabilities of the government in the future.

In summary, then, in China since 2008 the once-popular concept of SOEs as independent profit-maximizing entities has increasingly given way to one of SOEs as instruments of economic stabilization. Rather than generating profits for the government budget, SOEs are increasingly acting as arms of the government budget, spending on infrastructure and social services. But the low returns on those investments make this a bad deal for the government in the long term. Rather than the government itself borrowing directly at low rates and spending on low-return public works, it has forced SOEs to borrow at higher rates and spend on low-return projects.

If and when SOEs find they cannot service their debts out of the meager returns on infrastructure and public services, then the government will be under pressure to take over those debts, or to lower market interest rates until SOEs can afford the payments. By using SOEs to create a huge build-up of low-return assets, China's government has lowered economy-wide productivity and created systematic pressure for higher government debt and lower interest rates in the future. As these problems become increasingly apparent, SOEs will be blamed as the villains—but in fact they are just the victims of government policy.

State Enterprise Reform: Missing In Action

By Barry Naughton

In 2013, the Third Plenum Decision promised bold reform of the SOEs, to diversify their shareholding and improve their financial performance. Nearly three years on, little remains of that agenda beyond a conflicting jumble of vague directives.

State-owned enterprises lie at the heart of China's economic challenges, and in November 2013 the Third Plenum Decision galvanized hopes for far-reaching reforms that would streamline the SOEs, make them more market-oriented, and improve their financial performance. Yet this ambitious restructuring agenda has stalled. A detailed blueprint for SOE reform, released in August 2015, backtracked from the Third Plenum's call for marketization, and revealed a confused morass of conflicting objectives.

The fundamental problems are first, that President Xi Jinping undermined pro-market forces by insisting that SOEs retain a "dominant role" in many key sectors; and second, that the details of SOE reform were delegated to status-quo agencies that had little interest in fundamentally changing present arrangements. The outcome is an unsatisfactory policy that is unlikely to help SOEs resolve their deepening financial woes, and that will need to be abandoned in a few years' time in favor of more drastic measures.

Some nice ideas…

Before the 2013 Third Plenum, SOE reform had stalled. A massive restructuring—begun in the mid-1990s by then-premier Zhu Rongji—led, over the course of a decade, to a 60% reduction in the number of

Barry Naughton is Professor of Chinese Economy and Sokwanlok Chair of Chinese International Affairs at the School of Global Policy and Strategy at the University of California, San Diego.

SOEs, corporatization and stock-market listing of many of the survivors, and the layoffs of more than 30 million state-sector workers. In 2003 a national asset manager, the State Asset Supervision and Administration Commission (Sasac), was established to exert financial discipline over SOEs controlled by the central government. Initially Sasac achieved some success in improving state firms' performance (see "Profiting the Sasac Way," *CEQ*, June 2008, pp 19-26). But after 2007 efforts to continue state sector reform languished.

The Third Plenum infused new life into this moribund agenda. The Decision gave a prominent position to SOE reform, and floated several intriguing new ideas: the separation of SOEs into monopoly and competitive types, the creation of market-oriented investment funds to manage state-owned assets, private shareholding via "mixed ownership," and employee ownership. None of these ideas was precisely defined, and much work was needed to flesh out the concepts. But it was clear that the overall approach had the potential to be more than the sum of its parts.

Taken together, the ideas floated in the Third Plenum Decision suggested a top-level drive to create a new model of state enterprise management. In this model, the rationale for government ownership would be much more clearly spelled out. And in the large majority of cases, government ownership would take the form of wealth management by investment funds, rather than direct bureaucratic control. Another clear objective was to define the largest possible scope for competitive market operations, and to introduce greater competition into some monopoly sectors.

To be sure, large-scale privatization was not part of the new model, and government holdings of wealth would continue to be large. These features attracted a group of "left" policy intellectuals who liked the idea of a wealthy state with resources to deploy in the public interest. The fact that SOEs would immediately increase their contribution of profits to the national budget and social security fund pleased this group even more. The Third Plenum SOE reform agenda came out of the gate with substantial momentum, and the possibility of mobilizing a broader coalition of support.

…have dissolved into chaos

Two and a half years later, the SOE reform effort is in disarray, and hopes for a revival of serious state sector restructuring have been disappointed. The broad Third Plenum agenda has been frustrated by problems both of concept and of implementation. The overall Third Plenum reform program was broken down into 336 separate "initiatives" that were farmed out to different agencies for detailed work. Thirty-four initiatives related

to SOEs, and these were distributed mainly to Sasac, the Ministry of Finance, the National Development and Reform Commission (NDRC), and the Ministry of Labor (which works closely with the Party's Organization Department).

The result was a chaotic mess: each agency advanced its own views, with no effective coordination. Broadly speaking, the Ministry of Finance and Sasac represented two opposing visions. The Ministry of Finance was assigned initiatives that focused on capital management, investment companies, and budgeting, and it emphasized improving the efficiency and liquidity of state wealth management. It envisioned all state assets packaged into listed entities managed by professional financial management companies whose job would be to maximize asset value. This was sometimes called the "Temasek model" because of parallels to the sovereign wealth fund run by the Singapore government, which among other things oversees several state-run firms including Singapore Airlines, Singtel and DBS Bank.

The SOE reform effort is in disarray, with few hopes for a revival of serious state sector restructuring

By contrast Sasac, in its draft documents on SOE reform and corporate management, envisaged activist investment companies that would restructure existing SOEs into an increased number of large, internationally competitive ones. Sasac strongly opposed the Temasek model, in part because it would clearly require the abolition of Sasac in its current form. Thanks in large part to the rivalry between Sasac and the Ministry of Finance, the consensus so prized in the Chinese policy process did not emerge.

Meanwhile, the Party's top reform policy body—the Comprehensive Reform Leadership Small Group, headed by Xi Jinping himself—made some crucial decisions of its own at its August 2014 meeting. First, Xi brought forward three proposals from the Ministry of Labor that lowered the salaries of SOE managers and tied their compensation to that of government officials of the same bureaucratic rank. This confused matters further by severing the issue of managerial compensation—which would naturally be integral to either the Sasac or the Ministry of Finance vision for SOEs—from the reform agenda and linking it instead to Xi's anti-corruption campaign. Second, Xi spoke clearly in favor of maintaining strong SOEs, which he described as pivotal for Communist Party rule and having "a dominant role in important sectors and crucial areas that affect national security and the commanding heights of the economy."

Shortly after this meeting, Xi authorized the establishment of a State

Council Leading Small Group on State Enterprise Reform. A targeted Leading Small Group (LSG) like this is a standard way of resolving policy conflicts in the Chinese system. All the key bureaucratic actors are brought together in one LSG, assigned a kind of policy-specific "rank" within the group, and told they must agree on a policy. In short, the LSG is a tool to overcome fragmentation and force consensus.

Crucial questions are thus: "who heads the group?" and "what agency staffs it?" In this case, the group was headed by Vice-Premier Ma Kai, a long-serving economic bureaucrat who previously headed the NDRC. The office was placed in Sasac and led by State Councilor Wang Yong, a former head of Sasac. Organizationally, then, Sasac prevailed in the policy process and would have the most influence over the drafting. So at this point, the ultimate outcome was pretty much a foregone conclusion.

We don't know exactly what Xi's intentions were, but within a few months, his actions had increased tension within the state enterprise system (by reducing salaries), and put limits on the scope of SOE reform (by emphasizing the importance of strong SOEs and then endorsing a policy process that gave Sasac predominant influence over drafting). Having boxed in the process, Xi handed it over to the State Council and its LSG.

Sasac wins the battle, unfortunately

The State Council SOE Reform LSG has met monthly since November 2014. Its primary product was issued jointly by the Communist Party and the State Council in August 2015 as the "Guiding Opinions on Deepening SOE Reform," an authoritative "top-level design" laying out the broad principles that are in force today. It has been followed by 15 implementing regulations in various areas, with more to come. Implementing regulations are necessary, because the "Guiding Opinions" are complex, vague and contradictory, even by the standards of this type of document.

Broadly speaking, the present SOE policy consists of two parts. The first is the revival of reforms with their roots in the 2003-06 period. "Nearly all" SOEs will finally be converted into corporations (20 years after the Company Law was first passed). These corporations will be re-organized to include all state assets and will be listed on stock markets. Virtually all firms will be required to have boards of directors. These are familiar, practical policies that had petered out since 2007 and needed a reviving push. Along with the division of SOEs into commercial and public service types, these reforms can marginally improve performance and serve as a guide to local governments in reforming their own SOEs. The effect will be positive, and the effort is long overdue.

The second part consists of the investment and capital management system that governs SOEs. Here we see the total victory of the Sasac conception. Rather than being profit-oriented financial disciplinarians, as the Ministry of Finance envisaged, the investment companies that will gradually take over supervision of SOEs have extremely broad, ill-defined, and interventionist mandates.

Article 14 of the "Guiding Opinions" says that these investment companies should "push state capital into important industries and key sectors that affect national security, the commanding heights of the national economy and the people's livelihood; concentrate on key point infrastructure; concentrate on prospective strategic sectors; concentrate on outstanding enterprises with core competitive strength […] Fully bring into play the core and exemplary function of SOEs in realizing the strategy of innovation-driven development and becoming a manufacturing power." This is a substantial expansion of the mandate of SOEs, and it will severely hobble efforts to marketize and improve their performance for years to come.

The investment companies that will gradually take over supervision of SOEs have broad, ill-defined, and interventionist mandates

Supposedly, government will withdraw from operational decision-making. Instead these decisions will be delegated to the investment companies and SOEs, which are supposed to internalize the government's developmental objectives. This is problematic, especially in today's China where innovation and high-technology projects are being advanced as the panacea for all the economy's challenges. Money is pouring into state-sponsored innovation projects and state-funded venture capital funds. Now SOEs are being given additional policy-driven mandates, which will complicate the push for efficiency and improved performance. Until today, SOEs have not been the drivers of the successful parts of China's innovation economy. The SOE reform program seeks to change that, but there are good reasons to be skeptical of success.

The "Guiding Opinions" specify that "commercial" SOEs will be further divided into those in purely competitive sectors, and others in monopoly sectors or with special missions. In firms with special missions, "mixed ownership" means only that non-state minority shareholdings may increase a bit: the state must always maintain a controlling interest. Finally, "mixed ownership" also means that SOEs can take stakes in private firms in priority development sectors, thereby using access to cheap

capital to expand the state's reach. In effect, these policies mean the expansion of SOE missions and asset-manager intervention, both of which are antithetical to any truly market-oriented reform.

Return to business as usual

The 2015 SOE reform policy was determined by status quo agencies. The lack of massive top-down change in the institutions or principles governing SOE management is therefore unsurprising. The "reform" has done nothing to change the incentives governing asset managers, so there is no real reason to expect substantial changes in their behavior. Instead, it will essentially be business as usual, as the existing asset management agencies pursue their traditional goals, though perhaps with an increased sense of urgency. In practice, this means investment companies will be used "to liquidate a batch of companies, reorganize a batch of companies, and innovate and develop a batch of companies," as the "Guiding Opinions" say.

The process of reform implementation will also reflect this slow "batch at a time" approach. The April 4, 2016 meeting of the State Council SOE Reform LSG laid out the work program for 2016 in the form of ten (!) pilot programs, including the establishment of new investment companies (Sasac has already set up two), the merging and restructuring of some central SOEs, and experiments in mixed ownership. In other words, even though the broad principles of SOE reform have finally been laid out, implementation is still in the very earliest stages.

State asset managers will see their efforts diverted into closing down firms in sectors such as coal, steel, and building materials

Another complication is that SOE reform must now fit in with "supply-side structural reform," which since December 2015 has been Beijing's highest-profile economic policy. This has little to do with Reagan- or Thatcher-style tax cuts and deregulation: in essence, it boils down to shutting down excess capacity in heavy industry, and increasing capacity in new technology-intensive sectors.

In practice, this likely means that state asset managers will see their efforts diverted into closing down firms in traditional sectors such as coal, steel, and building materials. To be sure, they would rather be building new high-tech giants, but consolidating and restructuring excess capacity sectors is also compatible with their objective of building larger and more competitive firms, and employs the same familiar instruments of corporate reorga-

nization. It is quite possible that "supply-side structural reform" will become the main practical shape of SOE reform over the next couple of years.

A solution that is no solution

The SOE reform program that emerged in the fall of 2015 brought a temporary end to two years of argument about the objective and direction of SOE reform. Yet it failed to address the key issues: defining a clear and limited mission for state firms, and improving their financial performance. China's SOEs continue to face great pressure. The global decline in commodity prices hurts central SOEs in particular, reducing the value of their natural-resource monopolies. Industrial SOE profits have continued to decline, dropping from 3.9% of GDP at their peak in 2007 to only 1.6% in 2015.

Supply-side structural reform is, among other things, an effort to accelerate the pace of change in the state sector. It is forcing state asset managers to move more rapidly than they are used to, and in ways they would prefer not to move. Sasac's new chief, Xiao Yaqing (the former CEO of aluminum giant Chinalco) will bring dynamism to this task. He has taken to approving comments about Zhu Rongji's SOE reforms: "It's only because of the thorough changes brought about by reforms in the late 1990s that we have today's relatively good conditions." Today's tentative SOE reform program will stay on the books for the next couple of years, but the pressure of necessity may force policy-makers to move well beyond it.

The State Sector's New Clothes

Return Of The Line Ministries

By Michael Komesaroff

In the 1990s, Zhu Rongji broke up state-owned conglomerates, to spur efficiency through competition. Now Xi Jinping's SOE reform aims to bring those conglomerates back to life. The effort will be spearheaded by Xiao Yaqing, whose ambition to turn the state aluminum company into a global metals giant foundered, but who is now the bureaucrat in charge of all central SOEs.

An enduring question about China's state-owned enterprises (SOEs) is whether they are commercial actors or agents of state policy. The answer of course is that they are both: sometimes they act as custodians of state assets, with a mandate to increase their value, and sometimes they use those state assets to further national development goals, with scant regard for the financial consequences. When these two roles conflict, as they often do, the political mandate usually wins out over the business one.

The state-sector reforms of the late 1990s and early 2000s sought to shift the balance of SOE responsibilities in a more commercial direction, by breaking up old "line ministries" into nominally independent corporations, many of them listed on domestic or foreign stock exchanges. But after some initial success this program flagged, and the 2008 global financial crisis made Chinese policy makers less receptive to the idea that increased reliance on markets was always a good thing.

The far-reaching reform agenda announced in the Third Plenum Decision of November 2013 raised expectations that market-oriented reform of

Michael Komesaroff is principal of Urandaline Investments, a consultancy focusing on China's capital-intensive industries.

the SOEs would resume, with the creation of more efficient corporatized state firms which state and private shareholders would jointly own. It has become increasingly clear, however, that the real aim of Xi Jinping's SOE reforms is not efficiency but the creation of large state-backed national champions that can carry the Chinese flag in international markets. The government also wants to avoid the large-scale unemployment that would be a necessary side-effect of improving SOEs' financial efficiency.

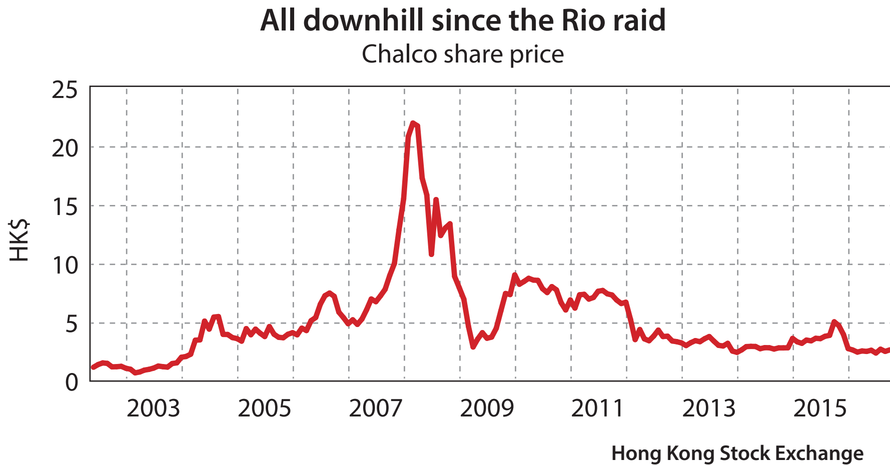
A case in point is China's biggest state-owned aluminum producer, Chinalco. The company was created in the late 1990s after the breakup of an old, sprawling metals conglomerate. In 2008 its ambitious boss Xiao Yaqing fell just short in an effort to turn it back into a sprawling metals conglomerate by buying key assets from global mining leader Rio Tinto. Today Xiao heads the State-owned Assets Supervision and Administration Commission (Sasac) and hence is in charge of executing the national champions strategy—a strategy that includes resurrecting the conglomerate that was broken up to create Chinalco.

First steps toward a national aluminum champion

Chinalco (formally, Aluminum Corporation of China) emerged from a tortuous evolution away from the Ministry of Metallurgy, which until the early 1980s controlled the nation's nonferrous metals smelting industries. Under the Ministry, China's aluminum smelting technology was old, heavily polluting and inefficient. Plants were dispersed all over inland China, insulating them from foreign attack but also ensuring that they were difficult to supply, suffered from high costs, and operated well below capacity.

In 1983, the nation's aluminum production was put under the new China National Nonferrous Metals Industry Corporation (CNNC), which despite its name was effectively a ministry-level agency supervising 200 large enterprises and institutions involved in various aspects of nonferrous metals including geology, mining, manufacturing, construction, research and design. These enterprises employed over a million workers and accounted for 70% of China's nonferrous metals output. CNNC's assets totalled around US$20bn, but size and importance did not translate into profitability. The creation of CNNC eliminated the inefficiencies caused by multi-headed control under the old Ministry of Metallurgy, yet its treatment of its subsidiary plants as self-contained businesses introduced cut-throat competition that eroded profits.

Under the leadership of its first general manager, Fei Ziwen, CNNC did much to bring its production processes up to international standard.



Fei had spent three months seconded to the Bougainville Copper mine in Papua New Guinea operated by CRA, a predecessor company of Rio Tinto. Starting in 1988, Fei sent many of his managers for similar secondments in Australia. One of the first was Xiao Yaqing. Fei also established 84 joint ventures with foreign mining firms, in an effort to gain access to modern technologies.

Fei retired in 1994 and was replaced by Wu Jianchang, who was married to Deng Xiaoping's eldest daughter. Wu was ineffective, owing his position to family connections rather than competence, and presided over a series of embarrassing financial scandals. His main positive legacy was a highly profitable 30-year deal to source alumina (the raw material for aluminum smelting) from US aluminum firm Alcoa, on very favorable terms.

The big breakup

After Deng Xiaoping's death Wu was shuffled aside, many of CNNC's managers were sacked or detained for economic crimes, and the corporation was dissolved. It was replaced in 1998 by the State Bureau of Nonferrous Metals Industry Administration (SBNMI) under the management of Zhang Wule, a former provincial governor and steel industry executive. Zhang was authorized by premier Zhu Rongji to organize the bureau into two branches, for administration and operations. The administrative branch was designed to be a think-tank that would develop policies for the whole of China's nonferrous metals industry. The operating branch was subdivided into three industry groups respectively for aluminum; for copper, lead and zinc; and for minor metals and rare earths. The idea was that each industry group would eventually be corporatized and spun off as an independent business unit.

For the aluminum assets, the first step was the creation of Chinalco (Aluminum Corporation of China), a wholly state-owned enterprise, which in turn created a joint-stock subsidiary, Chalco (Aluminum Corporation of China Ltd). Chalco contained most of the group's productive assets and listed on the Hong Kong and New York stock exchanges in December 2001, with Alcoa as an 8% cornerstone shareholder. Alcoa sold its shares in 2007 for a tidy US$1.8 bn profit.

Guo Shengkun, an engineer who led the Chinalco/Chalco corporatization effort, become the listed firm's first boss, and moved quickly to realize his vision of creating a profitable world-scale aluminum producer on par with the global leaders, Alcoa and Alcan. Under his skillful leadership Chalco's revenue doubled and profit quintupled in the space of three years—at a time when aluminum prices hardly budged.

Guo left Chalco in 2004 and subsequently became party secretary of the Guangxi Autonomous Region; recently he returned to Beijing as Minister for State Security. Guo's move from business leadership to political leadership set a pattern for subsequent Chalco leaders, all of whom were promoted to senior government or party positions. None has left for a business role in another SOE.

Xiao Yaqing's excellent adventure

Guo's successor was the 44-year-old Xiao Yaqing. Guo's vision of a global aluminum giant was daring; Xiao's ambition was even more extravagant. As a young engineer under Fei Ziwen he had visited CRA in Australia; his aim was to create a global metals conglomerate comparable to BHP or Rio Tinto.

Xiao realized that for this aim, the listed Chalco—in which the Chinese state held less than a 40% stake—was not useful, since outside shareholders would have to approve any diversification beyond the core aluminum business. The better vehicle was the unlisted parent, Chinalco, which could tap state funding to do huge deals that would not be subject to scrutiny by the listed company's minority shareholders. He acquired a series of domestic copper mines (previously owned by CNNC), won Beijing's approval to spend US$790mn buying Canadian-listed Peru Copper, and signed an agreement with the Queensland state government in Australia to develop a US$3.2bn bauxite mine and associated alumina refinery. Similar deals were signed in Vietnam and Guinea.

In November 2007, Xiao exploited a hostile takeover attempt by BHP for its rival Rio Tinto to move a step closer to his dream of creating a global champion. Rio was reeling from a costly, ill-timed, debt-financed takeover of Alcan, the world's third-biggest aluminum producer. BHP

sought to take advantage of this weakness to absorb its main rival. The bid sparked alarm in the Chinese government, which had long believed that foreign mining companies were colluding to drive up the prices of key raw materials, especially iron ore. A combined BHP and Rio Tinto would control more than 30% of the market and might have enough pricing power to hurt the profits of Chinese steel mills, which accounted for half of global iron ore demand.

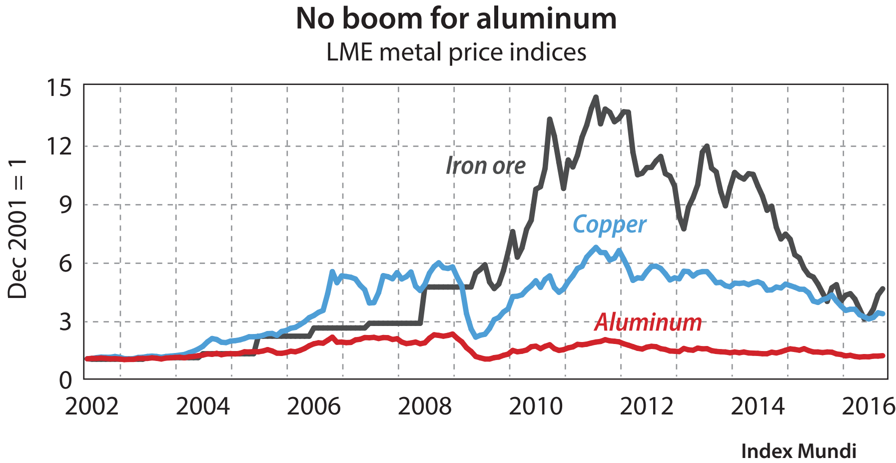
The National Development and Reform Commission (NDRC) convened a series of meetings to discuss how best to thwart BHP's bid. Xiao successfully proposed that Chinalco, financed by China Development Bank, buy up enough of Rio's shares to enable it to block the BHP takeover offer. After market trading closed on January 31, 2008, Chinalco executed a lightning raid, acquiring 12% of Rio stock for US$14bn. In November 2008 BHP formally dropped its bid.

This was a personal triumph for Xiao, and the fact that his firm incurred a huge financial loss to achieve it appeared not to bother him or anyone in the Chinese government. Between the time Chinalco acquired its stake and the end of the year, Rio's share price plummeted by 70%, leaving Chinalco with a paper loss of around US$10bn. A subsequent effort to increase Chinalco's stake in Rio to 18%, via a convertible bond and the purchase of several of the Anglo-Australian company's most attractive mining assets, was loudly opposed by Rio's shareholders and the Australian media. It was ultimately rendered moot by a rise in commodity prices which enabled Rio to walk away from the deal and instead refinance its huge debt with a rights issue.

Putting the politicians in charge

By the time that deal fell through, however, Xiao had already moved on, reaping the political reward for his successful attack on the BHP-Rio merger. In January 2009 he became deputy secretary-general of the State Council, China's cabinet. His successor at Chinalco, Xiong Weiping, ran the company until October 2014, and oversaw a steady decline in profitability. The listed arm, Chalco, reported losses in three of his six years at the helm, culminating in a monumental Rmb16.2bn loss in 2014. The main reason was sustained low aluminum prices, but mismanagement also clearly played a role. Chalco's main competitor, Hongqiao Group, sailed through those years without a loss and in 2015 surpassed Chalco to become the world's biggest aluminum producer.

In 2014 Xiong was shunted aside to a retirement job in Sasac, and for the first time in its history the aluminum giant was placed in the hands of



politicians rather than lifetime metallurgical engineers. Parent company Chinalco's new chief is Ge Honglin, who started his career as an engineer but came to Chinalco from a stint as mayor of Chengdu. The chairman of the listed Chalco is now Yu Dehui, a foreign-trained economist who spent most of his prior working life as a provincial and national bureaucrat.

This break from past practice suggests a change in government thinking about how the biggest SOEs should be managed. It should be considered alongside the 2015 appointment of Xiao Yaqing to lead Sasac, the agency that oversees the 100 or so biggest centrally-controlled SOE groups, and that appears now to be firmly in charge of Xi Jinping's state-sector reform agenda.

At Chinalco, Xiao wanted to build a diversified international mining company, something like the former CNNC only more efficient and on an international scale. This "national champion" vision, which apparently is shared by Xi and much of China's current leadership, differs starkly from the intent of Zhu Rongji's "grasp the big, release the small" SOE reforms of the late 1990s. Zhu sought to force state firms to improve their financial performance by making them endure fiercer competition. Xi evidently wants to create giant companies that face less domestic competition and that, by sheer virtue of their size, can exert greater power in global markets.

Support for Xi's vision also derives from the aftermath of the 2008 global financial crisis, which many Chinese analysts think exposed the weaknesses of China's overly fragmented industries. They believe this fragmentation caused excessive competition, encouraged excess capacity, and drove prices down so far that many SOEs are no longer profitable. The solution is therefore to consolidate state firms into a small number of industry leaders with enhanced pricing power.

Many past and present senior Chinalco executives also view the break-up of CNNC as a disaster, which weakened the state-owned nonferrous metals sector to the benefit of foreign and domestic private firms. Both Guo Shengkun (now Minister of State Security) and Xiao Yaqing (now head of Sasac) share this opinion and are now in a position to lobby for a bigger state role in the metals industry.

Is bigger better?

The recent organizational changes at Chinalco/Chalco and Xiao's appointment at Sasac suggest that Beijing aims to consolidate all of the state's nonferrous metals interests under the leadership of a state-owned holding company—in essence, resurrecting the old CNNC. The holding company structure is necessary because many of the state's nonferrous assets are held in joint stock companies where the existence of private shareholders—many of them foreign—limit the companies' freedom of action.

A first step is likely to be the transfer of all the state's aluminum assets to Chinalco. Entities that could be transferred include the aluminum arm of China Power Investment Corporation, Non-Ferrous Corporation (previously the engineering and construction division of CNNC), Beijing Engineering Design Institute (also hived off from CNNC) and Beijing General Research Institute for Nonferrous Metals (also formerly part of CNNC). Most of these entities are loss-making, and consolidation is a better option (from Beijing's point of view) than closure, which would result in large numbers of layoffs.

Consolidation will no doubt strengthen the government's grip on the economy. It is much less clear whether it will address the deep inefficiencies that many see as the cause of China's current malaise. Stronger government involvement will slow the productivity improvements required to rationalize the excess capacity that has long plagued China's aluminum industry. For the government, corporate consolidation takes priority over rationalization of capacity. Merging the various state owned entities will be a challenging task and closure of capacity would make the politics of these mergers more difficult. In much of its industrial policy, China seems to be trying to return to an earlier era, one in which big is beautiful and national interest trumps enterprise profitability.

The Economy

Stability Above All

By Chen Long

The government seeks to keep both GDP growth and the exchange rate as steady as possible ahead of the Communist Party Congress scheduled for the fall of 2017. It may succeed, but probably at the cost of further delaying its structural reform program.

The main theme of the Chinese economy in the first half of 2016 was "stabilization." The two major concerns—both for policy makers in Beijing and for international markets—were that GDP growth would slump below the 6.5% annual target set for the 2016-20 Five Year Plan period, and that the renminbi exchange rate would be forced into free-fall. Policy has focused on preventing these two undesirable outcomes, and so far it has succeeded. The questions now are how long this stability can be preserved, and how much damage has been done to the long-term structural reform agenda by the insistence on maintaining growth at all costs.

The main policy tool for supporting growth has been an expansion of credit. Credit policy has been quite loose since the second half of 2015, a stance not reflected in the official "total social finance" (TSF) figures which are supposedly the broadest measure of credit conditions. TSF growth has stayed roughly stable at around 12% year on year.

But this ignores a rapid rise in the debt of local governments, which stopped borrowing via their financing-vehicle companies (which are included in TSF) and stepped up their issuance of bonds (which TSF leaves out). Adding together government bond issuance and TSF, total credit growth accelerated from 12% in June 2015 to 16% in April 2016. In addition, commercial banks ramped up their lending to non-bank finan-

Chen Long is the macroeconomist at Gavekal Dragonomics.

cial institutions for the purpose of making "investments" in companies. Including this activity pushes up year-on-year credit growth to 18%.

A whole lot of borrowing going on

This is a substantial impulse, but far smaller than the credit expansion of 2012-13 (which saw credit growth hit 23%) let alone the mega-stimulus of 2009 (in which borrowing soared by more than 30%). And rather than prompting an acceleration of economic growth, it has merely tempered the slowdown. Industrial value-added and retail sales both slowed by about a quarter of a percentage point in the first four months of the year, to 5.8% and 10.3% respectively in April.

One beneficiary of the credit boom was state-led infrastructure investment. Growth in infrastructure fixed-asset investment has picked up and is now running at close to 20%; but growth in investment by the private sector continues its steady four-year decline and is now just barely above 5%.

The biggest gainer from easier money, though, was the property market. Housing sales growth accelerated for four months in a row to 44% year on year in April, the fastest expansion since early 2013. House prices are rising throughout the country and in some cities they are up 30-40% from a year ago. Strong sales have spurred developers to boost their land banks and start new projects: land sales and construction starts respectively rose by 8% and 23% year on year in April.

How long can this credit-fuelled growth continue? Politics suggests President Xi Jinping may want to keep credit policy as loose as need be to ensure 6.5% growth right up to the 19th Communist Party Congress, which will be held in October or November 2017. That Congress will be a pivotal moment in Xi's effort to cement his grip on political power. If established norms on retirement ages hold, five of the seven members of the ruling Politburo Standing Committee must retire (everyone, that is, except Xi and Premier Li Keqiang), and around two-thirds of the Central Committee will have to step down—the biggest turnover since 1969. Xi will want to have maximum authority to determine the new leadership lineup, so it is in his interest to be presiding over a strong economy when those personnel appointments get made.

The Authoritative Person speaks, obscurely

The problem with this is that, from a practical point of view, it will be quite difficult to maintain the present rate of credit acceleration for another 18 months. Since 2008, China's credit expansion cycles have lasted on average for about 15 months, and have always been reined in as concerns

about excessive leverage or asset price bubbles rise. The current expansion is already about a year old, meaning that it is probably due for a correction in a few months' time. The explosive growth in house prices, if it continues, could be the trigger for tightening. So the most likely scenario is for a slowdown in credit growth in the second half of 2016, followed perhaps by some supporting measures in 2017 to ensure that the economy is humming along nicely when the Party Congress convenes.

Regardless of how it is achieved, the 6.5% annual growth target now appears to be a more important objective than executing on the government's structural reform agenda, which has seen disappointing progress since it was unveiled in November 2013. The waters were muddied, however, by an interview with an unnamed "Authoritative Person" published on the front page of the *People's Daily* on May 9. This article, which is generally believed to emanate from the Party office responsible for economic policy, stressed that credit-fuelled stimulus is unsustainable, that GDP growth will follow an "L-shaped" pattern with no acceleration from the present level, and that structural reform remains the top priority.

Meeting China's 6.5% annual growth target now looks more important than structural reform

It is hard to know how to interpret a pronouncement by the Party's economic authorities, in the Party's main newspaper, criticizing the policies of these same authorities. The popular theory that this piece reflects a split between a pro-stimulus Premier Li and a pro-reform President Xi makes no sense at all, since all available evidence suggests that the arbitrary growth targets must be approved by Mr. Xi himself. More likely, the Authoritative Person's remarks were simply intended to warn people that the credit party will not last forever and that some tightening is on the way.

The PBOC gets a breather

Aside from growth, the other source of anxiety is the exchange rate. Between August 2015 and January 2016, Chinese companies aggressively sold renminbi to buy dollar assets, forcing the People's Bank of China (PBOC) to spend down its reserves at a rate of US$100bn a month to prevent the currency from weakening. Given that PBOC probably wants to maintain US$2-2.5trn in reserves for normal purposes of import cover and insurance against financial crisis, such a rate of reserve loss implied that PBOC had only a few more months before it would be forced to abandon its defense of the currency.

Starting in February, though, capital outflows abated, and reserve losses stopped. The main reason was that the US dollar exchange rate index, which rose rapidly from the second quarter of 2014 through the third quarter of 2015, fell by 7% between February and April. This lessened the incentive for Chinese companies to move money out of RMB and into dollars.

This gave PBOC a welcome respite, but there are legitimate worries it might not last. Futures markets are pricing in at least one more rate hike by the Federal Reserve this year. Rising rates could cause capital inflows into the US, pushing up the dollar and once again encouraging Chinese firms to sell the RMB to buy dollar assets. Capital outflows from China could be exacerbated if domestic credit conditions tighten and growth falls below the magic 6.5% number.

A rise in US interest rates could encourage Chinese firms to sell RMB and buy dollar assets

The situation is tricky, but not necessarily disastrous. First of all, it is by no means clear that Fed rate hikes will strengthen the dollar: in three of the four major previous rate-hike cycles since the late 1980s, the trade-weighted dollar maintained a stable value or fell.

Yet even if the dollar does rise a bit, it should be possible for the PBOC to reconcile the dual objectives of its exchange rate policy: to maximize the RMB's stability against a trade-weighted basket, while also holding the currency as steady as possible against the US dollar. ("Stability" against the trade-weighted basket is a somewhat elastic term, and seems to permit some significant downward movement. But the crucial fact is that the PBOC does not seek to engineer a major devaluation of the currency to boost exports.)

All's well so long as the dollar doesn't rise much

The last several months have provided a demonstration of how the PBOC hopes to balance its twin targets. As the dollar weakened between February and April, the PBOC permitted a small RMB appreciation against the dollar, by steering the RMB down against its own trade-weighted basket. Then, when the dollar reversed course and rose 3% between late April and the end of May, the PBOC also switched direction, pushing the RMB higher against its trade-weighted basket while allowing the unit to fall by 1.5% against the dollar.

So far so good. PBOC seems able to manage moderate exchange-rate fluctuations, and stave off destabilizing capital flows, so long as the dollar does not move too fast either up or down. This leaves us with three main scenarios for RMB movements over the rest of the year. If the Fed decides

not to hike rates, then the dollar will probably not move much and the PBOC's life will be pretty easy.

If on the other hand the Fed does hike rates later this summer, it is possible that the dollar could go up, either moderately or a lot. In the case of a moderate dollar rise, PBOC can simply continue its actions of the past month, letting the RMB go up gently against its basket and weaken gently against the dollar—perhaps to a rate of 6.8 against the dollar, from roughly 6.6 in early June. A move of this magnitude and speed is unlikely to cause much of a stir in financial markets.

The worst case is that the dollar moves aggressively higher. This will put PBOC under a lot of pressure to push the RMB down quickly, and this could catalyze capital outflows and financial market panic, similar to what we saw in August 2015 and January 2016. But this is the most unlikely scenario, because those two episodes drove home to the Fed that there is a strong positive feedback loop between its rate decisions, the RMB exchange rate, and financial market volatility. If it hikes rates, therefore, the Fed will almost certainly try to manage expectations in order to prevent the dollar from rising too fast and putting pressure on the RMB.

The bottom line—global financial markets face little risk of China-induced disruption this year

The bottom line is that while the risk of a China-induced disruption in global financial markets this year is not zero, it is also not very high. The tumult of last August and January has taught both the Chinese and the US central banks to move more cautiously; and market participants now have a much clearer sense of the PBOC's exchange-rate policy objectives than they did a few months ago.

Energy

The Future Of China's Oil Demand

By Rosealea Yao

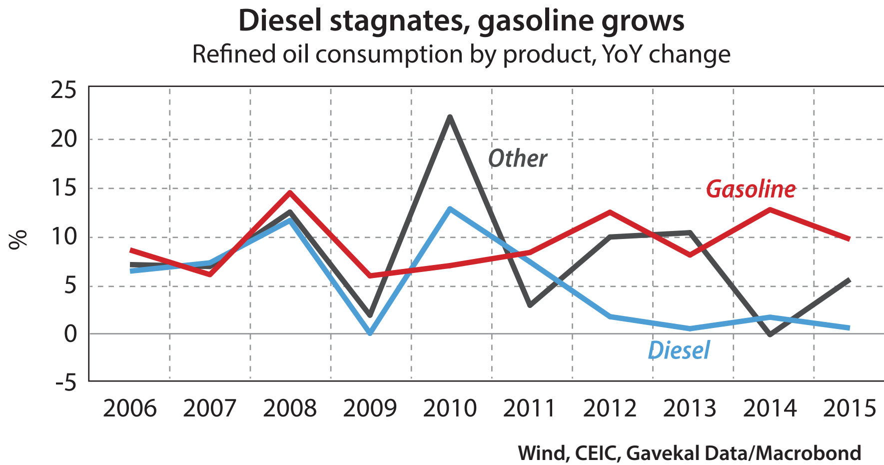
China's demand for oil—unlike its need for other commodities—will continue to grow, thanks mainly to greater use of automobiles. Imports, though, will be more volatile, and determined largely by how fast the country tries to fill its strategic reserves, and how quickly refiners adapt to changing consumption patterns.

Global commodity prices plunged in 2014-15 thanks to a flattening of Chinese demand and an excess of global supply. For industrial metals, the outlook remains bleak, because supply remains abundant and China's demand is now in secular decline thanks to the end of its long housing boom. Oil is different. The global supply/demand balance is tighter than for other commodities, and demand from China—now the world's biggest importer—is likely to keep growing, as transport, consumers and the filling of the nation's strategic petroleum reserve (SPR) take over from industry as the main drivers.

Just how much joy China will give to the world's oil producers, however, is a tricky question. Its crude oil demand is likely to keep rising by about 3% a year until 2020. With domestic production capacity barely growing, this would seem to suggest a rosy outlook for imports. But in reality, imports could well be quite volatile, or even decline, in the next couple of years, as SPR imports slow due to a lack of storage capacity.

Another complexity derives from shifting patterns of end-user demand. Historically, China's consumption of refined oil products has been weighted toward heavy distillates (diesel and fuel oil), used in heavy industry and trucking. Diesel demand has slowed sharply in the last four years, while

Rosealea Yao is the China investment analyst at Gavekal Dragonomics.



gasoline demand—driven by the country's inexorably rising passenger car fleet—continues to gallop ahead by around 10% a year. China's refineries are still set up to produce more heavy distillates than gasoline. Thanks to the inability of refiners to catch up to the changing demand pattern, China in 2015 for the first time became a net exporter of refined products, with net exports now running at an annualized clip of 7mn metric tons, compared to net imports of 14mn metric tons as recently as 2012.

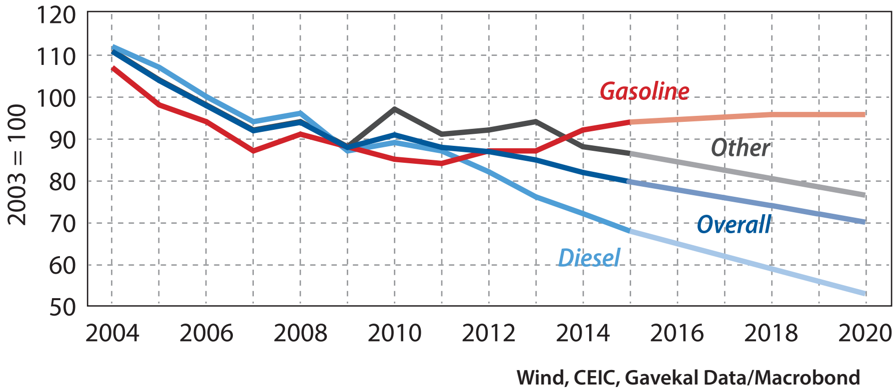
The bottom line is that, over the medium to long term, China will be a positive force for the global oil market, with consumption rising from 10.3mn barrels a day (bbl/day) in 2015 to 11.9mn in 2020, and imports rising from 6.7mn to 7.4mn bbl/day during the same period. But imports will follow a volatile path, and net exports of refined product—especially diesel—will continue to grow.

Structural change is a drag on oil demand

The key variable for China's future oil consumption is the country's oil intensity of GDP—the amount of oil consumed to generate each unit of output—and in particular, diesel and gasoline intensity.

China's energy and oil intensities are both set to decline over the next few years, as the result of a significant and structural drop in heavy industry and construction activity. This trend is the natural result of the end of a country's most capital-intensive stage of growth. Japan offers a pertinent precedent. In the early 1970s, Japan's housing starts peaked, and per capita steel use topped out. Japan's oil intensity of GDP fell by more than 30%.

China today faces a similar structural slowdown in construction activity, led by housing. After tripling between 1997 and 2012, China's annual construction of housing has peaked and will likely decline by 15-20%

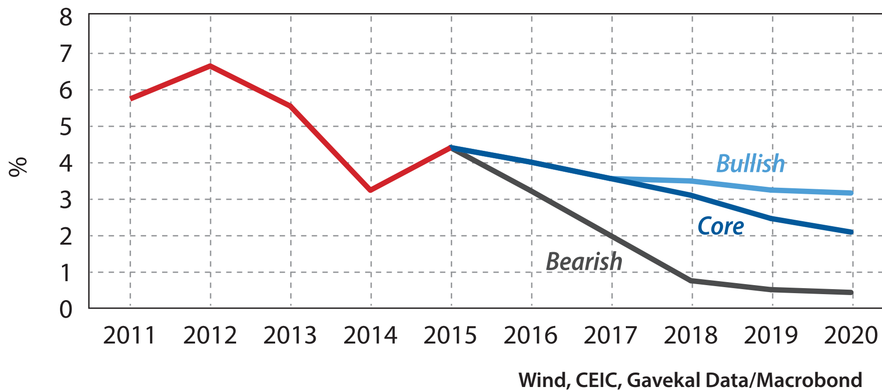


over the next decade. A comparable fall in demand for heavy industrial products, and an increasing share of energy-light services in GDP, mean that the economy's overall energy intensity will decline by 21% by 2020.

Oil intensity will fall less, by 12%. (The reason for this is that most of the reduction in energy use will come from coal, which comprises nearly two-thirds of China's total primary energy consumption.) The biggest victim will be diesel, which accounts for 40% of China's oil product demand mix, and whose growth will be approximately zero in 2016-20. This is because much of China's diesel consumption goes to fuel the heavy equipment used in the mining and construction sectors, as well as the trucks that transport bulk materials. As property investment and construction activity slow, so will demand for diesel.

China's shift towards a more consumption-driven economy will generate strong gasoline demand

Another reason for the relatively modest projected decline in oil intensity is that China's shift towards a more consumption-driven economy will generate strong demand for lighter distillates, notably gasoline. Gasoline use is directly linked to rising automobile use; consumer demand for other types of products, such as furniture and various types of plastic goods, creates new markets for petrochemicals. Growth in gasoline demand remains strong despite more efficient engines, an increasingly replacement-driven pattern of car purchases, and restrictive regulations designed to curb car use in congested cities. Demand is likely to rise by 6% a year through 2020, making gasoline the only refined product whose intensity relative to GDP will increase.



With our intensity projections in hand, we can combine them with forecast GDP to arrive at an estimate of likely future oil volume demand. Our core scenario is that GDP growth gradually slows from 6.5% in 2016 to 5% in 2020; under this assumption, oil demand growth will average 3% a year over the next four years, but on a slowing trajectory which will leave demand growth at around 2% in the early 2020s. Tweaking the GDP growth assumptions leads to slightly higher or lower oil demand growth. But barring a major financial crisis or economic collapse, China's oil demand will still be growing at 1-3% a year by the end of the decade.

Forecasting imports is much trickier

Growth in underlying demand is likely to remain relatively stable, but crude oil import volumes, and product export volumes, will be more volatile. Strategic stockpiling and the restructuring of China's refining sector will play the key roles.

In the past two years, low crude prices led to an acceleration of strategic and commercial stockpiling, pushing up imports. Thanks to stockpiling, crude oil imports hit a record high of 6.7mn bbl/day in 2015, despite slowing domestic consumption. Whether import growth will continue to outstrip domestic consumption growth in this fashion will depend on three factors: how much crude oil storage capacity China has now, how full it is, and how quickly China is likely to add to its storage capacity in future.

Our estimates show that stockpiling is likely to slow down due to storage constraints. At the end of 2015, China's combined commercial and SPR reserves were around 500mn barrels, about double what they were a year earlier. In 2016/17 the annual pace of reserve additions will probably slow to around 170mn bbl/year; and after 2017 the lack of storage facilities

Estimated total storage capacity and stockpiling

	Commercial reserve capacity mn bbl	Strategic reserve capacity mn bbl	Total capacity mn bbl	Estimated stockpile mn bbl
2013	291	90	381	
2014	307	192	499	240
2015	315	294	609	500
2016	328	498	826	730
2017	342	498	840	840

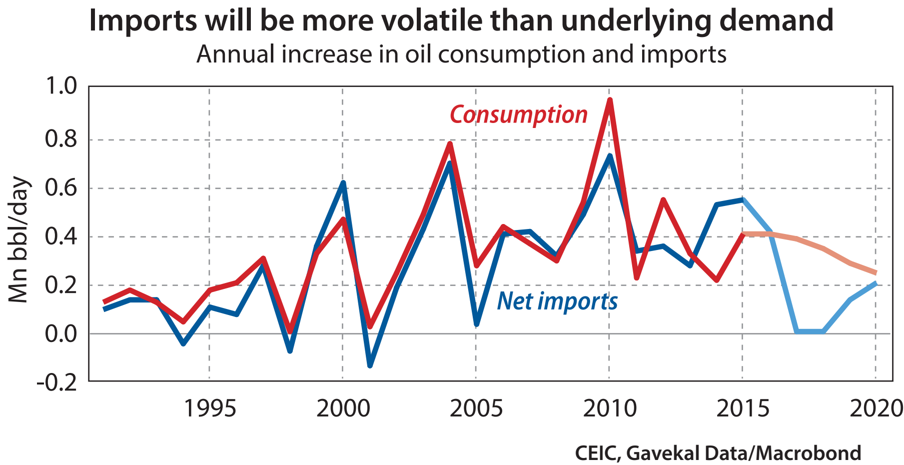
CNPC, NDRC, author's estimates

could slow the pace of stockpiling significantly. If that occurs, imports could fall even if underlying end-user oil demand keeps rising. There are a lot of "ifs" in that scenario, obviously: China could also ramp up construction of new SPR facilities, enabling continued rapid stock-building. The point is simply that there is significant risk that storage capacity could fail to keep up with the present rapid pace of stock-building, so imports are likely to be more volatile than end-user demand.

A second variable is how quickly China's refiners adapt to changing consumption patterns, producing less diesel and more gasoline. The average diesel-to-gasoline ratio of Chinese refiners has fallen from around 2:1 before 2012 to 1.5:1 in 2015. Ideally, it would fall further to 1.2:1 by 2020. This will be hard. The decline so far was enabled by the rapid installation of new gasoline-oriented refining capacity. But overall oil demand growth is now so low that new capacity addition will slow. This means that existing refineries will have to be reconfigured to produce more gasoline, and in the case of the smaller and less sophisticated "teapot" refineries that generate about a fifth of China's refined oil products, progress will be slow—especially since Beijing will be reluctant to simply shut these refineries down, for fear of inflicting local economic damage.

> Growth in underlying demand will likely remain stable, but crude oil import volumes, and product export volumes, will be volatile

In short, a portion of China's refinery sector will probably continue refining crude at its present ratio of diesel to gasoline, while still needing to produce increased amounts overall in order to meet China's growing gasoline demand. The result will be a rising surplus of diesel: China became a net diesel exporter in mid-2015 and these exports will prob-



ably rise. Another consequence could be that crude oil imports run at a rate higher than implied by underlying end-user demand, because diesel-focused refiners will buy as much crude as they need to produce the required amount of gasoline, even if this means they wind up dumping a lot of extra diesel on the international market.

All in all, China's underlying demand for oil should continue to grow at an average annual rate of around 3% for the remainder of this decade. Import demand will be more volatile. It could be pushed higher by opportunistic SPR buying and by the need of diesel-oriented refiners to buy extra crude in order to meet their gasoline targets. Imports could also be boosted if China's national oil companies choose to leave their relatively high cost-of-production domestic crude in the ground and buy cheaper imports instead. But imports could also be depressed if a shortage of commercial or SPR storage limits stockbuilding. China is likely to continue being a constructive presence in global oil demand, but a somewhat erratic one.

China Abroad

The Long March To Europe

By Philippe Le Corre and Alain Sepulchre

China's investment in Europe is surging, as Chinese firms step up their M&A efforts and put more money into infrastructure ventures. European authorities must do a more active job of weighing the economic benefits of this investment against the political risks.

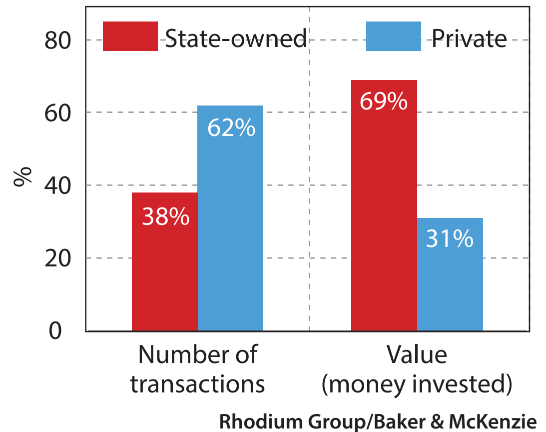
For years China has been known as a destination for foreign direct investment, as multinationals flocked there to build export platforms and take advantage of its fast-growing market. Now, however, it is China's outbound foreign direct investment (OFDI) that is shaping the world. In the first quarter of 2015, China claimed its largest-ever share of global mergers and acquisitions (M&A), with mainland companies' takeovers of foreign firms amounting to US$101bn, or 15% of the US$682bn of announced global deals. In three months, China recorded more outbound investment transactions than in the whole of 2015, when US$109bn in deals were announced.

These figures probably overstate the true level of capital flows, since some announced deals inevitably fail to reach fruition. But whatever the levels, it is clear that China's outbound investment is rapidly growing, and that its share of global direct investment flows is among the largest of any country.

The rise in China's direct investment in Europe is especially striking. According to a recent report by law firm Baker & McKenzie and consultancy Rhodium Group, the total stock of Chinese investment in Europe increased almost ten-fold from US$6bn in 2010 to US$55bn in 2014. In 2015 alone,

Philippe Le Corre is visiting fellow at the Brookings Institution in Washington DC. Alain Sepulchre is senior adviser at the Boston Consulting Group in Hong Kong. They are co-authors of *China's Offensive in Europe* (Brookings Institution Press, 2016).

Chinese OFDI in Europe increased by 44 percent (with deals such as Italian tire manufacturer Pirelli's US$7.7bn takeover by ChemChina). Total flow of US$23bn exceeded China's investments in the US, which were US$17bn in the same year. This year could see an even more dramatic jump, if ChemChina's proposed US$46bn takeover of Swiss agro-technology firm Syngenta is approved by regulators.



There are two main reasons why Chinese investors favor Europe over the US. First, the issue of Chinese direct investment is less politicized in Europe. A handful of high-profile Chinese investments in the US have been blocked for political reasons, and the national security review process of the Committee on Foreign Investment in the United States poses an obstacle for some types of acquisitions, especially by Chinese state-owned enterprises (SOEs). Europe lacks a similar review process, and this perhaps explains why SOEs represent nearly 70% of Chinese OFDI in Europe, but less than half in the US. Second, Europe's ongoing economic and financial difficulties since the global financial crisis of 2008 mean there has been a hunger for Chinese cash to finance infrastructure or bail out debt-ridden firms.

The flows are impressive, but it is important to remember that on a stock basis, China's aggregate investment in Europe is still fairly modest. By the end of 2014, China's cumulative OFDI represented only 3-4% of all FDI in Europe, and the pool of workers directly affected by Chinese FDI was a mere 2% of the number of Europeans working in American-owned firms in Europe. The rising trend of Chinese investment, however, raises some interesting economic and political questions for European leaders.

Moving up the value chain…

What motives, aside from the sheer availability of cash, are driving this enormous wave of Chinese outward investment? A review of China's OFDI in Europe over the past decade points to five distinct strategies. Some of these are similar to the strategies seen in earlier waves of cross-border investment by Western, Japanese and South Korean companies; others seem to be more China-specific. They also display widely divergent reli-

Strategies of Chinese firms investing in Europe

Strategy	Example	Unique to China?	Political leverage
From cheap to sophisticated products	Haier	No	Low
From low margin to high margin	Huawei	Somewhat	Medium
Technology acquisition	Lenovo, Fosun, Geely, ChemChina, Bright Foods	Yes	Medium
"Orientalism"	Jinjiang, Peninsula Hotels, Mandarin Oriental, Shangri-La Hotels, Dalian Wanda	Strongly yes	Low/medium
National champions	Dongfeng Motor	Strongly yes	High

Authors research

ance on political leverage—with SOE investments, unsurprisingly, being the most politically driven.

The first strategy is driven by a desire to move from cheap products to more sophisticated ones. An exemplar is Haier, the world's largest white goods manufacturer. Haier's development closely tracks that of Japanese and South Korean consumer appliance makers: it first concentrated on making cheap copies of established products, for sale in the Chinese market. It gradually moved up to more sophisticated and innovate products and services and began to export more aggressively.

Haier came to cross-border M&A relatively late, and has used it mainly to scale up its core "made-in-China" portfolio and accelerate its move up the value chain. Its first acquisitions came in 2012, when it bought part of Sanyo's Asian operations and New Zealand's Fisher & Paykel. After a failed effort to acquire bankrupt European white-goods firm FagorBrandt in 2014, it bought GE's consumer appliances business for US$5.4bn in January 2016. Political backing for Haier's overseas expansion has been limited, probably because of the low political importance of the white goods sector.

Haier's development closely tracks that of Japanese and South Korean consumer appliance makers

A second strategy, exemplified by telecoms equipment maker Huawei Technologies, is a straightforward effort to raise margins by diversifying out of the low-margin Chinese market into higher-margin foreign ones. Huawei has derived more than half its sales from abroad for over a decade,

and has gradually increased its presence in European markets, in part through loose alliances with major clients such as BT, Orange, Deutsche Telekom, and Telefónica. It has also moved quickly into the device sector. From tablets to smartphones and 3G keys, its products are now spreading across Europe, as are its greenfield investments in European R&D centers. Its efforts to expand through M&A have been hampered by its image as an arm of the Chinese state—although privately owned, it has benefited from huge lines of credit from Chinese policy banks, and has never put to rest rumors of close ties with the People's Liberation Army.

…and acquiring technology

The third model essentially involves technology acquisition that enables a Chinese firm both to bolster its position at home and create strategic opportunities abroad. Notable examples include personal computer maker Lenovo (which bought IBM's PC division), carmaker Geely (which acquired Volvo's passenger-car unit), and more recently ChemChina (with its purchases of Pirelli and Syngenta). The technology-acquisition strategy is much more characteristic of Chinese firms than of Japanese or South Korean companies, which mainly preferred to build up their technological know-how internally, or through licensing arrangements. Even though many of the Chinese acquirers in these deals are private, they are often able to mobilize enormous state support in the form of generous and low-cost financing.

Technology acquisition allows a Chinese firm to bolster its position at home and create strategic opportunities abroad

The fourth internationalization model is characteristic of the hospitality industry and is one we dub (perhaps controversially) "Orientalist." Essentially this involves the acquisition of established high-end hotel and leisure brands, with the ultimate aim of reorienting them to cater to a growing Asian—and especially Chinese—clientele. Examples include Shanghai-based Jinjiang International's recent purchase of the Louvre Hotels group and of 11.7% of Accor's hotel business. Hong Kong hotel chains Shangri-La, Mandarin and Peninsula have focused their expansion over the past three years in Europe, buying high-end assets in Paris and London. Dalian Wanda, a conglomerate with interests in real estate, retail and cinemas has plans for a series of major mixed-use projects in the UK and France. Like many such projects in China, these are designed to offer a combination of commercial, residential, shopping and recreational

15 Largest Chinese Deals in the EU (2014-15)

	Target	Country	Acquirer	Sector	Value, US$ mn	Share	Year
1	Pirelli	Italy	ChemChina	Automotive	7,700	26%	2015
2	Eni, Enel	Italy	SAFE Investments	Energy	2,760	2%	2014
3	CDP Reti	Italy	State Grid	Energy	2,600	35%	2014
4	Pizza Express	UK	Hony	Food	1,540	100%	2014
5	Groupe de Louvre	France	Jinjiang Int'l Holdings	Real estate	1,490	100%	2014
6	Caixa Seguros e Saude	Portugal	Fosun	Insurance	1,360	80%	2014
7	10 Upper Bank Street	UK	China Life Insurance	Real estate	1,350	100%	2014
8	Chiswick Park	UK	China Investment Corp (CIC)	Real estate	1,300	100%	2014
9	Nidera	Netherlands	COFCO	Food	1,290	51%	2014
10	Club Med	France	Fosun	Hospitality	1,120	100%	2015
11	Peugeot	France	Dongfeng	Automotive	1,100	14%	2014
12	Hertsmere Site (in Canary Wharf)	UK	Greenland Group	Real estate	1,000	100%	2014
13	Wandsworth's Ram Brewery	UK	Greenland Group	Real estate	987	100%	2014
14	Canary Wharf Tower	UK	China Life Insurance	Real estate	980	70%	2014
15	House of Fraser	UK	Sanpower	Retail	746	89%	2014

Heritage Foundation, media reports

facilities. These culturally-oriented acquirers have also benefited from generous financing from China's state-owned banks.

The final strategy is a "national champions" model, under which big SOEs use political and financial support from the government to make acquisitions that they hope will vault them into positions of global market leadership. A noteworthy recent example in Europe Dongfeng Motor's purchase of 14% of PSA, the parent company of Peugeot.

The wave of Chinese investment creates several challenges for European companies and policymakers. For firms, the sudden appearance of hungry and well-financed Chinese acquirers has prompted incumbent multinationals to step up their own M&A efforts, in order to maintain their market dominance. Moves into the European market by China's leading construction equipment firms, Zoomlion and Sany, most likely

prompted the purchase of Finnish crane company Konecranes by its American rival Terex. Similarly, ChemChina's unexpected bid for Syngenta has caused disquiet among European chemical firms, and probably motivated Bayer's subsequent bid to take over Monsanto.

In the policy arena, two issues stand out. The narrower one relates to reciprocity: Chinese firms are pretty much free to buy companies in any sector in Europe, without restriction; foreign firms by contrast are barred from investment or majority control in a host of sectors in China, including banking, insurance, telecom, media, logistics, construction, and healthcare. One potential solution is to include reciprocity provisions in the EU-China bilateral investment treaty now under negotiation.

The broader question for Europe is whether some broader geopolitical strategy lies behind China's outward investment surge, and if so what to do about it. There can be little doubt that in recent years China has increased its political leverage in Europe, and has done so via a "divide and rule" approach of dealing as little as possible with the EU as a whole and as much as possible with individual states. Another tactic has been to create new multilateral forums in configurations favorable to China, the most prominent example being the "16+1," which consists of 16 central and eastern European nations plus China. Beijing has tried—so far without success—to develop similar forums with the Nordic and Southern European countries.

Anxiety along the Belt and Road

A related issue is to what extent Europe should welcome Chinese investment that comes in the form of infrastructure spending. Part of China's "Belt and Road Initiative" is about increasing connectivity between China and Europe, and this comes with clear financial benefits: China has pledged, for instance, to contribute to the European Commission's European Strategic Infrastructure Fund; and Chinese-led logistics platforms such as Athens' Piraeus Port are proliferating.

But with increased connectivity comes an increased flow of Chinese goods—and especially a flood of low-priced products from China's excess capacity industries such as steel and building materials. In response to the apparent dumping of Chinese industrial goods in Europe, the European Parliament on May 12 adopted a non-binding but pointed resolution asking the European Commission to reject China's claim to "market economy status" in the World Trade Organization (WTO). That status—which China says should come to it automatically in December this year under the terms of its 2001 WTO accession—would make it much harder for the

EU to impose anti-dumping duties on Chinese imports. The Commission now faces the delicate choice of accepting China's claim (to the detriment of European producers) or rejecting it (an action that is likely to invite some form of economic retaliation from Beijing). A possible middle way would be to recognize China's market economy status but to carve out a set of exceptions to protect key European industries. However this dispute plays out, it will simply mark the beginning of a long and complicated relationship between Europe and its fastest-growing investor.

Books

Hope And Hard Work On A Shanghai Street

By Arthur Kroeber

Street of Eternal Happiness
by Rob Schmitz (Crown 2016)

Accounts of economies are often bloodless affairs, so it is a relief when a writer comes along who can bring to life the people buried beneath the GDP statistics. Rob Schmitz, since 2009 a business reporter for American public radio in Shanghai, has done just this in a small gem of a book that illuminates China's economic transformations through portraits of the residents of his neighborhood. *Street of Eternal Happiness* joins a small circle of journalistic accounts—Leslie Chang's *Factory Girls*, Peter Hessler's *Country Driving*, and Michael Meyer's *In Manchuria*—that enable one to catch a glimpse of what life is like for ordinary people in a fast-changing China.

Schmitz weaves together four lives, exemplifying the themes of restlessness, striving, frustration and hope that run through much of Chinese urban life today. One is the dreamy entrepreneur Chen Kai (or "CK"), who makes a comfortable living as the main salesman in China for the leading Italian maker of accordions, but whose true aspiration is to run an American-style sandwich shop that will become a haven for artists, poets and other non-conformists. At the other end of the entrepreneurial spectrum is Zhao Shiling, a woman who fled a dead-end life and abusive husband in a dreary coal town and carved out self-sufficiency as the proprietor of the Bright Happiness Flower Shop.

Alongside these success stories are tales of disappointment. Auntie Fu and Uncle Feng are locked in a marriage of constant bickering, and after day of quarreling they retire to bed to watch television—each tuning to a different program on the two TVs perched at the foot of their bed. Uncle

Arthur Kroeber is editor of the *China Economic Quarterly*.

Feng scrapes by selling scallion pancakes out the front window of their tiny house; Auntie Fu squanders most of their earnings in a series of ever more hopeless get-rich-quick scams.

Fu and Feng are members of the "lost generation" of people born around 1950, whose prospects were permanently damaged by the Cultural Revolution. Uncle Feng's youth was wasted after he dropped out of high school in Shanghai and joined a group of students assigned to till arid wastes in far western Xinjiang. Auntie Fu's father, denounced as a counterrevolutionary, died when she was a child. She wound up assigned to Uncle Feng's village in Xinjiang, where they met and married. By the time they were able to make their way back to Shanghai in the 1990s, they were both too old and too uneducated to join the great wave of prosperity that began to sweep over coastal China.

Schmitz's China is a place with little trust in institutions, least of all the Communist Party

Finally there is "Mayor" Chen, so called because of his unofficial status as leader of the residents of an alleyway of traditional Shanghai townhouses demolished to make way for a modern development. Chen hangs on to his home after many of his neighbors have been paid off or chased away by the developer's thugs, but his efforts to gain fair compensation for the lane's old residents end in failure when he and his wife are kidnapped and a demolition crew destroys his house.

Hardship and optimism

There is plenty of hardship in these stories, and in the lives of other past and present occupants of the Street of Eternal Happiness that Schmitz brings into his kaleidoscope. And there is very little trust in institutions, least of all the Communist Party. Instead there is a hardy culture of self-reliance. Schmitz writes:

> After years of living and traveling through the country, I had met only a handful of Chinese who truly, deep down, believed in the Party. It was foolish to have faith in a government that, time and time again since the beginning of its rule, had proven it wasn't trustworthy. The Party's principles—broadcast in flowery catchphrases—might sound nice, but after so many years of authoritarian rule, the Chinese had become pragmatists. Inside of a political system that provided little real benefit, you were left only to rely on your family and, ultimately, yourself.

One response to the untrustworthiness of political and social institutions is a quest for meaning through religion. Auntie Fu attends an underground church whose hucksterish preacher's naked demand for tithes mirrors the investment schemes to which she often falls prey. (And indeed, many of these scams rely on church networks to generate new victims.) CK, the worldly accordion salesman and sandwich entrepreneur, makes pilgrimages to a Buddhist master who mixes one part of spiritual guidance with three parts of medical advice to desperate people priced out of China's pay-as-you-go healthcare system.

But the characteristic shared by virtually all of Schmitz's protagonists is brave persistence against long odds, and in the end the picture that emerges is an optimistic one. Zhao the flower-seller maintains a cheerful attitude despite the hardness of her life and her two sons, neither of whom enjoyed a good education, both manage after a struggle to land on their feet—one as a chef at a Greek restaurant and the other as a futures trader. Her grandson, as the child of migrants without a Shanghai residence permit, must be sent back to Zhao's old coal town for his education. Yet even that town has developed: Zhao's flower-shop earnings finance the purchase of a nice suburban apartment, the local school is decent, and high-speed trains have cut the travel time to Shanghai from 12 hours to three. Her efforts, and those of millions like her over the past three decades, have made China a wealthier, better place. One can only hope that in the decades to come such efforts will produce not just more wealth, but a healthier and more trustworthy society as well.

The characteristic shared by virtually all of Schmitz's protagonists is brave persistence against long odds

www.gavekal.com

Head office
Suite 3101, Central Plaza
18 Harbour Road
Wanchai, Hong Kong

Beijing office
603 Soho Nexus Center
19A Dongsanhuan Beilu
Beijing 100020, China