Statement before the Senate Committee on Banking, Housing, and Urban Affairs
Subcommittee On Economic Policy
On "Rebuilding American Manufacturing"

The Importance Of Chinese Subsidies

Derek Scissors

Resident Scholar

American Enterprise Institute

December 11, 2013

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute, even when they should.

Large economies should always get their own house in order first. American private wealth is by far the world's highest, on the order of $45 trillion ahead of Japan's and China's.[1] This staggering achievement has been due overwhelmingly to American policies, not foreign. The challenges facing the U.S. economy, and manufacturing in particular, can and should be addressed primarily by American policy.

As a secondary matter, manufacturing is now a global activity and foreign actions play a role. Among the many global factors, the single most important is Chinese subsidies. The People's Republic of China's (PRC) manufacturing sector is the only one of comparable size to the U.S. It is driven by government intervention, rather than genuine commercial competition, and this intervention harms American manufacturing companies and workers.

The harm is usually identified as large-scale U.S. imports from China. In fact, the main problems are barriers to American exports to the PRC and, perhaps soon, a growing battle in third markets. For the last decade, Beijing has acted as if competition is good for everyone except Chinese firms on their home turf.

The best American policy does not, and indeed is unable to, imitate the PRC's anti-competitive actions. Instead, the U.S. should document Chinese regulatory and financial subsidies, then take a sequence of steps – multilateral, bilateral and, if ultimately necessary, unilateral – to reduce them. The PRC will remain a competitor regardless of whether its new government returns the country to the path of market-driven reform. But wise choices by the U.S. could help move China further from an unpleasant challenge to American manufacturing and closer to the intriguing opportunity many hope for.

Barriers to Competition

Competition is the foundation of economic prosperity. It cuts prices, raises quality, and drives innovation. Even limited competition offers considerable benefits along these lines. For an economy as a whole, whether a national economy or the world economy, the more competition the better. Conversely, anti-competitive behavior by companies or governments is always harmful to the economy as a whole.

Monopolization is the most basic form of anti-competitive behavior. Monopolies can extend over specific goods or services or a specific region. Monopolies don't innovate, and the quality of their goods and services is generally substandard due to lack of incentive to improve.[2] Very close to outright monopolization is guaranteed market shares. Here, there is more than one firm but some or all participants are guaranteed business. If any portion of such industries is competitive, it is only a slice.

The second main form of undermining competition is through prices. These can be sales prices, of course, but there are also a number of input prices that can be manipulated. Wages (the price

[1] Credit Suisse., "Global Wealth Report 2013," October, 2013, https://publications.credit-suisse.com/tasks/render/file/?fileID=BCDB1364-A105-0560-1332EC9100FF5C83
[2] "We're the phone company: We don't care, we don't have to," Saturday Night Live via Stop the Cap, http://stopthecap.com/2012/08/23/were-the-phone-company-we-dont-care-we-dont-have-to/

of labor) can be distorted, as can borrowing costs (the price of capital), the price of land, power, water, telecom services, and so on. A determined and effective government has many tools to limit competition.

These and other tools are all subsidies. There are always individuals or firms who benefit from limited competition. They may receive outright regulatory protection, such as a guaranteed market share. They may receive government transfers to offset their labor costs. They may be able to borrow at low prices, or receive free land or power. Subsidies can be financial in nature, but they do not have to be. Indeed, regulatory protection is more fundamental.

Regulatory Protection

The PRC has legitimate and sizable comparative advantages. It has a solidly capable labor force with wage rates that are still relatively low compared to many of its peers. It now has plenty of capital. And China is hardly the only country in the world to engage in large-scale subsidies. The U.S., for one, has subsidized some farm goods despite being the world's biggest agriculture surplus country. It is in the size, range, and effectiveness of its subsidies that the PRC is unmatched.

For a set of major industries, the principal subsidy is regulatory shelter from competition. By central government decree, the state is required to control these industries to various extents. At the top of the list, where the state must have "absolute" control, are armaments, aviation, coal, oil and petrochemicals, power generation and distribution, shipping and telecom. The state should also lead in autos, construction, IT, machinery, and metals.[3] Though it is not formalized, state entities also control nearly all of insurance, media, railways, and some smaller sectors.

In addition, there are ongoing consolidation efforts, to address what Beijing calls "disorderly" competition.[4] The solution is to contract the total number of firms, while increasing the combined market share of remaining state-owned enterprises (SOE's).[5]

Non-state firms have not been able to enter any of these industries, nor could non-state firms already in the industry succeed beyond a certain, unspecified point. In contrast, SOE's can only fail to the extent of being absorbed by other SOE's, the state share as a whole is not permitted to shrink. Such SOE's have no final obligation to ostensible creditors and certainly cannot go bankrupt. For these sectors and companies, nothing else matters – wages, borrowing, land are all details when success is essentially guaranteed for some and barred for others.[6]

[3] Zhao Huanxin, "China names key industries for absolute state control," *China Daily*, December 19, 2006, http://www.chinadaily.com.cn/china/2006-12/19/content_762056.htm

[4] Liu Jin, "Construction machinery industry on the road to recovery," *China Economic Net*, May 16, 2013, http://en.ce.cn/Insight/201305/16/t20130516_24390213.shtml

[5] For instance in autos, see: Han Tianyang, "Another call for consolidation," *China Daily*, January 28, 2013, http://www.chinadaily.com.cn/cndy/2013-01/28/content_16178732.htm

[6] Zhao Huanxin, *op cit*; Zhang Xiang, ed., "China to nurture 7 new strategic industries in 2011-2015," Xinhua, October 27, 2010, http://news.xinhuanet.com/english2010/china/2010-10/27/c_13578293.htm.; Central Huijin Investment Ltd., "Investments," http://www.huijin-inv.cn/hjen/investments/investments_2008.html?var1=Investments; Grant Turner, Nicholas Tan and Dena Sadeghian, "The Chinese Banking System," Reserve Bank of Australia, September 2012: 53-64

Table 1: Where Public Ownership Still Dominates	
Alternative energy and energy conservation	Materials
Autos	Media
Aviation	Metals
Banking	Oil and gas
Biologic science	Petrochemicals
Coal	Power
Construction	Railways
Environmental protection	Securities
Information technology	Shipping
Insurance	Telecom
Machinery	Tobacco

Beijing's mandates are exacerbated by analogous provincial goals. Provincial leaders listen to the central government when they want to and when they absolutely have to. That is: not all the time.[7] Unfortunately, the provinces are almost always pleased to accept the demand for state dominance of major industries. They typically want more, to add sectors such as agriculture and environmental protection to the monopoly list.[8]

Alternately, they want their SOE's to be the major players in the industries set aside by Beijing. Of course, this breeds a sort of competition, political – it is always someone else who should close down excess capacity. This is far from healthy - immense amounts of resources are wasted as provinces seek to best each other in the battle of subsidies. Perhaps the most perverse example is in shipping, where state regulatory protection and provincial competition have kept 1500 shipyards open, even though fewer than 100 have won orders in the past year.[9]

Financial Subsidies

http://www.rba.gov.au/publications/bulletin/2012/sep/pdf/bu-0912-7.pdf.; Mu Xuequan, ed., "China launches new state-owned railway corporation," Xinhua, March 14, 2013, http://news.xinhuanet.com/english/china/2013-03/14/c_132234204.htm; Chinese Government, "State Tobacco Monopoly Administration," news release, http://english.gov.cn/2005-10/03/content_74295.htm; and Towers Watson, *The Chinese Insurance Market, No. 19* (Shanghai, China, March 2012), http://www.towerswatson.com/en/Insights/Newsletters/Asia-Pacific/The%20Chinese%20Insurance%20Market%20Newsletter/2012/The-Chinese-Insurance-Market-Newsletter-No19.

[7] See, for example, Yongheng Deng et al., "Incentives and Outcomes: China's Environmental Policy," *National Bureau of Economic Research*, February 2013, http://www.ires.nus.edu.sg/workingpapers/IRES2013-004.pdf

[8] Alan Chu, "China by the numbers: Understanding China's provincial priorities," *PwC LLP*, http://www.pwc.com/us/en/view/issue-13/understanding-chinas-provincial-priorities.jhtml

[9] Keith Wallis, "Orders climb at China's shipyards, but rebound favours a few," *Reuters*, September 18, 2013, http://www.reuters.com/article/2013/09/18/china-shipyards-idUSL4N0GD1LS20130918

On top of all this, the single most important area of control for the state is banks, both national and local. Competition in banking is suppressed – there is exactly one large domestic private bank and the foreign share of banking assets is under two percent and still managing to fall.[10] Not only is banking itself tightly controlled, the control gives the state a gigantic lever to influence the rest of the economy.

State banks lend for political not commercial reasons, as dramatically demonstrated by the surge in lending in 2009 as the global crisis struck home and profit opportunities disappeared. They loan overwhelmingly to state firms, with estimates of the state share still in excess of 80 percent of formal borrowing from all sources.[11] Interest rates on these loans are often less than producer inflation, so that the real cost of borrowing is negative. When loan payments actually bite, most state firms have the option not to repay.[12]

Not all SOE's are deemed worthy of an endless supply of credit but most are, at least for some periods. These range from industries targeted for expansion, such as green energy, to those losing vast amounts of money and targeted for consolidation, such as parts of the food industry.[13] Many unsuccessful SOE's receive a seemingly permanent bailout. The subsidies are enormously wasteful and have led to daunting debt problems.[14] Nonetheless, it is naturally quite difficult to compete with any firms getting so much nearly free capital.

A proper estimate of the size of the subsidy would involve a great deal of work, especially given lack of financial and corporate transparency. At the end of 2012, the People's Bank reported outstanding loan volume of $12.93 trillion.[15] On the order of $10.3 trillion was loaned to SOE's and almost all of that on non-commercial terms – at near-zero costs or with optional repayment. This certainly does not constitute a $10 trillion subsidy, since there would be a large amount of lending under a commercial banking system. But the amount of capital affected by Chinese subsidies and used by SOE's is approximately $10 trillion.

About half of this has been rung up since 2009, thanks to the loan spike after the crisis. While a rigged banking system is not a guarantee of success the way regulatory protection is, the quantity

---

[10] Wang Zhaoxing, "Integration of foreign banks," *China Daily: Europe*, June, 2, 2012, http://europe.chinadaily.com.cn/business/2012-06/02/content_15456078.htm

[11] Wing Thye Woo, "China meets the middle-income trap: The large potholes in the road to catching-up*," Journal of Chinese Economic and Business Studies*, Volume 10, Issue 4, 2012, http://www.tandfonline.com/doi/abs/10.1080/14765284.2012.724980#preview and "State capitalism's Global Reach: New Masters of the Universe," *The Economist*, January, 21, 2012, http://www.economist.com/node/21542925

[12] "Zhou Xiaochuan: Real interest rate to stay negative for now," *China.org.cn*, March, 14, 2011, http://www.china.org.cn/china/NPC_CPPCC_2011/2011-03/14/content_22133432.htm

[13] "Chinese Zombies Emerging After Years of Solar Subsidies," *Bloomberg News*, September 9, 2013, http://www.bloomberg.com/news/2013-09-08/chinese-zombies-emerging-after-years-of-solar-subsidies.html and Adam Jourdan, "China milk makers including Yili, Mengniu to get state support," *Reuters*, September 22, 2013, http://www.reuters.com/article/2013/09/22/us-china-dairy-idUSBRE98L03F20130922

[14] Liyan Qi and Grace Zhu, "Researcher Puts China's Local Government Debt at $3.3 Trillion," *The Wall Street Journal*, September 17, 2013, http://online.wsj.com/article/SB10001424127887324665604579080683134844374.html and Xinhua, "Corporate debt reaches 'alarming levels'," *China Daily*, May 18, 2012, http://www.chinadaily.com.cn/business/2012-05/18/content_15328186.htm

[15] All loan data taken from National Bureau of Statistics, *China Monthly Statistics*, Beijing PRC.

of money involved qualifies as an powerful distortion of competition. Domestic bonds and stock markets are also heavily biased toward SOE's, further inflating their access to capital. [16] (This is a considerable problem for the Chinese economy, but less important as a subsidy than loans.)

A new group of Chinese Communist Party leaders was named in fall 2012, a new government took over in March of this year. As a result, the fall 2013 Party plenary meetings provided a real opportunity for fresh economic reform, the first such opportunity in a decade.

This is a potentially vital development, but the success and direction of reform are open questions. Pro-competition reforms – the ones the U.S. is interested in – are strongly opposed by some elements of the Party, both nationally and locally. In addition, Beijing has a full menu of items competing for high-level attention - including corruption, pollution, and an aging population - and internal disagreement over priorities.[17] Even progressive steps such as the promised modification of the one-child policy do not enhance economic competition. For the next five years, at the very least, Chinese subsidies will be a major problem.

Immediate Impacts

Chronicling the full impact of Chinese subsidies would require multiple books. At one level, Chinese subsidies drive national imbalances and contribute prominently to global imbalances.[18]

Subsidies do not appear from thin air, someone always pays for them. In the PRC, it is consumers and savers. Consumers pay because state monopolies charge higher prices and offer lower quality. Savers pay because interest rates on deposits lag inflation so that banks can afford to hand money to SOE's. These implicit taxes on savings and consumption are transferred to producers and borrowers.

The obvious result is not enough consumption and too much investment, a decade-long phenomenon that is now driving Xi Jinping's China toward an investment-consumption imbalance reminiscent of Mao Zedong's China. The PRC's large trade and other external surpluses arise from this imbalance and are a destabilizing factor globally.

At the corporate level, subsidies mean that all foreign and private Chinese companies face an unbalanced fight when competing with SOE's in China or other markets. Focusing on American

---

[16] Pierre Pessarossi and Laurent Weill, "Choice of corporate debt in China: The role of state ownership," *China Economic Review* Volume 26, September 2013, pg. 1-16, http://www.sciencedirect.com/science/article/pii/S1043951X13000242 and Henk Berkman, Rebel A. Cole, and Lawrence J. Fu, "Improving corporate governance where the State is the controlling block holder: Evidence from China," *The European Journal of Finance*, June 13, 2012, pg. 1-26, http://www.tandfonline.com/doi/abs/10.1080/1351847X.2012.671784#.UkGqRoashcY

[17] Derek Scissors, "The U.S. Should Be Wary of Fake Chinese Economic Reform," The Heritage Foundation, August 12, 2013, http://www.heritage.org/research/reports/2013/08/us-should-be-wary-of-fake-chinese-economic-reform

[18] Derek Scissors, "The Facts About China's Currency, Chinese Subsidies, and American Jobs," The Heritage Foundation, October 4, 2011, http://www.heritage.org/research/reports/2011/10/the-facts-about-chinas-currency-chinese-subsidies-and-american-jobs

firms, the unbalanced competition is embodied in American imports, American exports to China, and in third markets.

A disproportionate amount of attention, some of it misguided, has been paid to unbalanced competition from imports. Chinese subsidies certainly affect American imports. Measuring this through the bilateral trade imbalance is unwise, however, since it reflects neither value added nor the new phenomenon of Chinese production moving off-shore.[19] More important, even while some American producers suffer, most American consumers benefit from Chinese subsidies in the form of lower producers.

The same cannot be said for American exports. There, Chinese subsidies do nothing than deny sales to American firms and workers. The demand for state dominance leads to regulatory barriers that ensure that exports of American goods and services can claim only a tightly limited share of the market in banking and many other sectors. The same is true for firms operating within the PRC, especially in oil and gas. Financial subsidies cap American exports of environmental technology and other areas of U.S. comparative advantage.

The blocking of American exports is well-established and by far the worst problem but a new area of difficulty is Sino-American competition in third markets. Guaranteed revenue at home from regulatory protection and financial subsidies targeted at overseas expansion make Chinese firms artificially competitive outside the PRC, too.[20]

Not surprising, the main areas for financing are what are labeled strategic industries such as power, transport, and telecom.[21] The Heritage Foundation's China Global Investment Tracker puts Chinese overseas investments from January 2005 through June 2013 at $430 billion. Though their share is slowly declining, SOE's still account for slightly over 90 percent of this.[22] That's another $400 billion in corporate spending that is heavily subsidized. It does not measure up to the amount of spending subsidized at home but it is directly and increasingly salient to American companies and workers trying to compete with Chinese in foreign markets.

The American Response

It is extremely unwise to enter into a subsidies battle with the People's Republic of China. Beijing has myriad ways to intervene in the market, starting with simply telling companies and banks what to do. In 2009, President Obama was frustrated that American banks were not

---

[19] Robert Johnson and Guillermo Noguera, "The value-added content of trade," *VoxEU.org*, June 7, 2011, http://www.voxeu.org/article/value-added-content-trade-new-insights-us-china-imbalance

[20] For an illustration, see Japan External Trade Organization–Institute of Developing Economies, "China in Africa: The Role of China's Financial Institutions," October 2009, at http://www.ide.go.jp/English/Data/Africa_file/Manualreport/cia_11.html (September 27, 2011).

[21] Cyrus Lee, "ZTE receives $20B loan from China Development Bank," *ZDNet*, December 5, 2012, http://www.zdnet.com/cn/zte-receives-20b-loan-from-china-development-bank-7000008321/. For an overview, see China's Superbank: Debt, Oil and Influence - How China Development Bank is Rewriting the Rules of Finance by Henry Sanderson and Michael Forsythe

[22] Derek Scissors, "China's Steady Global Investment: American Choices," The Heritage Foundation, July 16, 2013, http://www.heritage.org/research/reports/2013/07/china-s-steady-global-investment-american-choices

lending more.[23] Chinese banks, meanwhile, were following orders and expanding lending 34 percent. State ownership is the ultimate trump card for subsidies.

Rather than having subsidies envy, the President and Congress should be thankful for their limited authority. American corporate balance sheets have been returning to normal while Chinese corporate debt is worst among major economies.[24] The PRC has doubled local government debt while seeing macroeconomic indicators deteriorate.[25] Chinese subsidies without question hurt individual American companies, but they harm the entire Chinese economy. Promoting competition, not sinking to China's level, is by far America's best response.

The obvious first step is negotiation. This has failed to now. The Strategic and Economic Dialogue (S&ED) is a sensible idea that, for eight years running, has yielded precious little in the way of results. The latest hope for better Sino-American economic relations is renewed talks on a Bilateral Investment Treaty (BIT). But a BIT has only limited scope to deal with internal Chinese policies – at most it will create a few new hurdles to subsidization which can be easily overcome if Beijing desires.

What matters is not the acronym governing talks but the nature of the Chinese government. A pro-market Chinese government will act on its own to enhance competition to some extent. In turn, the U.S. should have a very small number of priorities in negotiations, with reducing regulatory protection first in line. A long list of American demands on scattered issues, formulated to satisfy interest groups here, will continue to be ignored. The U.S. should compile a comprehensive measurement of subsidies to enable concrete bargaining and, more important, objectively measure progress over time. The U.S. should also be ready to offer something of value in return, such as a faster, clearer review process for Chinese investors here.[26]

In contrast, it has proven to be a waste of time to merely negotiate with a pro-state Chinese government. Such a government, such as the one which just left office, will only reduce subsidies if pushed hard, which will require considerable time and effort.

The first step in this case is also a needed action with a Chinese government positively disposed to reform. Though it is dull politically, the U.S. must periodically identify and measure Chinese subsidies, including regulatory protection.

---

[23] Helene Cooper and Eric Dash "Obama Presses Biggest Banks to Lend More," *The New York Times*, December 14, 2009, http://www.nytimes.com/2009/12/15/business/economy/15obama.html?_r=0

[24] Federal Reserve Board, Financial Accounts of the United States, Table B.102: Balance Sheet of Nonfinancial Corporate Business, September 25, 2013, at http://www.federalreserve.gov/releases/z1/current/accessible/b102.htm versus Xinhua, "Corporate debt reaches 'alarming level'," *China.org.cn* May 18, 2012 at http://www.china.org.cn/business/2012-05/18/content_25416137.htm

[25] Liyan Qi and Grace Zhu, "Researcher Puts China's Local Government Debt at $3.3 Trillion," *The Wall Street Journal*, September 17, 2013, http://online.wsj.com/article/SB10001424127887324665604579080683134844374.html

[26] Derek Scissors, "A Better Committee on Foreign Investment in the United States," The Heritage Foundation, January 28, 2013, http://www.heritage.org/research/reports/2013/01/enhancing-the-committee-on-foreign-investment-in-the-united-states-cfius

Measuring the subsidy provided by protection against competition will be difficult and controversial. If it is not done, though, subsidies will be seriously underestimated and considerable harm will continue to be inflicted on American companies and workers, as well as the Chinese and global economies. Including regulatory protection along with capital and other subsidies means that initial estimates will be inexact, but they will improve over time. And measuring subsidies will enable important actions.

A fairly exhaustive measure of Chinese subsidies may somewhat improve bilateral negotiations, or at least clarify their status. Another route is through the WTO. The U.S. has asked for Chinese documentation of subsidies via the WTO but this has accomplished almost nothing, in part because the American inquiry was based on too little information.[27]

Last, if renewed and better informed bilateral and multilateral approaches fail, a rigorous measurement of subsidies is necessary to determine the best unilateral actions. Otherwise American policy risks being ill-targeted or even, if seen as unjustified protectionism, counter-productive.

Pushing China Toward Genuine Competition

In sum,

1) **The U.S. should not engage in competitive subsidization against the PRC.** This will waste hundreds of billions of dollars and achieve almost nothing.
2) **The United States Trade Representative (USTR)**, with assistance from the Department of the Treasury, Department of Commerce, and International Trade Commission, **should immediately begin the process of measuring Chinese subsidies**, featuring regulatory protection and non-commercial loans.
3) **The Department of the Treasury**, with assistance from the USTR, **should make the economic segment of the 2014 S&ED primarily about subsidies.**
4) Failing identifiable progress at the S&ED, the **USTR should petition the WTO** regarding China's failure to disclose the subsidies documented in the USTR-led effort.
5) If these steps fail to change Chinese policy, the U.S. should use the subsidies measurements to inform unilateral actions.

Chinese subsidies are certainly not the biggest challenge for American companies and workers. But they are the biggest international challenge. As a first step, the U.S. can do a far better job of the information gathering and economic diplomacy that can reduce what is become a global threat to the health of American manufacturing.

[27] Office of the United States Trade Representative, Executive Office of the President, "United States Details China and India Subsidy Programs in Submission to WTO," October 2011, http://www.ustr.gov/about-us/press-office/press-releases/2011/october/united-states-details-china-and-india-subsidy-prog