Unique Economic Circumstances of China

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Chinese finance minister, Jin Renqing, announced at the beginning of the month the creation of what will undoubtedly be one of the world's largest investment firms. The newly chartered corporation, to be governed by the State Council, will be endowed, likely gradually, with funds derived from China's massive foreign reserves, the world's largest, most of which are now very conservatively invested in US dollar denominated assets (mostly US Treasury Securities). The widely discussed initiative is especially revealing as to the unique economic circumstances in which China now finds itself. **A Nagging Problem** In China today perhaps as much as 90% of household savings (the accrual of which some observers identify as the locus of China's remarkable economic surge) are deposited in state-owned banks. This effectively provides the government with a monopoly over the "mobilization and deployment of savings in the economy." These savings are then often used to directly and indirectly subsidize China's state-owed enterprise (SOE) sector on whose attendant burdens social stability largely rests. While some SOEs are certainly healthy, vibrant companies, many are foundering as elements of the country's economy are still inextricably bound to development and sustainability strategies devised many years ago and often on faulty or ill-conceived premises that yield uneasily to change. The future employment and pensions of countless current and former SOE employees, not to mention the loan bank's business interests, depend on enterprise perpetuation. This is a fragile system indeed, responsible in large part for China's enormous non-performing loan (NPL) count as well as providing a strong impetus for not creating widespread investment or savings instruments for public use—voluntarily opting for shallow financial markets. As a result of this awkwardly structured banking system, China's healthier, more dynamic enterprises—private non-SOEs—are usually forced to self-finance or receive funding from abroad. These kinds of potentially valuable investment opportunities are not only discouraged but also are usually not possible and instead ordinary Chinese are left to deposit with banks at low interest rates. Some go so far as to call this "financial repression". **A Sensible Solution** If, as it is reasonable to assume, the new agency can manage annual returns commensurate with other sizable public trust/pension funds at roughly 10%, regardless of the fund's initial or eventual worth, it should yield massive returns. Though the investing agency will likely gradually receive funds to be deployed, experts say only about $100 billion of the estimated $1 trillion reserves would be required to defend against a speculative drain and maintain the Yuan's current managed float. Management and disbursement of the fund(s) earnings will be guided at high levels of the PRC government, the nature of which will surely be a source of great public policy interest. Irrespective, however, of the kinds of investments pursued and the degree to which foreign economies are welcoming, a good portion of proceeds will almost certainly (and appropriately so) be used to relieve certain social pressures. The method of such relief could come in many forms. The Wall Street Journal notes, "China has already injected about $70 billion from its foreign-exchange reserves to shore up the balance sheets of state-controlled banks and other financial

institutions." While this is certainly a form, albeit indirectly, of social burden alleviation—welfare for faltering banks—it entirely lacks a remedially focused component. Were investment returns pooled and funneled directly into SOEs themselves, the salutary effects would be manifold, not least of which would enable banks to better do their jobs. **Subsidies for SOEs, Not Banks** Were returns used to assume the social burdens now shouldered by banks, both bank and state interests would then be significantly less wed to SOE perpetuation. If banks could scale back the need to provide the SOE sector its welfare program, they could more freely roam the marketplace for sound investments of a more genuine nature. The SOE sector then, while retaining a welfare source, would simultaneously be treated and consequently forced to act more as private enterprises, the viable ones persist, the nonviable eventually closed down. In this respect, the SOE sector as well as the economy as a whole would be constructively nudged towards innovation, reform and viability without incurring dramatically destabilizing repercussions. This would not only have a tremendously salutary effect on Chinese markets by allowing them to function more efficiently and encouraging transparent accounting, but should also directly benefit ordinary Chinese whose savings could then be deployed more appropriately and garner higher returns. The necessity of the government to monopolize the economy's savings would recede, perhaps even paving the way for the future establishment of and greater participation in more advanced financial instruments.