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From: Sullivan, Jacob J <SullivanJJ@state.gov>
Sent: Monday, October 1, 2012 1:38 PM
To: H
Subject: FW: Tackling the Many Dangers of China's State Capitalism

The below is worth a read.

From: Waterman, Jeremie [mailto:]
Sent: Thursday, September 27, 2012 9:58 PM
To: Waterman, Jeremie
Subject: Tackling the Many Dangers of China's State Capitalism

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A copy of Jim's new book is attached. An e-book is also available for download on Amazon.

WSJ

SEPTEMBER 27, 2012

Tackling the Many Dangers of China's State Capitalism

The biggest commercial problem the U.S. faces today is the pervasive power of China's state-owned capitalism. A new book says the U.S. is getting seriously out-manuevered by the Chinese, and there's little Americans can do about it. John Bussey explains on The News Hub.

Here's an easy bet:

The U.S. won't solve the problems created by China's economic juggernaut until it finds a way to tackle the big issue rather than sideshows like the country's currency rate.

The big issue is China's state capitalism, the tens of thousands of state-owned enterprises that dominate half of China's economic output and that the government heavily subsidizes and protects. Foreign competitors—which threaten these near monopolies—are restricted by government rules, forced to "share" their technology in joint ventures with state enterprises, and denied lucrative government business, which goes instead to the state champions.

'Members of China's National People's Congress have become so wealthy that their meetings may best take place in a bank vault.'— James McGregor

"We haven't faced this kind of problem of this size before," says Robert Hormats, who heads economic policy at the State Department and has raised alarms about China's commercial statism.

If the U.S. needs another wake-up call, it will get one this week with the publication of a bracing account of the danger that China's state capitalism poses to global business—and to China itself. James McGregor's new book, "No Ancient Wisdom, No Followers: The Challenges of Chinese Authoritarian Capitalism," dissects the complex policies and state structures that produced China's novel system. And it describes the limited recourse the U.S. and other nations have. (Full disclosure: Mr. McGregor is a friend and former colleague at the Journal.)

"The Communist Party of China has two unwavering objectives: Make China rich and powerful and guarantee the Party's political monopoly," Mr. McGregor writes. "At the center of this are behemoth state-owned enterprises that dominate all key sectors and have been instrumental to the country's current success.

"As China's global reach expands, this one-of-a-kind system is challenging the rules and organizations that govern global trade as well as the business plans and strategies of multinationals around the globe. At the same time, the limits of authoritarian capitalism are increasingly evident at home, where corruption is endemic, the SOEs are consuming the fruits of reform, and the economic engine is running out of gas."

Born in the 1950s when 10,000 Soviet advisers helped China organize central planning, the state-owned enterprises quickly became bloated extensions of the Party's patronage and power.

They would wane in the days before China's 2001 entry to the World Trade Organization (and access to global markets), when Beijing sought to show it was embracing competition. And they would wax again over the next decade as China reversed course, gorged the SOEs on state cash, and protected them from foreign competition through an array of industrial policies.

Disconnects with the rest of global business multiplied. Mr. McGregor describes how

- China violates international restrictions on subsidies by hiding the funds where investigators can't find them.
- China built China UnionPay, a credit-card payment company, into a monopoly, clipping the activity of foreign companies in violation of trade agreements and retaliating when Visa complained.
- Publicly-listed SOEs keep information from auditors by claiming it's a state secret.
- The Big Four state-owned banks comprise China's inefficient financial system, guiding cash to money-losing SOEs and thus undercutting competitors.
- China's judges are Party-appointed and lack the authority to compel evidence gathering, making it nearly impossible for foreign companies to build a trade case.
- China has delayed for years joining the WTO pact on government procurement, which would restrict the country from discriminating against foreign products.

In fact, Mr. McGregor says China is a master at delaying trade cases, including one involving auto parts, until it has built a competitive bulwark of SOEs. WTO rules, he says, are "ineffective in dealing with the wide range of discriminatory and distorting Chinese industrial policies."

"Because the U.S. market is already wide open to Chinese products," he argues, "U.S. negotiators have no bargaining chips left."

As the state enterprises grew, China's share of world trade rocketed to 10%, corruption flourished, and Party members got rich. Citing Bloomberg data, Mr. McGregor notes that the "wealthiest 70 National People's Congress members are more than 10 times richer than the top 660 officials in the U.S. government."

The enterprises themselves, meanwhile, crowded out private competition. SOEs account for about 96% of China's telecom industry, 92% of power

and 74% of autos. The combined profit of China Petroleum & Chemical and China Mobile in 2009 alone was greater than all the profit of China's 500 largest private firms, Mr. McGregor writes.

An independent Chinese study, he adds, says that if you subtract government subsidies from the biggest SOEs they actually lose money.

Mr. McGregor believes pressures are building within China for change—the result of SOEs that don't innovate enough, slowing growth, an angry private sector, and a pending leadership change, among other factors. Even some top leaders say reform is needed.

"If they don't reform, they'll be the guys who killed the economic miracle," he says on the phone from Beijing. He's optimistic, he says, because the Party has no choice.

That leaves the U.S. playing a waiting game. Not exactly what the world's largest economy had in mind when it led a global campaign in 2001 to welcome China into a modern era of open trade and competition.

— Write to John Bussey at john.bussey@wsj.com; follow [@johncbussey](https://twitter.com/johncbussey) on Twitter