PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

State-Owned Enterprises and U.S.-China Relations

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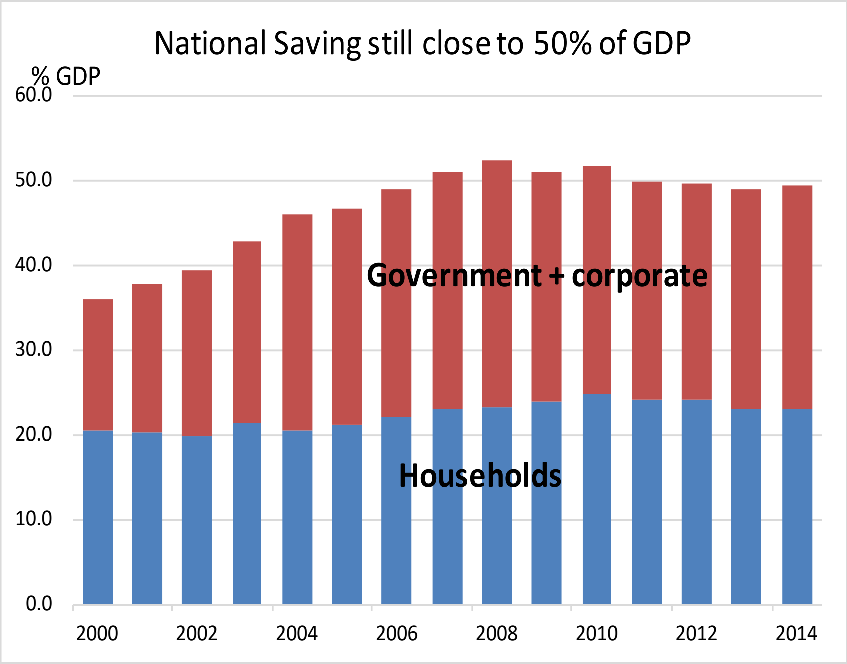
China's SOEs, Our Problem

- Chinese SOEs are more indebted, less profitable and less productive than private firms - but reforms adrift due to Communist Party ideology and vested interests
- Failure to reform SOEs is not only a domestic problem for China: China's SOEs inhibit international rebalancing, distort the competitive playing field, and their outward investment may raise national security concerns for the United States
- Two classes of policy levers:
  - International trade and investment disciplines to induce China to reform
  - U.S. domestic restrictions to limit spillovers to the US market

SOEs inhibit rebalancing

- SOE retained earnings contribute to excess national saving, current account surpluses, and capital outflows
- SOE profits are largely retained or redistributed to other SOEs, not remitted to the Finance Ministry
- 2013 Third Plenum Decision: by 2020, 30% of SOE dividends to be transferred to the budget
- …but share of profits paid as dividends remains low



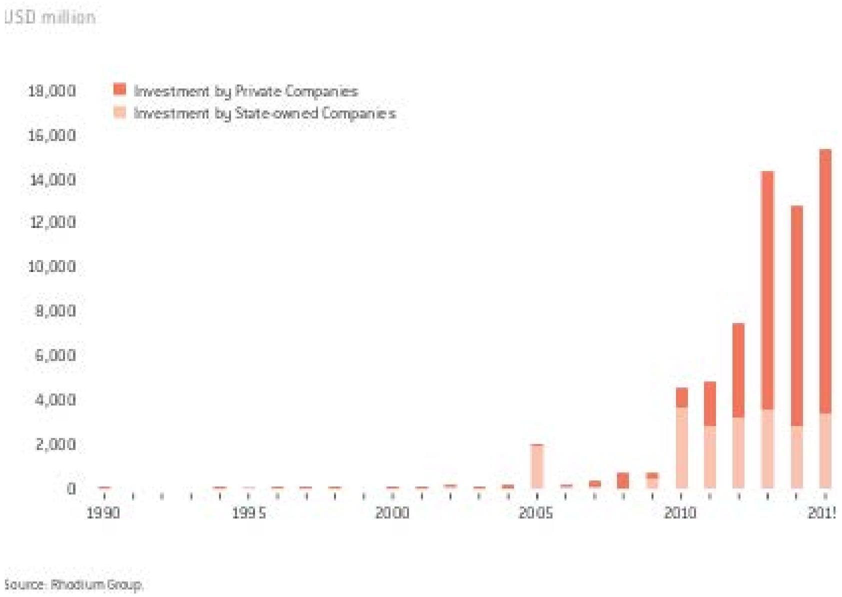
SOEs distort trade

- SOEs in China enjoy privileged regulatory treatment, access to low-cost financing by state-owned banks, and underpriced factor inputs
- …though well-connected private businesses also enjoy “national champion” or “local champion” status
- Soft budget constraints avert exit by loss-making SOEs in sectors with excess capacity, forcing the adjustment on others
- SOE collusion can affect behavior in the US market
- Distorted competitive playing field hurts foreign companies, not only in China but also in their home markets

SOEs raise national security concerns

- China asserts that SOE FDI is commercial, though some deals defy business logic
- SOE investment represents diminishing share of Chinese FDI in the United States…
- …but China's interest in maintaining investment access gives the US leverage
- CFIUS already required to scrutinize "foreign government transactions"; now, there are increasing calls for outright ban

Chinese FDI in the United States



Policy Options

- Two broad approaches to China's SOEs:
  - <u>Encourage China to accelerate SOE reforms</u>, including through WTO litigation and negotiating new bilateral (e.g., US-China BIT) and multilateral (e.g., TPP) trade and investment disciplines
  - <u>Limit the spillover impact of China's domestic distortions on the United States</u>, for example through aggressive use of domestic trade remedies (AD/CVDs), competition policy, and scrutiny of inward FDI by Chinese SOEs
- Obama Administration deployed both approaches
- Early Trump Administration rhetoric suggests domestic enforcement will dominate – but Chinese backlash could strengthen opponents of reform