



Sinology

by Andy Rothman

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- * The most fundamental misunderstanding about the Chinese economy is that it is dominated by state-controlled companies. The truth is that most Chinese work for small, private firms.
- * Private firms account for 82% of urban employment, as well as about 70% of investment and industrial sales.
- * The Communist Party still controls the financial system and many capital-intensive sectors, but most economic growth comes from entrepreneurial, small private companies, just like in the U.S. and Europe.

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ANDY ROTHMAN lived and worked in China for more than 20 years, analyzing the country's economic and political environment, before joining Matthews Asia in 2014. As Investment Strategist, he has a leading role in shaping and presenting the firm's thoughts on how China should be viewed at the country, regional and global level.

This is the inaugural issue of a Matthews Asia publication designed to provide investors with a framework for understanding the Chinese economy and its impact on the global economy. The focus will be on longer-term trends, to help put in context the daily flood of China news. We begin with the first in a series of 'demystifying China' reports, to address some of the major misconceptions about the structure of Chinese economy.

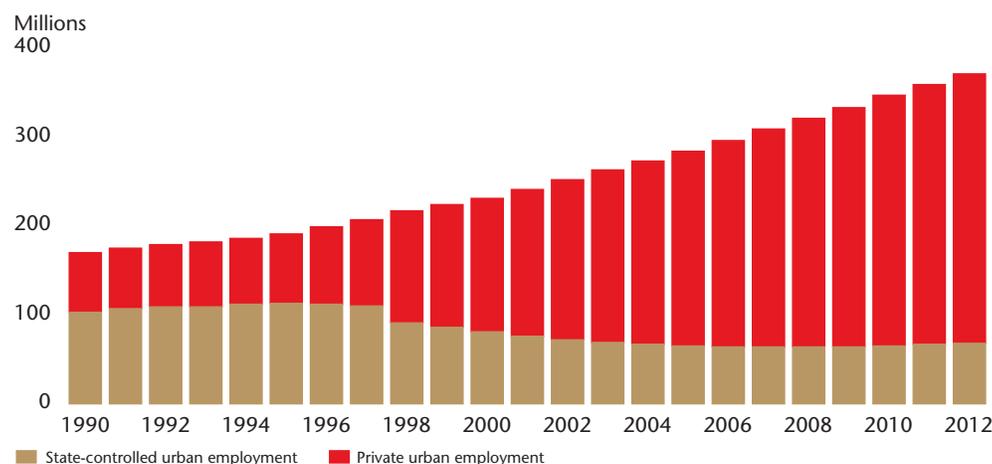
ENTREPRENEURIAL CHINA

The Communist Party maintains significant control over China's economy, but this control is exercised primarily via macro policy rather than through state-owned enterprises (SOEs). Macro policy includes everything from control of monetary and fiscal policy to loan quotas, the minimum wage and subsidized access to land and utilities.

Every significant financial institution is controlled by the Party, and state-controlled firms continue to dominate many of the capital-intensive sectors, such as telecoms, aviation, oil & gas and petrochemicals. But state firms are far less important than they once were. China's economic growth is increasingly driven by entrepreneurial small- and medium-sized enterprises (SMEs).

PRIVATE FIRMS EMPLOY 82% OF URBAN WORKERS

Urban employment by firm ownership



Back in 1958, 86% of urban workers were employed by state firms, and that share remained above 70% through 1989. But between 1995 and 2001, the Party laid off 46 million state-sector workers—equal to sacking about 30% of today's U.S. labor force over six years! As a result, the state share of urban employment fell from 59% in 1995 to 28% in 2002.

Even in 2009, when China undertook a massive economic stimulus, the share of the workforce employed by state firms fell to 19%, versus 20% in 2008. As of 2012, the state share of total urban employment was only 18%, with 82% of Chinese workers at private firms.

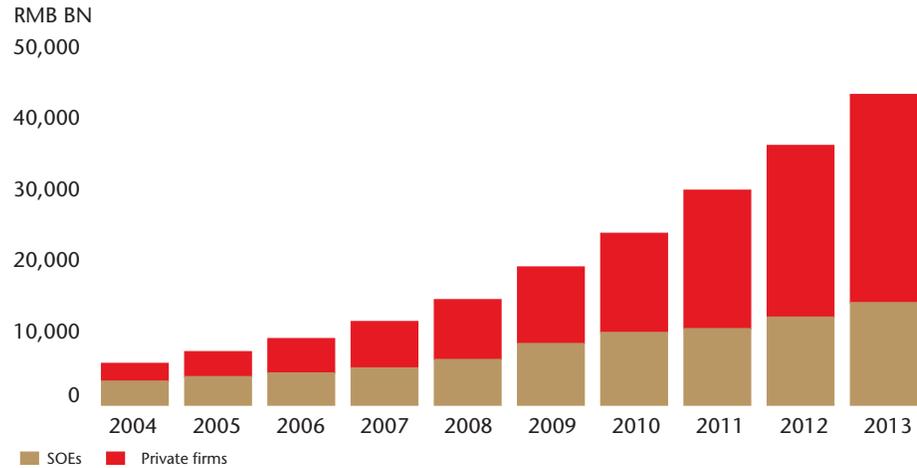


In recent years, almost all new job creation in China has come from private firms. Between 2005 and 2012, employment at state firms rose at an average annual rate of less than 0.1%, while employment by private firms rose 4.7% per year.

PRIVATE FIRMS DRIVE CORPORATE INVESTMENT

We can also see the declining role of state firms when we look at investment. In 2004, the first year where we are able to break out fixed-asset investment (FAI) data by firm ownership, SOEs and other state-controlled firms accounted for 58% of total FAI. That share fell to 43% in 2008 and rose only slightly to 45% in 2009 as a result of the stimulus. But with the stimulus quickly withdrawn, the state-firm share of FAI fell back to 42% in 2010 and 33% last year. In 1Q14, private firms accounted for 70% of fixed-asset investment in China.

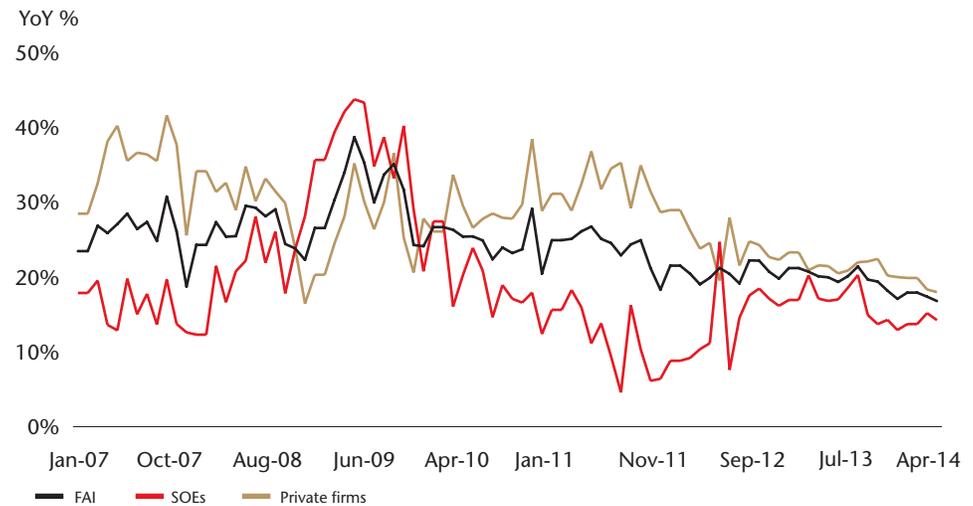
FIXED-ASSET INVESTMENT BY FIRM OWNERSHIP



Source: CEIC

The following chart illustrates that for 49 of 50 months through April 2014, investment by private firms grew faster than investment by SOEs.

GROWTH RATE OF FIXED-ASSET INVESTMENT BY FIRM OWNERSHIP



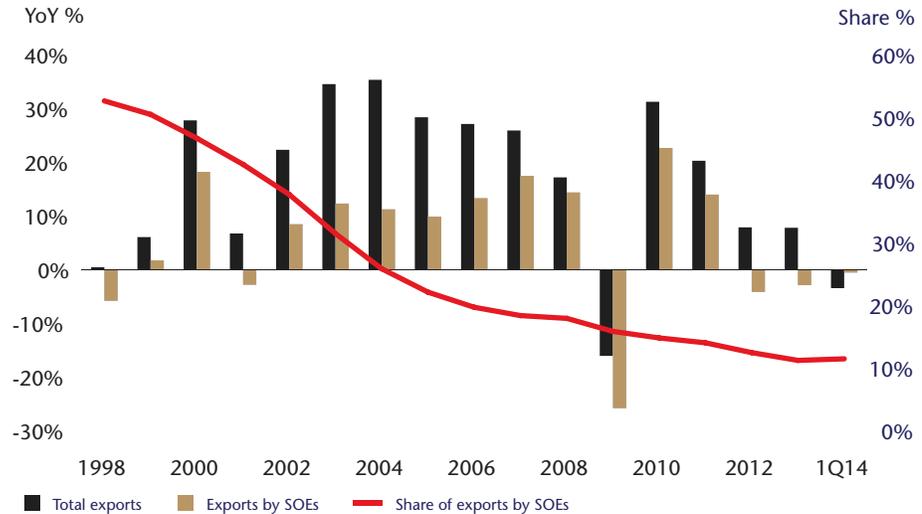
Source: CEIC



PRIVATE FIRMS DRIVE INDUSTRIAL PRODUCTION AND EXPORTS

The SOE share of sales by larger industrial firms has declined steadily, from 50% in 1998 to 34% in 2005 and 25% in 2012. The SOE share of China's exports has also shrunk, from 56% in 1997 to 11% last year (although 47% of all exports are produced by foreign-owned firms).

EXPORTS BY FIRM OWNERSHIP



Source: CEIC

Private companies are also the source of the majority of China's corporate tax revenue. From 2000 to 2009, total tax revenue in China rose 373%, but SOEs accounted for only 15% of tax revenue in 2010, down from a 43% share a decade earlier.

Misunderstanding these trends leads to understating the important role of Chinese entrepreneurs, who are the most dynamic part of the economy and drive its growth.

The Communist Party has shrunk significantly the number of SOEs and reduced the number of sectors where they operate, while scaling up the size of the remaining state firms and limiting competition in those sectors from private and foreign-owned companies. While the Party still plays an outsized role, especially through its control of the financial system, it has turned over most of the economy to Chinese entrepreneurs.

And Chinese private firms, most of which are very small, are similar in size to U.S. private companies. In the U.S., about three-quarters of all business firms have no payroll—most are self-employed persons operating unincorporated businesses. Only about 10% of U.S. firms employ 20 or more workers, and only 2% of firms employ 100 or more.

China's state sector is unlikely to shrink much more in the near term, but most of the country's economic growth will continue to come from entrepreneurial, privately owned firms. This will require the Party leadership to continue making the reforms necessary to create a more market-oriented economy.

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Sources: CEIC and U.S. Census Bureau

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