

A Guide for Supply-Side Reform

Several obstacles must be addressed when further pushing forward the restructuring

By Xu Hongcai | NO. 11 MARCH 16, 2017, Beijing Review.



Workers of Northern Heavy Industries Group Co. Ltd., based in Shenyang, northeast China's Liaoning Province, disassemble a tunnel boring machine to transport it to Sao Paulo, Brazil (XINHUA)



Since the global financial crisis broke out in 2008, one of the major challenges for the world economy is dealing with inadequate effective demand. The Chinese economy is facing this issue as well, but the essence of the problem is that the quality of the supply does not satisfy the demand. The supply side's poor quality has impeded China's plans for economic transformation, upgrading, and growth.

The Central Economic Work Conference held in December 2016 concluded that

structural imbalance is the root cause of problems facing the Chinese economy, calling for further reforms on the supply side.

Last year, China made remarkable achievements in supply-side structural reform—cutting excess capacity, destocking, deleveraging, lowering corporate costs and improving weak links. However, there are still severe challenges remaining: The work of cutting excessive production capacity in steel and coal industries was uneven in 2016, and some shutdown production centers covertly resumed work after product prices soared.

Deleveraging in the real estate market achieved remarkable results, with more than 80 percent of unsold houses in Beijing, Shanghai and Guangzhou being sold. Nonetheless, housing prices in some first and second-tier cities rose rapidly while third and fourth-tier cities still had a large amount of housing inventory. Furthermore, the cost of corporate financing, logistics, energy, land use and transactions is still not low enough to support the transformation and upgrading of the manufacturing industry. Finally, working capital is not adequate in many sectors of the economy's so-called "weak links," meaning coordinated and high-quality economic growth is stymied.

To address these problems, attention must be paid to the following issues when continuing supply-side structural reforms this year.

Correct understanding

Supply-side structural reform is a term that must be well understood. Some people mistake "cutting excess capacity" as "cutting output." Government orders to cut excess capacity could be meaningless under certain circumstances—when prices rise because of drops in output, industries will naturally put their shut-down production capacity into operation again.

For instance, cutting excess capacity in the steel and coal sectors in 2016 had mixed results mainly because steel and coal prices kept rising since the third quarter of the

year. In major steel-producing provinces such as Hebei, Jiangsu and Shandong, output of crude steel increased rapidly amid price surges while in Shaanxi, Xinjiang, Inner Mongolia and Shanxi, China's major coal-producers, coal output also grew.

The government should instead formulate standards concerning energy and resource consumption, pollution, and workplace safety. It should also ensure that everyone adheres to the same standards, order the termination of firms which fail to obey the standards and let the market play its role.

It is hard to demonstrate fairness through compulsory overcapacity reduction. Many people have complained that when ordering firms to cut overcapacity, the government offers aid and subsidies only to state-owned enterprises (SOEs), which have more difficulty in dealing with the ensuing layoff issue, while private firms have to solve these problems by themselves. This ultimately leads to an unfair market environment and competition.

To ensure fairness, the government must formulate rules concerning safety, quality and emission reduction standards, and then ensure that these standards are obeyed by all.

During the reform process, administrative measures are emphasized because they can produce rapid results and are easy to use. But without market-oriented schemes, these measures will soon lose effectiveness.

We must stop using administrative intervention on microeconomic affairs as a way to advance supply-side structural reform. It is reasonable for the government to guide and nurture market schemes in order to solve problems caused by poor quality of the supply side. However, the ultimate goal should be to make the market play a decisive role in resource allocation.

China's Iron and Steel Industry

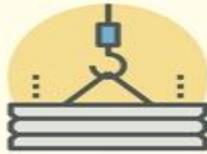
Overall capacity of iron and steel in 2016

1.1 bln tons

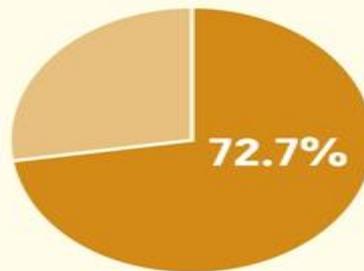
Consumption of iron and steel in 2016

800 mln tons

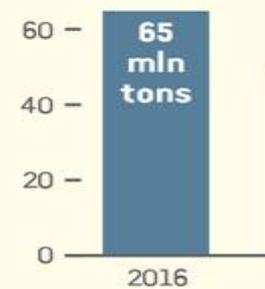
0 100 200 300 400 500 600 700 800



Utilization rate



Cutting overcapacity



(Source: National Development and Reform Commission; designed)

Breakthroughs in key sectors

China's economic growth will follow an L-shape trend, which is in line with the current national condition and economic structure. However, we can unleash more potential by advancing supply-side structural reform. Several examples can be cited. A large number of domestic farm products become dead stock due to poor quality while China imports a large amount of foreign farm produce each year. Also, some Chinese refuse domestic milk for safety concerns and choose to buy milk imported from countries like Australia and New Zealand.

If Chinese firms can achieve breakthroughs in product safety and quality, less will be imported. For example, importing \$10 billion less a year will push up GDP growth by 0.1 percentage point. Moreover, in the heavy and fine chemical sectors, we have to pay \$500-600 billion per year for imports because of the poor quality of domestic products. China must upgrade its industries and make breakthroughs in some key sectors.

According to the Central Economic Work Conference held in December 2016, supply-side structural reform also includes invigorating the real economy, advancing supply-side reform in agriculture and establishing long-term mechanisms to ensure sound and stable real estate development. It requires that progress be made in some key areas of reform. For example, in the seven sectors of SOE monopolies such as the power, oil, natural gas, railway, aviation and defense industries, mixed-ownership reform should be facilitated.

Shifting leverage

Debt-for-equity swaps will be promoted in 2017 because the corporate debt ratio is too high, which may intensify potential financial risks. Corporate leverage ratios must be lowered. However, as China strives to stabilize growth, the leverage ratio of the entire economy will inevitably rise. Therefore, the transfer of leverage is needed.

On one hand, the public sector, the government and residents need to increase leverage; on the other hand, businesses will be better off through debt-for-equity swaps, as the scheme will help introduce new strategic investors, improve the ownership and corporate governance structure, and establish medium and long-term incentive mechanisms—all of which are key areas for reform in 2017.

In brief, the supply-side structural reform should focus on improving quality, reducing ineffective supply, and making the supply structure more adaptable to demand.

Reducing ineffective supply helps eliminate poor-performing companies, squeeze the market for low-quality products, strengthen oversight of product quality and crack down on counterfeit commodities. Focusing on higher-quality production helps companies establish core competitiveness, realize innovation-driven growth, and nurture more time-honored brands.

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