

Privatization or Inflation

By GENG XIAO

HONG KONG — In order to understand the inflation problem in China, one can imagine the country's centrally planned economy is one, giant, unhealthy firm.

The only way it will regain health is if it makes some money by spinning off parts of itself to private individuals who can run the parts more profitably. The giant firm will make money in the initial sale, and if it maintains a minority interest in the parts it sells off, it will also do well by them as they become healthier and more profitable.

This firm called the Chinese state sector has since 1949 been taking on enormous amounts of debt that will come due at some point in the future. The liabilities take the form of socialist poverty-reduction programs, infrastructure projects, unemployment compensation, pensions, housing, medical care and all the other ingredients that have gone into the iron rice bowl of each of China's millions of state employees.

Add to the right hand side of the balance sheet all the deposits in China's state banks; they are also debts, owed by the banks to China's diligent savers. The government cannot let those banks fail even if the depositors' money is nowhere to be found.

Top off the liabilities with the expensive government institutions that a massive centrally planned system like China has had to set up since it began to open itself up to the world two decades ago. Legal institutions, tax structures, policing and regulation—all these cost money.

Yet it's money that China has less and less of. This giant firm is losing actual as-

sets as well as asset value at an astounding pace through corruption, policy mistakes, mismanagement and currency depreciation. Other assets are privatized illegally—sold off by company bureaucrats who pocket the money. That's not to mention the assets that China has sold knowingly, those it has watched disappear as state monopolies have given way to private competitors and importers, or the foreign exchange Chinese state firms have

of the asset side of the balance sheet, through the hands of state-firm managers, into the non-state sector.

In fact, the imbalance is not a flow problem but rather a "stock" problem, accumulated over forty years. Research that a colleague and I are doing shows that the problem demands a one-time adjustment on the asset side in order to be resolved. The adjustment is called dramatic ownership reform.

In theory China should sell almost everything off. And of course it should cut back on its accumulation of debt. But here is how my colleague and I would make the privatization not only correct but also palatable to the assets' current owner, the Chinese state: In practical terms, China should reduce its holding of assets to a fraction of what it holds today—say, to 30%. The state should become at most a minority shareholder in the enterprises and banks it now controls, and it should remove itself as far as possible from the firms' decision making.

The private owners with majority control can hire good managers and run the enterprises and banks effectively. The market value of the state-owned assets will increase thanks to the better management and private ownership. And the state can free-ride on the success of the individual owners. As long as the Chinese economy is growing, the diversified state-owned assets will appreciate, and thereby solve the state's asset-liability imbalance for once and for all.

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lost because of cheaper world prices for the goods they export.

China's asset-liability imbalance is not just a cash flow problem in which recurring debts can be covered by tax revenues and the like. However, that's how China has been trying to cover the liabilities—the giant firm prints money and borrows both at home and abroad.

Treating the asset-liability imbalance as a flow problem tests Chinese citizens' tolerance for inflation. The loans push against the limits of China's repayment capacity. Furthermore, when the banks loan the state firms money, say to boost productivity, the money instead leaks out