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BY JOHN JULLENS

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Just a few days into 2016, China's stock market was back in the headlines. The CSI 300 index plunged 7 percent on January 4, triggering the government's new circuit breakers, which suspended trading. On January 7, trading was halted again, this time only a half hour after the market opened. Predictably, Beijing intervened by injecting billions into the interbank market, directing state-controlled funds to buy shares, postponing the expiration of its recent selling ban on major investors, and supporting the yuan. And just as predictably, global markets overreacted almost immediately, sparking a sell-off eerily similar to last summer's meltdown.

In reality, China's markets are largely disconnected from the real economy and are a poor leading indicator. Their total market value represents only about 40 percent of GDP, and individual retail investors account for as much as 90 percent of daily transactions. In addition, traded stocks are heavily skewed toward the manufacturing and construction sectors, and Chinese firms rely far more on the banking system to raise capital.

Nevertheless, all is obviously not well in China. GDP growth has slowed significantly, debt levels are still increasing, and capital efficiency is unacceptably low. At the same time, overcapacity has reached dangerous levels in sectors such as steel, glass, and cement. And although it continues to exercise strong systemic control over the economy, Beijing is rapidly depleting its cash reserves as it tries to prevent the yuan from devaluing too quickly. As a result, most mainstream economists believe that China urgently needs to "rebalance" by implementing structural reforms and moving to a more market-based economy.

An October 2015 presentation by Tepper School of Business professor Marvin Goodfriend to the Federal Reserve Bank of New York sums up the conventional wisdom: "China is facing a severe macroeconomic adjustment problem…[and] must reduce its excessive dependence on investment as the main source of aggregate demand…. The heart of China's problem is its exceptionally low share of private consumption…. Unless consumption can pick up the slack in a timely manner, the requisite contraction of investment would precipitate a recession."

That is technically true, but also a little misleading. Consumption as a share of GDP is indeed unusually low, but only because the main economic driver of China's growth over the past decade has been capital investments in industrial capacity and physical infrastructure. In fact, retail sales in China are estimated to grow 10.7 percent this year; certainly not enough to offset the decline in industrial output, but clearly far from problematic. Even though Chinese families hoard much of their rising incomes (in response to the absence of a compre-

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hensive social safety net), low consumer demand simply isn't the problem most economists believe it to be.

Ultimately, a country's economic health is a function of the type and strength of its domestic companies. In other words, a national economy's institutions and policies should create an environment that stimulates the formation, development, and global competitiveness of its domestic companies over time. For a desperately poor, mostly agrarian economy, such as China's 30 years ago, that initially means implementing various rural improvement measures to migrate subsistence farm labor into low-cost manufacturing for export markets.

But now that even China's vast supply of surplus farm labor is disappearing and costs are rising, domestic firms have begun to lose business to cheaper countries, such as Vietnam and Thailand. Thus the real underlying challenge for China is how to upgrade its industrial base, from manufacturing most of the world's shoes, toys, and other labor-intensive, low-skill products into more capital- or technology-intensive products, such as cars or medical equipment, and services.

Of course, it isn't easy to elevate a developing economy's industrial base and compete head-to-head against the West's far more experienced and capable world-class firms. In fact, only a handful of countries have successfully managed this, and none with China's scale, complexity, and systemic impact on the world's economy. What should Beijing's policymakers do? In addition to addressing endemic corruption and serious environmental concerns, China needs to take three critical steps to avoid getting ensnared in the dreaded middle-income trap while simultaneously maintaining economic and political stability:

1. Continue to grow the services sector
2. Remove constraints on the private sector, and redirect investment toward higher value-added activities
3. Implement reforms of state-owned enterprises (SOEs)

China is actually making progress against the first two objectives. For example, the services sector has grown steadily and now represents more than 50 percent of GDP. Similarly, China is implementing a series of initiatives, such as tax reform and better credit access for small businesses, and is making substantial investments in numerous new and green technologies.

However, much less progress has been made in improving the competitiveness of the thousands of SOEs that still make up roughly 40 percent of China's GDP. Most economists prefer privatization, but for various reasons, Beijing doesn't want a Western-style, asset-light balance sheet. That's actually fine; state control of strategic sectors can be advantageous during a developing economy's catch-up period. However, those assets must then be well managed — and that's where China has fallen short. Instead of simply protecting SOEs indefinitely, Beijing's focus should be on administering a healthy dose of tough love.

First, China needs another round of SOE rationalization similar to then Premier Zhu Rongji's draconian program in the late 1990s, which spurred China's entry into the WTO and its subsequent global economic rise. Such rationalization programs may be even more difficult to implement today, often requiring mergers instead of outright liquidations, but nevertheless must be completed sooner rather than later.

Second, SOE management itself must be overhauled. Recently announced "supply-side" reforms, including mixed ownership, are a promising first step. But they don't go far enough, as many SOEs still lack advanced managerial skills, for example, in marketing and strategic planning. In addition, executive incentives need to be more clearly focused on improving firm competitiveness instead of meeting local political objectives or advancement in the party hierarchy.

Finally, the remaining SOEs have to develop truly world-class capabilities and integrate them into a coherent and differentiated capabilities system. They must decide how to progress from relying primarily on state protection and country-based comparative advantages, such as low-cost labor, to developing their own firm-specific competitive advantages, and whether to fill existing capability gaps through external contracting, internal development, or M&A.

China's greatest challenge may be a lack of consensus on the best way forward. The New Right favors pro-market reforms whereas the New Left advocates a return of the state, which may explain recent policy inconsistencies and the lack of coordination between the interventionist securities commission and the more market-oriented central bank. Ultimately, much will ride on the political courage and business acumen of China's leaders. Let's hope President Xi is up to the task. +

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