The Economist

Entrepreneurship in China

Let A Million Flowers Bloom

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China is often held up as an object lesson in state-directed capitalism. Yet its economic dynamism owes much to those outside the government's embrace

IT IS Sunday January 2nd, a national holiday, in a medium-sized Chinese city, just north of the Taiwan Strait. The temperature is well below freezing. There is no heating in the factory, which makes components for electrical tools. This probably reflects frugality rather than a ban, imposed by Mao Zedong, covering every building south of the Yangzi River. A thin haze of winter light comes through the windows. The only other sources of illumination are flickering cathode-ray computer terminals, which make silhouettes of the heavily clad workers sitting at them.

Down the corridor, in a huge office even colder than the main floor, the company's president sits at the head of a low table surrounded by friends. His hands are too busy to shiver, plucking tiny cups out of boiling water and making tea with a jumble of strainers and clay kettles. The cups are passed around, returned, and passed again, providing little jolts of warmth.

The friend to his left has his own company, also making tools: the two of them are links in China's vast, fast-expanding production line. Another man, possibly an official, is just leaving, having concluded discussions about a new factory. A fourth, who runs a private investment firm, explains why work goes on even during a holiday by citing the title of an American film: "Money Never Sleeps."

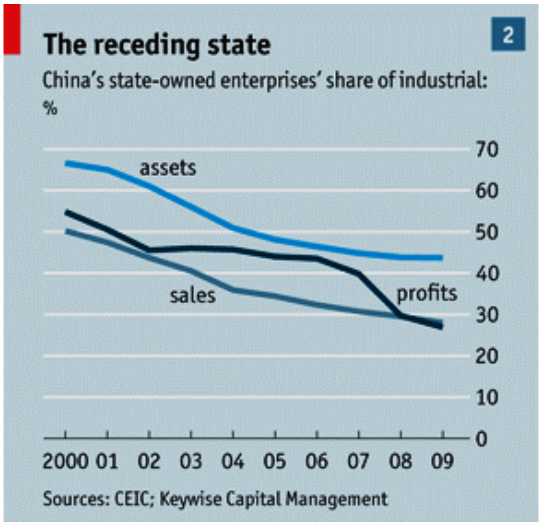
Each of the three businessmen at the table grew up in families which struggled even to afford food; each now owns at least four luxury cars. The results of similar stories can be seen outside other factories, where work also seems to be going on: in the car parks are BMWs, Jaguars, Land Rovers, Mercedes and Porsches. The prices of nearby flats equal those in the richest Western cities. And Chinese money is buying not only cars and property, but also the tractors and backhoes that are preparing the ground for a new lot of buildings.

The twilight zone

Luxury goods notwithstanding, wealth is created quietly in Zhejiang's cities and other places that not long ago were wretchedly poor. None of the people interviewed for this story wanted to be named. Their companies tend to be small and privately owned. They make ordinary (but increasingly good) products under their own names, or sophisticated ones under the strictest anonymity for well-known foreign companies which demand silence as a condition of doing business.

Of the foreigners' many demands, this is likely to be the most welcome. The right of China's private companies to exist is by no means clear. Private companies with more than eight employees began to emerge only in 1981 and were not officially sanctioned until 1988 (the number was drawn from an essay by Karl Marx on an inflection point for the creation of a rentier class); and China has a brutal history of ideological retreats. Today's entrepreneur can become tomorrow's convict. Best, therefore, to avoid too much attention.

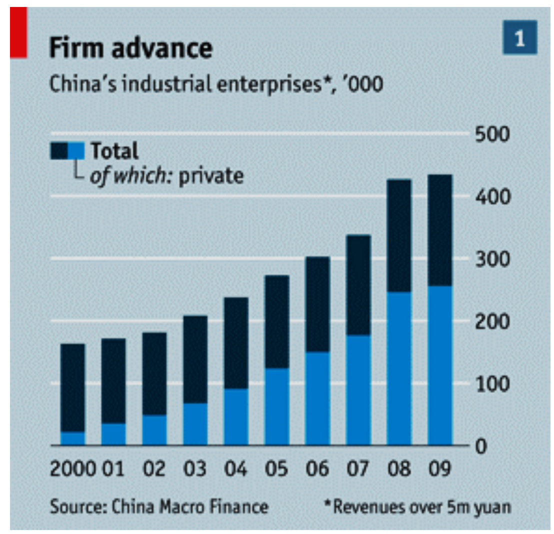
Not all China's private businessmen are as reticent as the quiet men of Zhejiang. A handful of private entrepreneurs, it is true, have won the backing of the state in the form of finance or legal forbearance—and with it a bit of fame. This reinforces the common belief that China's economic success is an object lesson in state capitalism. The government owns the biggest companies: as the economy grows at double-digit rates year after year, vast state-owned enterprises are climbing the world's league tables in every industry from oil to banking. Yet alongside the mighty state engine myriad smaller ones are whirring—and probably more efficiently.



China's state-controlled entities are not particularly profitable. A study by Qiao Liu, a professor at the University of Hong Kong, concludes that the average return on equity for companies wholly or partly owned by the state is barely 4%, despite the benefit of cheap leverage provided by government-controlled banks. According to a recently published paper by Mr Liu and a colleague, Alan Siu, the returns of unlisted private firms are no less than ten percentage points higher.

Another sign of the economic energy of the private sector can be found in its rate of growth. According to China Macro Finance, a research firm in New York, the number of registered private businesses grew by more than 30% a year between 2000 and 2009 (see chart 1). The gross figure (ie, before netting off firms that closed) was at least seven percentage points higher, estimates Ronald Schramm, China Macro Finance's managing director.

These figures exclude unregistered businesses, among them the country's ubiquitous tiny offices and manufacturers. Millions of people trade through electronic platforms like Taobao, which is intended as a site for individuals but has listings for transactions involving volumes that could not possibly be for personal consumption. At a conference in November Zheng Yumin, the Communist Party secretary for Zhejiang's commerce department, said that there were 43m companies in China, 93% of them private, employing 92% of the country's workers.



No one knows quite how much private companies contribute to China's fast-growing economy. Chinese firms fall into a bewildering variety of legal categories and their respective contributions to GDP are not reported in official statistics. However, enterprises that are not majority-owned by the state account for two-thirds of industrial output, according to the latest figures from the National Bureau of Statistics. And according to Eva Yi of Keywise Capital Management, a hedge fund, such firms account for about 75-80% of profit in Chinese industry (see chart 2) and 90% in non-financial services. Jun Yeop Lee of Inha University, in South Korea, calculates that enterprises not majority-owned by the state contribute about 70% of GDP, assuming that they account for all agricultural output and two-thirds of services.

The significance of the private sector, though, lies in its vibrancy rather than in precise measures. For a state-directed country, much of China's success comes from businesses that thrive in large part because they operate outside state control.

From nothing

It is commonly said that Zhejiang's greatest contribution to its citizens—and ultimately to China's economic resurgence—was to provide them with nothing and to cut them off from outside help. The province's topography comprises mostly mountains and rivers. Until fast trains, highways and airports were built over the past 15 years, access was poor from everywhere except Taiwan. That made it, viewed from Beijing, the wrong place for public investment. As a result, what business did exist was largely private, and meagre in the extreme.

Zhejiang's first successes came in the collection and recycling of four unlikely commodities, says Raymond Ma, who grew up in Wenzhou, the province's best-known city, and now heads China research for Fidelity, an international fund-management company. These were used packaging, plucked chicken feathers, tattered cotton and spent toothpaste tubes. The cotton, for example, would be picked apart and "refreshed" into new garments. This trade eventually spread beyond the province's borders and laid the foundations for other, more dynamic businesses. Governors sent from Beijing would invariably begin by attempting to impose state control, but gradually accepted private enterprise as the only way to eke out growth.

As China came out of its Maoist gloom, Zhejiang's scrappy entrepreneurs had already acquired, in the least auspicious circumstances, a culture of opportunity and a belief that anyone could become successful. These would prove to be extremely useful assets.

The anecdotes are almost endless. A Wenzhou businessman who is now ensconced in an office with an elegant address (but no heating) in Shanghai dropped out of high school in the 1980s. A relative lent him 30 yuan (then less than $10) which he paid to an agent for a job in a shoe factory at less than 300 yuan a month. From shoes he went on to electronics, from electronics to selling building materials, from selling building materials to manufacturing them. Today he employs 1,300 people.

Another native of Wenzhou, also now in Shanghai (but who chose to meet in a heated coffee shop), left school at 16 and borrowed 360 yuan. That bought two noodle-making machines and a ticket for a 30-hour rail journey to a remote area of China, rumoured to be untapped territory. He sold the machines for 480 yuan. More orders followed. The business grew for six months, and then competition entered: it was time to start again. Selling buttons came next; then trading in scrap that could be used to make them; then factories to produce plastics for buttonmaking (and later for watchmaking). Now he is searching the world for machinery to create the high-grade plastics used in LED screens.

The focus on business often came at a high personal cost. A woman who began as a primary-school teacher in Wenzhou on 30 yuan a month moved to a slightly better-paid job in a textile factory. She then became a printer, clothing exporter, property developer and, most recently, wine importer. She is by any measure a tycoon. Along the way she sent her children to Europe when the elder one was ten, to live with a sister who handles overseas sales. The means to support them were in China; their lives would be better in France.

China's entrepreneurs were quick to shift into exports. State-approved trade fairs, notably one in Guangzhou, used to be rare opportunities to meet foreign customers. Now there are many more chances. In 1982 Yiwu, a city on Zhejiang's northern border, opened a permanent trade centre that in the past dozen years has become popular with foreign buyers. It is one of the largest indoor markets in the world, claiming 140,000 outlets. They line the sides of narrow corridors, their doorways overflowing with bales of wire, crockery, wrenches, lights, cutlery, pens, toys, tools, ornaments for the world's holidaymakers and even newly manufactured Middle Eastern "antiques". Across the street are *halal* restaurants for the many Arab customers.

A family multinational

The foreigners in Yiwu come to buy; increasingly, the Chinese are going abroad to sell. At the forefront are families like Natasha's. Natasha lives in southern China with her child and husband, a petroleum engineer. Her sister graduated from a Chinese university and found herself, like many students, jobless but ambitious.

In 2004 a Yiwu-like market was opening in Dubai. With Natasha's help the sister found on the internet a local marble producer, with an annual turnover of 1m yuan, who wanted a Dubai representative. Off the sister went; a younger sister followed later. The family outlet in Dubai added a finishing factory and Natasha's sisters donned headscarves and whatever other conservative garments were required to make sales calls to Iran, Lebanon, Syria and elsewhere. Recently, in response to clients' requests, marble slabs from Italy have been added to the product line. Another client needed bathrooms and kitchens, 200 units at a time: sourcing those in China became Natasha's job. Turnover for the Dubai office rose above 100m yuan, fell by half during the financial crisis but then rebounded to a higher level. Within seven years, therefore, a few young Chinese women have created a small, diversified, multinational company.

They would not consider themselves unusual. There are now more than 4,000 Chinese enterprises selling through the Dubai Dragon Mart; many of them have expanded their operations to Africa and Latin America.

The capital mystery

Like any growing venture, China's private businesses need capital, and in much bigger amounts than 30 yuan for a job agent or 360 yuan for a couple of noodle machines. Its sources are a bit of a mystery: largely unofficial, even secretive. Very little seems to come from the big, state-owned banks, although China's government has made increasingly loud noises about small firms' need for finance. Loans to small and medium-sized enterprises comprise 4% or less of the total made by three of the country's four largest banks, according to company reports.

A few other smaller institutions have begun to emerge. Zhejiang Tailong Commercial Bank, a privately owned lender, has grown at a rate of more than 40% a year making smallish loans (averaging 500,000 yuan, or $76,000). It has imbibed the same entrepreneurial spirit as its clientele, employing workers in two shifts to maintain office hours of 7.30am to 7.30pm, seven days a week. But it is an exception.

That leaves a huge gap, which has been filled by an unofficial system that is discerning, vibrant and (depending on the authorities' sentiment of the moment) even illegal. According to research by China's central bank cited by *China Daily*, a state-run, English language newspaper, 89% of Wenzhou's population and 57% of its enterprises have borrowed outside the banking system, paying interest rates of 10% for 30 days or 214% for a year. (Established businesses say rates of 1.5-2% a month are common.) Although the scope of this form of finance is not known, a Wenzhou businessman reckons that there are 100,000 people in his city who could each raise up to 1 billion yuan within 48 hours. So liquid is the system that, unlike private-equity groups in the West, Chinese partnerships often do not raise money before seeking prospective investments; investments are found and then partnerships are formed in short order.

A Westerner with family ties in Fujian province, to the south of Zhejiang, says he is constantly presented with opportunities. He rejects many of them, most recently one in importing second-hand women's handbags (because criminals may have been involved) and another in exporting hair extensions to Japan (too complicated), but he has embraced others, notably in coal (which doubled his money in a year). The system is entirely informal. Records, he says, are minimal and all investments are in cash. A by-product is a proliferation of vast steel safes in homes and offices.

This freedom from financial bureaucracy should not be underestimated. Transactions can unfold at breathtaking speed. Within three months, this Westerner said, his relatives had been involved in the purchase of one steel mill and, in a separate deal, the sale of another. Businesses can be created or liquidated overnight. Rather than pay taxes, he adds, many companies make nominal payments to the local government. This is particularly true of Chinese based abroad, who move quickly from one country to another as opportunities, often tied to Chinese exports, arise.

Nevertheless, this form of business has inherent limits. To the extent that firms operate outside the law, they are vulnerable to shakedowns from local officials and mood-swings in Beijing. Although success brings praise, too much of it can invite envy and scrutiny. Each new list compiled of China's greatest tycoons is often accompanied by stories about those on earlier lists who later fell foul of the law. In his remarks last year Mr Zheng, the provincial party official, said that the significance of private business was not understood: businessmen were often criticised (perhaps a veiled reference to being jailed) without good reason and if continually squeezed, would emigrate, sapping China's vitality. The prospect of expropriation undermines the willingness of these entrepreneurs to make the long-term investment needed to develop brands, novel products and capable middle-management.

One method used to bring private companies into the mainstream appears to be the sale of shares in a public offering. In the West, offerings of shares on a stock exchange are used to raise capital, to provide cash to the initial investors, to create a currency to buy other companies and perhaps to provide independent valuations and external discipline. All this may be true in China too. But share offerings play another essential role: they legitimise a company.

Before an offering, it is not uncommon for a company to fail on any number of legal standards. It may not have full title to the land on which its factories sit. It has almost certainly avoided taxes. The process begins with bringing accounts into conventional forms, repaying taxes or paying for the land. The money for this, says an experienced banker, often comes from a "pre-IPO" offering to a small group of investors. These are perceived to be hugely lucrative to financial institutions, but vital to issuers. The resulting company is then deemed clean enough to pass a rigorous government inspection. Share sales usually happen only once: secondary offers, though common in other countries, are rare.

According to Mr Liu and Mr Siu, listed private companies continue to be more profitable than listed state-owned enterprises. However, their returns on equity are nothing like as good as those of unlisted private firms. This not only underscores the importance of China's upstart businessmen, but also raises questions about how Chinese enterprise will evolve. It is possible that returns dip simply because companies use share issues to load up on capital, and hence overcapitalise themselves and depress returns on equity, at least in the short term. It is also possible that they go public only when their best days are past. Another, more pessimistic, possibility is that as the Chinese private sector grows, comes under scrutiny and adopts commonly accepted structures, its vitality will diminish.

It is often said in China that a new economic era has recently begun, described as *guo jin min tui*: state advances, private retreats. The government has reasons for such a change: it is tightening laws, building infrastructure and providing strategic guidance it considers necessary for the country's next steps. Many in the West applaud the expansion of the government's sway, believing in the wisdom of the state in pushing China's economy forward. But behind China's remarkable success has been an odd and often unappreciated experiment in laissez-faire capitalism.