CHINA ECONOMIC UPDATE JULY 2016

Taming the beast – the challenges of reforming China's state-owned enterprises

NAB Group Economics

Last month, we highlighted our concerns around the slow pace of China's broad reform agenda since 2013's Third Plenum. Despite decades of change, China's State-Owned Enterprises (SOEs) are a specific segment of the economy that still requires substantial reform. While the role of SOEs has generally declined across recent decades, they still control a significant share of the economy – varying by sector – and have considerable financial and political influence, which poses challenges to the reform process.

A BRIEF HISTORY OF SOES AND REFORM

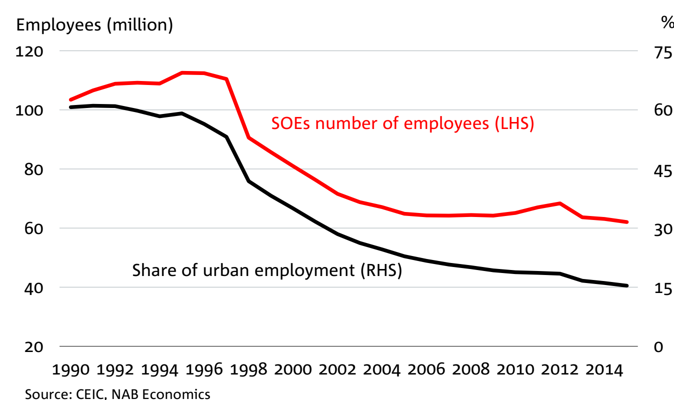
Until the reform period that commenced in 1978 under the leadership of Deng Xiaoping, the entire Chinese economy was state-controlled – largely inspired by the Soviet economic model following the establishment of the People's Republic. The first wave of SOE reform largely occurred during the 1980s, but was comparatively minor, providing management with greater autonomy and allowing firms to sell excess production (above their mandated quotas).

The 1990s saw more rapid reform of firms – particularly in the second half of the decade – under the principle of 'grasping the big, letting go of the small.' The central government retained broad control and merged some of the largest and most influential SOEs, while local governments were permitted to restructure smaller SOEs – with some retained, while others were merged, privatised, formed joint ventures or were forced into bankruptcy. In addition, SOEs faced increased competition in some sectors – with both private companies and foreign firms permitted for the first time (albeit with a range of regulatory restrictions).

Across this period, mergers, corporatisation (separating the ownership and management of SOEs) and partial privatisation (typically mixed ownership with the state remaining the primary shareholder) reshaped the structure of the broad sector, with a goal improving the efficiency, profitability and governance of firms. These changes had a substantial impact on workers – with estimates that over 35 million jobs were lost from SOEs between 1995 and 2002. In addition to the loss of employment, these workers also lost a range of benefits, such as guaranteed pensions, healthcare and housing provisions. The socio-political fallout from these changes in part explains the subsequently more conservative approach to SOE reform.

SOE EMPLOYMENT

Sharp cuts in 1990s triggered social turmoil



Source: CEIC, NAB Economics

Consolidation of SOEs continued across the first half of the 2000s – with the total number of SOEs sharply declining – from over 260,000 in 1997 to around 110,000 in 2008. Administration of centrally owned SOEs changed significantly over this period, with the establishment of the State-Owned Assets Supervision and Administration Commission (SASAC) in 2003, taking control of key central SOEs from individual government ministries and organisations.

In 2006, the State Council classified SOEs by their industrial sectors, such as 'strategic' (defence, electricity, petroleum, telecommunications, coal, aviation and shipping) – where it sought to retain full state control – 'pillar' (machinery, electronics, information technology, automobiles, steel, non-ferrous metals, chemicals and construction) – where

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it sought strong influence for SOEs – while other sectors would be exposed to greater competition.

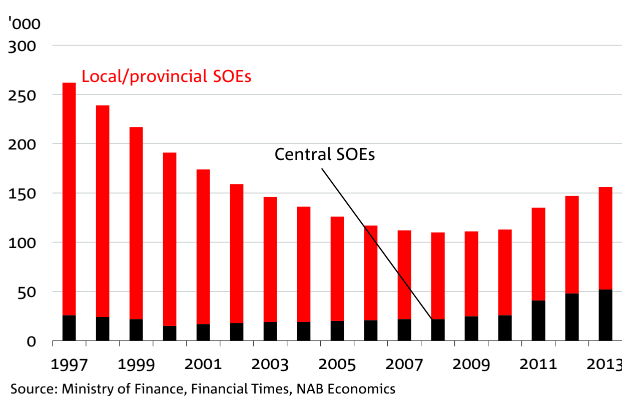
The general influence and importance of SOEs gradually declined across much of the 2000s, as private firms recorded stronger growth in investment and revenue. However this changed with the GFC, as the government directed SOE banks to expand lending to SOE firms, contributing to the development of excess capacity across a range of industrial sectors. Since the GFC, both the total number of SOEs and (by some measures) the level of SOE employment have increased. Much like reforms to the financial sector and capital account, the global volatility generated by the GFC may have cooled reformist sentiment in favour of stability.

THE CURRENT STATE OF PLAY

Multiple decades of reform to China's SOE sector has transformed the shape of the country's economy. Today there are around 155,000 SOEs, the majority of which are controlled at provincial and local government levels. There is considerable variation between these firms – some are comparatively small, operating only in their local areas, while others are of an international scale. The Fortune Global 500 list – which features the top companies by revenue – features 76 Chinese SOEs in 2015. Three SOEs – Sinopec, China National Petroleum and State Grid – were among the top 10 – highlighting the sheer scale of China's top tier SOEs.

TOTAL NUMBER OF SOES

Upward trend since the GFC



Source: Ministry of Finance, Financial Times, NAB Economics

At an industry level, SOEs remain concentrated in secondary sectors – manufacturing, construction and utilities. Data on the attributes and performance of SOEs outside these sectors is patchy at best – making comparative analysis difficult between private and SOE firms.

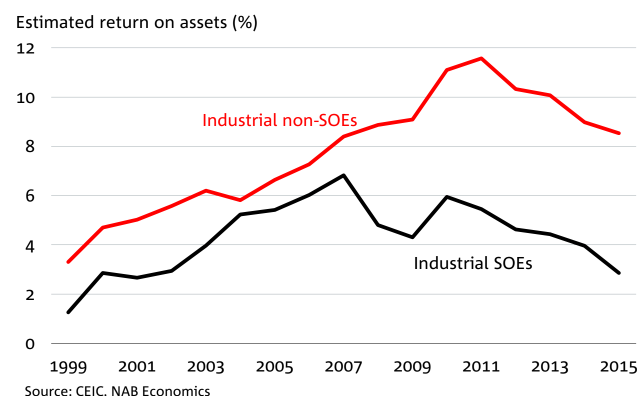
As a result, the actual contribution of SOEs to China's economy is somewhat unclear – with estimates that SOEs share of GDP ranging anywhere from 20% to 40% – however it is generally accepted that SOEs are a drag on economic growth, given institutionalised inefficiencies and the negative effects of barriers to entry for private firms.

A key barrier remains preferential access to finance. In 2014, SOEs accounted for almost 48% of enterprise loans, often with superior terms to those available to private sector firms. This allows so-called zombie firms to continue to operate – firms that are essentially insolvent but continue to operate under an implicit government guarantee – with banks rolling over existing debt with new loans. This has been a major factor in the growing gap between debt and GDP growth rates – expanding the level of debt to high levels.

Despite preferential treatment, SOE profitability lags the levels of the private sector. In the industrial sector – where comparisons are most easily made – the estimated return on assets for SOEs was around 2.9% in 2015, compared with 8.5% for non-SOEs. Returns have declined for both categories over the past four years, as economic conditions have slowed.

RETURN ON ASSETS

SOEs lag private sector firms



Source: CEIC, NAB Economics

LATEST REFORM PROPOSALS

Reforms to state-owned enterprises announced at the 2013 Third Plenum were relatively modest and somewhat inconsistent – with policy statements that noting that markets should have a decisive role in allocating resources, but that SOEs should continue to have the leading role in the economy. One key change was an increased dividend payment. Prior to the Third Plenum, SOEs typically paid around 15% of their profits to the government, with this target increased to 30% by 2020.

Further details of SOE reforms were outlined in September 2015, with the State Council seeking to modernise SOEs, promote further mergers and mixed ownership and strengthen management – with a goal of improving competitiveness and efficiency as well as risk management. Under the latest plans, SOEs are grouped into two classes – public (which provide social services and welfare) and commercial (which operate for profit) – with the level of control and performance expectations differing between these

classes. That said, the full scope of these proposals is yet to be released, highlighting competing economic, social and political pressures in the path of reform.

Although mixed ownership would inject much needed equity into SOEs – given the typically high debt levels – it is possible that the volatility in China's share markets in 2015 may delay or even defer this process.

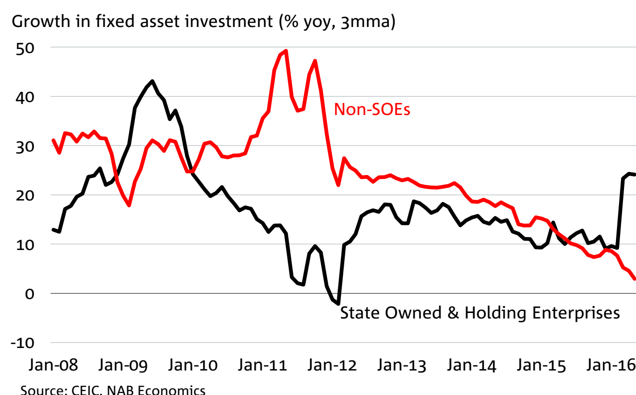
In June, a proposed merger between Baosteel and Wuhan Steel Group (respectively the fifth and eleventh largest producers globally in 2015) was announced, which would create the world's second largest steel company. Although government policy favours further mergers among SOEs, this will not necessarily address underlying issues within China's economy. The principle of efficiency improvements through mergers has been based on economies of scale, but a range of industrial sectors – steel being the most high profile – have excess production capacity that needs to be eliminated.

RECENT BACKTRACKING – SHORT TERMISM AND POLITICISING

As seen with a range of reforms and policy responses over the past two years, short term volatility and slowing economic trends can lead to backtracking on reforms in the interests of immediate growth. The political necessity to maintain economic growth near the government's target may have inspired the rapid recovery in real estate investment in early 2016 – counter to market driven declines across 2014 and 2015. While data is not disaggregated for SOE investment by sector, it does show a rapid acceleration in SOE investment over this period, whereas non-SOE investment growth has continued to trend lower.

FIXED ASSET INVESTMENT

SOEs lead recent rebound



Source: CEIC, NAB Economics

Despite efforts to separate SOE management from government influence, there also appears to be recent backtracking in this goal. In June, the Financial Times reported that the Communist Party was increasing its influence over SOE decision making. According to an article written by SASAC in a party magazine, major management decisions must be studied and discussed by internal party committees before any decision by the board and/or company management – arguably reducing the influence of market forces on SOE business strategy. Some academics have described the change as a return to the pre-reform era (prior to 1978) management model.

CONCLUSION

From a purely economic perspective, further reform to SOEs is an obvious course of action to improve the performance of China's economy – reflecting the inefficiencies, excess capacity and negative competitive impacts from their preferential arrangements with government and banks. However, this overlooks the social importance of SOEs – as major employers – and their political influence – being able to directly influence economic activity at the government's behest, as well as a growing role in foreign political measures, such as 'One Belt, One Road'. These factors increase the likelihood that SOE reform will remain at best a slow and limited process.

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