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Long term pain – could the COVID-19 recovery disrupt SOE reform?

NAB Group Economics

Reforms to China's state-owned enterprises (SOEs) have been underway for four decades, however the progress of reform has ebbed and flowed over this period. While outsiders have long hoped that the role of SOEs in China's economy would continue to diminish over time, the most recent reform measures appear to have strengthened their position; a trend which could be accelerated by measures to stimulate the post-COVID-19 recovery.

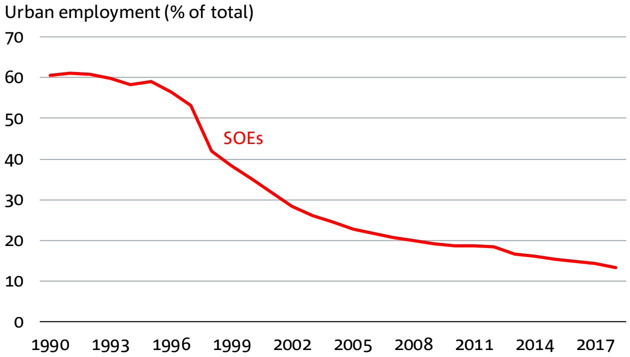
A BRIEF HISTORY OF SOE REFORM

Prior to Deng Xiaoping's rise to power in 1978, China's entire economy was state controlled. Modest reforms in the 1980s gave individual firms greater discretion regarding their production decisions. However, it was the changes in the 1990s, including mergers, privatisation and forced bankruptcies of SOEs (particularly at the local government level) along with increased private sector competition that significantly changed the shape of China's economy.

Over 60% of China's urban workforce was employed by SOEs in the early 1990s, but this share had fallen to just over 13% by 2018 (the most recent data). The bulk of the decline occurred between 1995 and 2002, with mass layoffs triggering a significant socio-political fallout, with workers losing a range of benefits, such as guaranteed pensions, healthcare and housing provisions. The negative consequences of these changes largely explain the cautious subsequent approach to SOE reform.

EMPLOYMENT BY SOES

Bulk of declines between 1995 and 2002

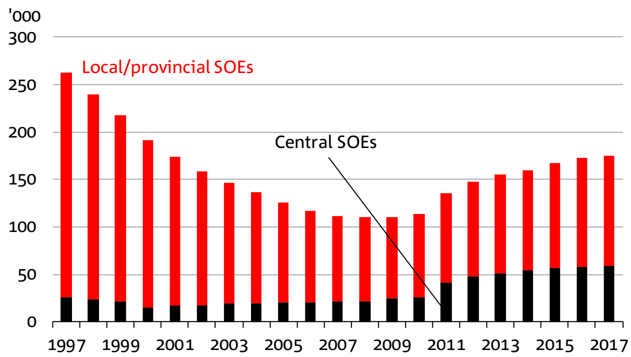


Source: CEIC, NAB Economics

Restructuring in the mid-2000s saw firms divided into three categories – key industries (where the state sought to maintain absolute control), pillar industries (where SOEs would have strong control of the sector) and normal industries (where there would be open competition). During this period, the decline in employment share started to slow, while the overall number of SOEs started to increase.

NUMBER OF SOES

Declines stopped around the GFC



Source: Ministry of Finance, NAB Economics

Today, the SOE sector is highly diverse – comprising more than 174,000 firms spanning across all major industries in the economy, ranging from small local service providers to global multinationals. For example, the 2019 Fortune's Global 500 (which lists the world's largest firms) featured 82 Chinese SOEs, including three of the top five firms. Estimates by the World Bank suggest that SOEs account for around 23%-28% of China's economy, although some other studies put the figure higher, closer to 40%.

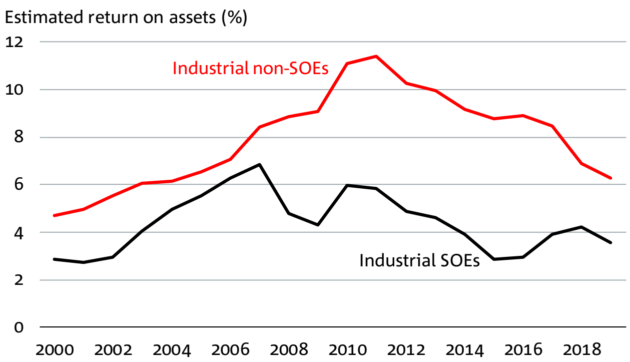
China's SOEs have different degrees of government ownership. Few of the largest firms are purely state owned, with private investors having partial ownership through joint ventures, partnerships, shared operations and public listing on equity markets.

However, there remain some significant issues in the sector that have not been resolved. As a general rule, SOEs have higher leverage than private sector firms – with SOEs estimated to account for over 80% of China's total corporate debt in mid-2018 (much of which was accumulated following the debt fuelled recovery from the Global Financial Crisis). Research by the OECD shows that the bulk of the increase in SOE debt was in the service sector (particularly for firms providing social services) – almost tripling their debt levels in the decade to 2015.

There remains substantial excess capacity in the state-owned sector – particularly among industrial SOEs in areas such as machinery & equipment, construction materials, chemicals and metals – leading to a poor return on assets versus the private sector.

RETURN ON ASSETS

SOEs have historically lagged private firms



Source: CEIC, NAB Economics

Despite efforts to improve access traditional finance and funding costs for private firms, SOEs continue to enjoy preferential treatment by banks. In Q1 2019, lending to private firms rose by 6.7% yoy, compared with an overall increase of 13.7% (PIIE).

THE PRE-COVID DIRECTION OF REFORM

The reform agenda unveiled at 2013's Third Plenum had inconsistent messages when it related to SOEs. Documents from the Plenum stated that markets should have a decisive role in allocating resources, but that SOEs should continue to have the leading role in the economy.

Since this time, the two primary approaches from authorities towards reform of SOEs has been to consolidate SOEs via mergers and boost capital via mixed ownership. The former has been primarily used as a way to eliminate unprofitable SOEs (by merging with profitable ones) while having a minimal impact on employment. However, the success of these mergers has been questionable – with various examples of merged firms maintaining separate offices and management structures. This can result in considerable inefficiencies and poor oversight – exacerbating the problems that mergers are intended to resolve.

Mixed ownership has been increasingly encouraged since the Third Plenum. Prior to 2013, mixed ownership allowed approved private sector investors to take equity stakes in state-owned enterprises, however following the plenum, SOEs were also permitted to purchase stakes in private sector firms. By the end of 2018, around two-thirds of central SOEs and more than half of their subsidiaries had mixed ownership to some degree. Private equity positions have typically been minority shares, however from March 2019, private firms have been permitted to hold major ownership of SOEs in selected industries.

In theory, mixed ownership should provide additional capital for SOEs while increasing competitiveness due to profit motives. However, in practice there has been little evidence of changes to management practices following mixed ownership reforms. Indeed in recent years, party committees within firms – both SOEs and private sector firms – have increased their influence over decision making, suggesting that the outcome of recent reforms has been greater state influence in the economy, beyond just SOEs. For private firms, the incentives for introducing party committees includes greater legal protection and improved market access, however it has the potential to reduce competition in markets.

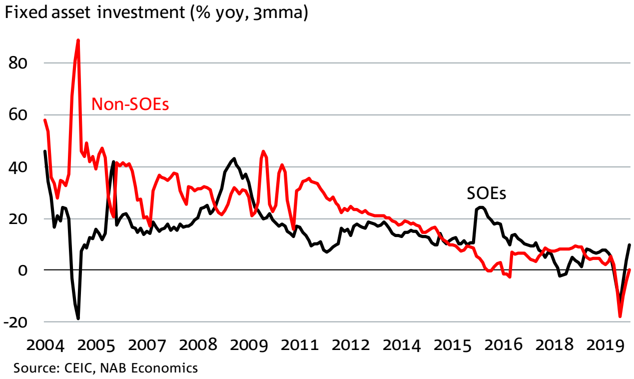
CONCLUSIONS – COULD COVID-19 LEAD GREATER STATE CONTROL?

China's economy contracted in the first quarter of 2020, as COVID-19 counter-measures restricted activity. There was a comparatively strong recovery in Q2, with growth of 3.2% yoy (following the 6.8% fall in Q1). This was led by China's "old economy" – with manufacturing and construction growing more rapidly than services (which was the key engine for growth over the past decade).

Investment also grew strongly towards the end of the quarter, with real investment in the month of June increasing by its fasted pace since mid-2016. State-owned enterprises were the key driver of this increase. In nominal terms, SOE investment rose by almost 10% yoy in Q2, compared with no growth for private sector firms.

FIXED ASSET INVESTMENT

SOE investment contributing to COVID recovery



Given that reforms prior to COVID-19 appeared to be strengthening the influence of the state within the economy, the recovery led by SOEs has the potential to accelerate this trend. As market based reforms have been viewed as essential to underpinning longer term growth, particularly given the negative impacts from demographic pressures (due to the declining working aged population), this trend is a negative one.

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