Conference Documents Series 2017-1

Presentation

China's Enterprise Reform and Internationalization with Reference to the Economy of Peru

Liu Guy (PhD)
Senior Professor and Head of United Kingdom Campus
Peking University HSBC Business School

Building H

December 2017

Organized by: Center for China and Asia-Pacific Studies, Universidad del Pacífico.
With the Cooperation of: Chinese Enterprises Association in Peru

Index

Figures Index

Table Index

China's Enterprise Reform and Internationalization with Reference to the Economy of Peru

1. Introduction

This paper provides a brief history of the evolution over the years of Chinese state-owned enterprises (SOEs). It also considers the questions of whether Chinese SOEs will be privatized in the future or how China's economic growth could influence the reform of its enterprises. This is especially important considering that the Chinese economy has entered a slowdown. In 2017, GDP was 6.5% and the trend that growth will follow is not clear. Chinese SOEs have almost 70 years of history—as does the People's Republic of China, which was founded in 1949. Meanwhile, the reform of SOEs started 40 years ago and is still in motion.

China is no longer an investment-driven economy, but a consumption-driven one; consumption has now surpassed 50% of GDP, and its share is expected to keep on increasing (Figure 1). Eventually, China will become the largest consumer in the world, which will create a lot of opportunities for businesses elsewhere to export their products. China expected to grow by 6.7% in 2017 and had 120 trillion RMB in outstanding loans, which for many represent a potential risk (Table 1).

Figure 1. Major role of consumption in driving the economy.

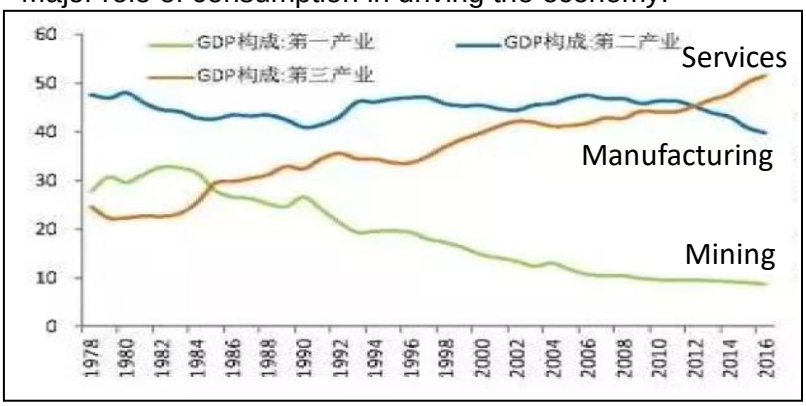


Table 1. Prediction of Economic Growth for 2017

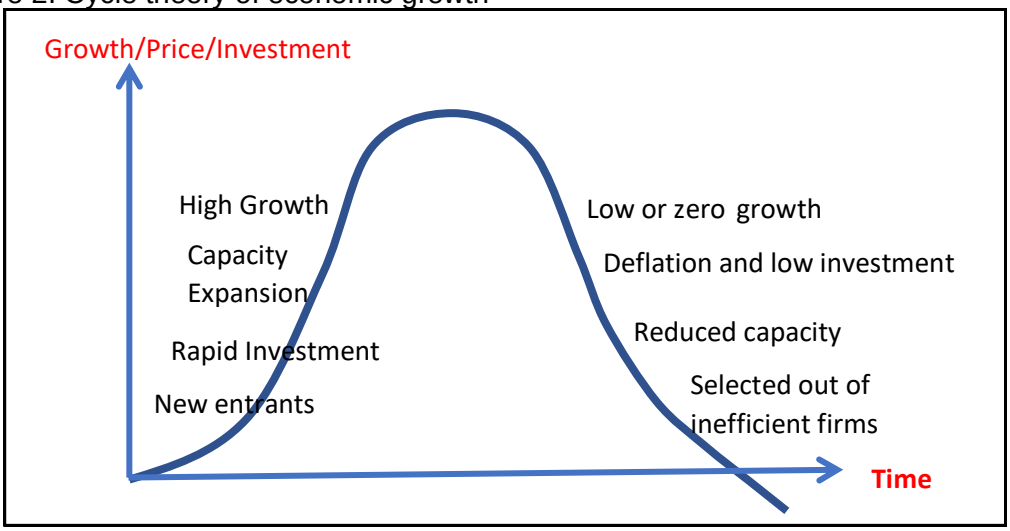
	方正宏观预测值	市场一致预期
GDP实际增长率（%） Growth Rate	6.7	6.5
CPI同比（%） Inflation	2.5	2.2
PPI同比（%）	3.5	2.4
工业增加值同比（%）	6.5	6.2
固定资产投资同比（%）	8.3	8.2
社会消费品零售总额同比（%） Retail	10.8	10.5
出口同比（%）	7.0	4.8
M2（%）	10.0	9.8
人民币贷款（亿元）	153,000	144,000
美元/人民币	6.6	6.8

贷款余额 outstanding loans (RMB Trilling):	120	115
国有企业贷款余额 SOE outstanding loans:	80	

Figure 2 shows the economic cycle. During the upward period, everything grows, and enterprises enter the market, expand, invest and are profitable. When the downturn

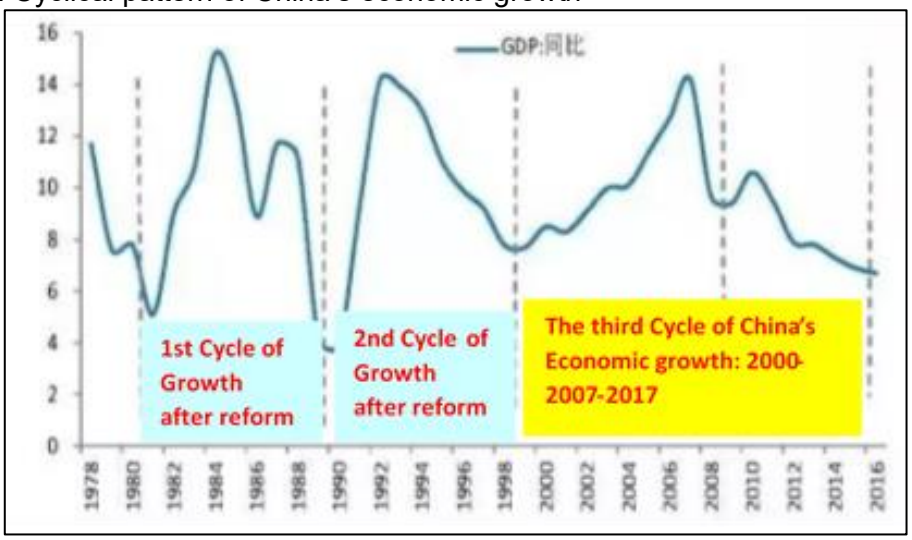
begins, firms are driven out of the market and deflation and low growth ensue. China is currently undergoing such a downturn in which overcapacity is notable; as a result, the government has developed a policy to deal with this problem and get rid of unproductive firms, whether they are SOEs or not.

Figure 2. Cycle theory of economic growth



Chinese economic growth has experienced three cycles (Figure 3). The first started in the 1980s and ended in 1988, the second covered the 1990–1994 period, and the third started in 2000 and continued for almost ten years but was halted by the 2008 crisis. Thereafter, the economy briefly recovered before presenting a slump that is still ongoing. It is not clear whether it has bottomed out and will start climbing again.

Figure 3. Cyclical pattern of China's economic growth



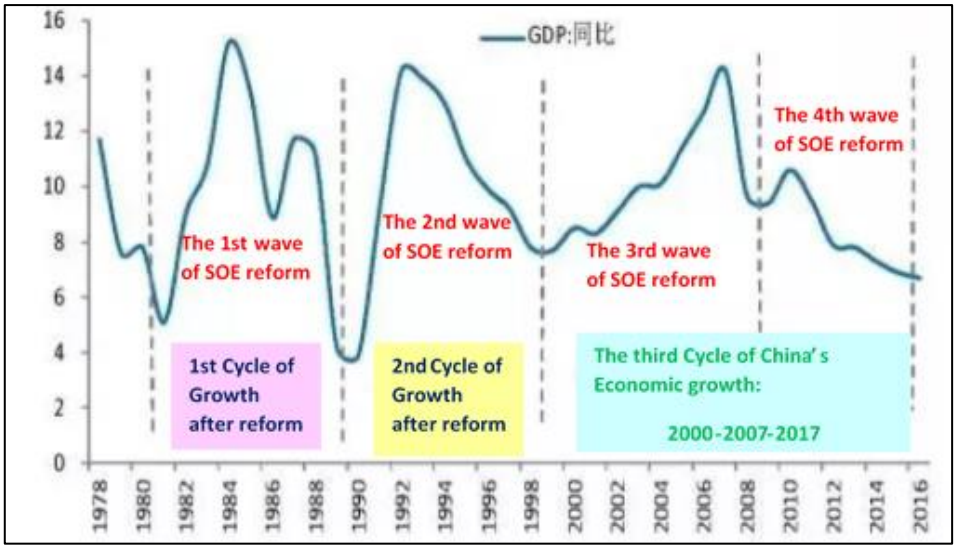
2. Reforms of State-Owned Enterprises through the Years

Economic growth and SOE reforms have been closely related (Figure 4). The first cycle of economic growth, which began in 1982 and featured growth rates of as much as 15% a year, was driven by the first enterprise reform. This reform started with a remarkably simple idea: managers and workers at SOEs enjoyed permanent jobs and fixed salaries with no bonuses. Therefore, nobody worried about their job prospects, and they were not given bonuses based on performance.

At the beginning of the 1980s, China's economy was suffering from a serious shortage of supply; as a result, the Chinese government decided to reform by giving bonuses to managers and workers and linking salaries with bonus payments. This led to an economic boom which brought up inflation. Moreover, at that time, China had a two-price system and the market price, due to the economic boom, rose. So, the government had to tighten up the economy in order to lower returns and slow down economic growth. In this context, in which many SOEs faced problems, the government decided to further the reform, introducing the contract responsibility system at the beginning of the 1990s.

The second reform of SOEs was that managers received a contract which stated that they were hired to deliver profits to the government. The issue is that when an economic boom is in motion, firms make profit and do not have problems fulfilling their targets; but in a situation of economic decline firms suffer losses and breach their contracts. The government realized that this kind of contract did not work and did not make enterprises accountable for their performance. Subsequently, in 2000, the government introduced the third wave of SOE reform which consisted of privatizing small and medium-sized firms, particularly loss-making firms. This triggered a new economic boom based on an ownership reform that was accompanied by China's entry to the WTO; the boom lasted until 2008, when the economic slowdown led to a fourth wave of SOE reform.

Figure 4. Cyclical pattern of China's economic growth and its connection with SOE reform



Focusing on the reforms individually, the last two implied bigger changes (Figure 5). The third was the privatization of small and medium-sized SOEs, which only left large firms in the hands of the state. Nonetheless, when one talks about privatization of Chinese SOEs, it must be recalled that the process is not so straightforward as in the West, where it mainly consists of a change of ownership from public to private (Figure 6). In China, ownership cannot be changed easily since there are four players involved in the privatization game (Figure 7). The first is the government; second, managers of SOEs; third, workers at SOEs; and fourth, state-owned bankers. Each party has a decisive role in whether or not privatization should take place.

Figure 5. Evolution of SOE reform

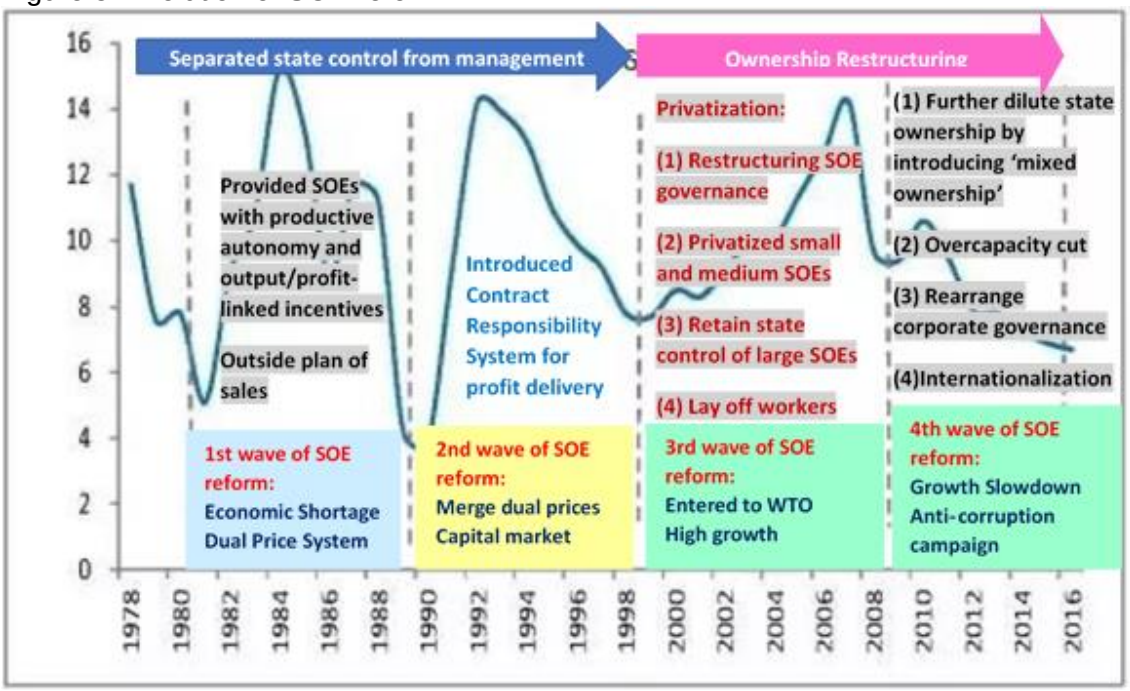


Figure 6. Conventional approach to privatization

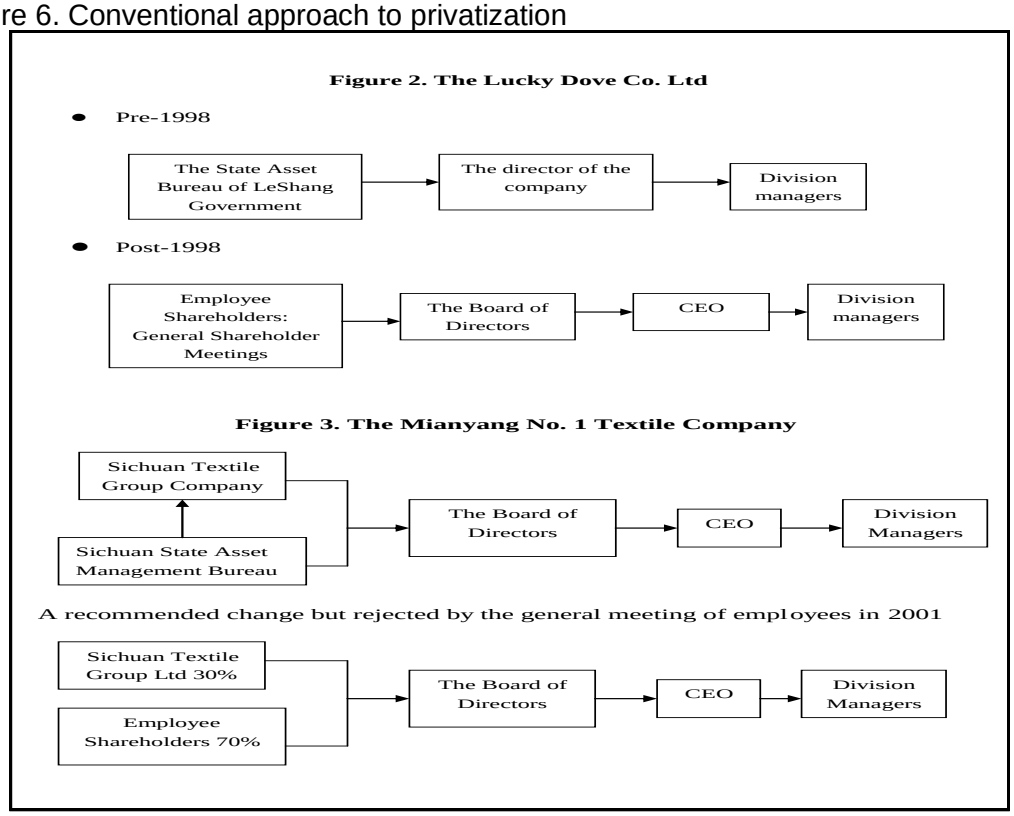
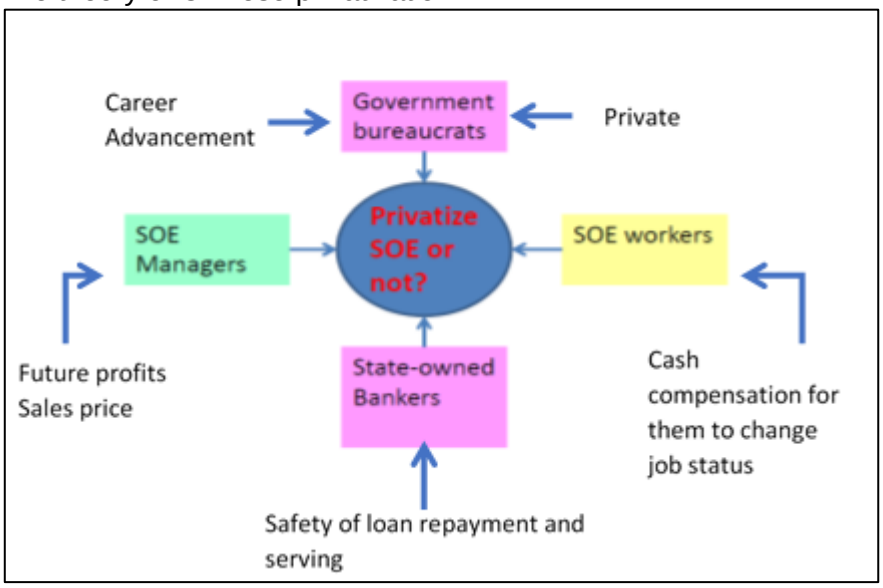


Figure 7. The theory of Chinese privatization



In this framework of Chinese privatization, the four parties must align in order to proceed. First, the government must have a motivation, so government bureaucrats usually consider two things: career advancement and private benefit (Figure 8). If these two factors are not present, bureaucrats will not have any incentive to push SOEs towards privatization. Second, SOE managers weigh up whether future profits and personal interests can be served. Third, the government considers employees as a priority, which maintains the stability of society and prevents riots. Thus, if workers are not satisfied, privatization does not happen given that they have power of veto. Fourth, bankers also have a role in privatization decision-making because SOEs must continue to service their debt; if they feel unsure, they can stop the process.

Hence, the government decision to privatize SOEs is subject to three constraints: managers' participation, workers' compensation and bank loan servicing (Figure 9). Each constraint must be fulfilled to avoid the failure of privatization.

Figure 8. Government bureaucrats' incentives for privatization

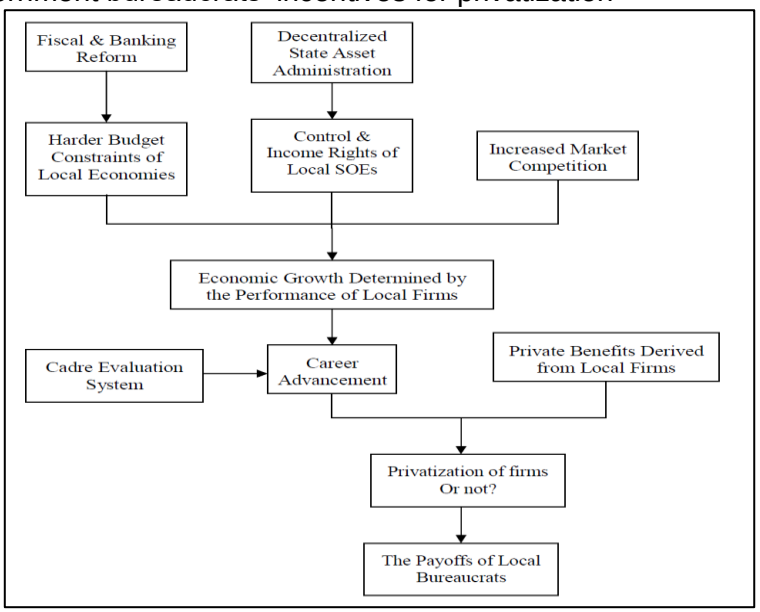
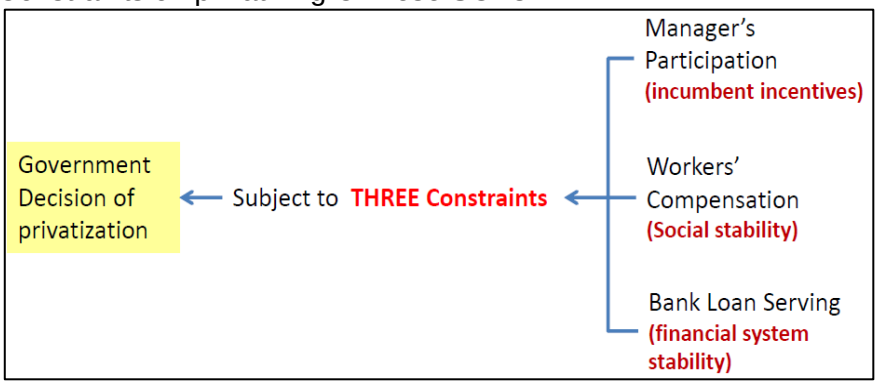


Figure 9. Constraints on privatizing Chinese SOEs



Furthermore, after the privatization reform, one of the main issues was how to deal with workers' compensation (Table 2). In the West, when a government sells the ownership of a company, it receives the money. In contrast, when one sells state assets in China, the money does not go to the government but to paying the workers' compensation, so not having enough money to cover this presents a huge problem. Thus, Chinese entrepreneurs decided to only partially privatize, meaning that they only privatized the ownership and found a way to avoid the huge compensation costs. Consequently, 68% of SOEs took this partial privatization route (Table 3).

Table 2. Compensation for workers when ownership transformation occurs.

	State-controlled partially privatized firms	Fully privatized firms
Full privatization, compensation for workers	N.A.	170 (70%)
Full privatization, no compensation for workers, but guarantee of employment	N.A.	32 (13%)
Partial privatization, compensation for workers	81 (14%)	N. A.
Partial privatization, no compensation for workers	245 (41%)	N. A.
All sample firms	597 (100%)	242 (100%)

Table 3. Partial privatization of SOEs

	Total Sample of Firms		Central government owned Firms		Local government owned Firms	
	Firms	**% of sample**	**firms**	**% of sample**	**Firms**	**% of sample**
Partially privatised firms	652	**68.63%**	219	89.39%	419	62.17%
Fully privatised firms	298	**31.37%**	26	10.61%	255	37.83%
Total sample	950	100.0%	245	100.0%	674	100.0%

Source: The 2004 Enterprise Survey (Liu & Liu, 2005).
Note: In the surveyed sample, 997 firms reported their new ownership structure after the transformation, of which 220 firms are affiliated with central government and 777 are local firms.

China has 15 million companies, of which only 1% are SOEs. However, the SOEs control 30% of assets. SOEs have USD16 trillion in both assets and debt, so SOEs do not have much net assets left. Despite this, if one considers China in its totality, the assets of its 15 million companies are USD53 trillion compared to their USD18 trillion debt, making the total debt ratio of Chinese firms 30%, which is a safe and healthy rate (Table 4). As such, China's business sector is rather safe. When it comes to state assets with matching debt and assets, the debt mainly comes from the high-speed train and huge investments in railway infrastructure, which have zero chance of going bankrupt.

Table 4. SOEs in China after the third wave of reform

	No of companies in China	No of SOEs	SOEs/Total as %	Central SOEs	Local SOEs
2013	15,000,000	155,000	1.03%	52,000	104,000
2005			5.5%		
Assets (2013)	$ 53 trilling	$ 16 trilling	30%		
Sales (2013)		$ 7 Trilling			
Net Profits (2013)		$ 0.3 trilling (£216b)			
Total loans	$18 Trilling	$16 Trilling			

3. What is the Fourth Wave of SOE Reform?

The fourth wave of SOE reform encompasses five aspects: mixed ownership, rearrangement of corporate governance, overcapacity cuts, internationalization, and anticorruption campaigns. First, mixed ownership is just an extension of the previous reform of partial privatization. The Chinese government wants more private firms to invest in SOEs, so they created the mixed ownership structure to dilute state ownership. Second, corporate governance is something of an anomaly, representing a kind of step backwards. In the past, directors or chairmen of the board had a salary in line with the market level, but now they receive a civil service salary, which is lower. In addition, the bonuses of senior managers are capped, which diminishes incentives to work harder and willingness to take some risks.

Third, overcapacity is a huge problem that the Chinese government is trying to deal with, and they have been quite successful in this respect. Fourth, internationalization has also been quite successful; Chinese SOEs can be found all around the world (Figure 10). In Peru, 179 Chinese firms from both the private and public sectors are currently present. Large SOEs usually become multinationals and invest abroad, but 90% of SOE investment outside China is not yet profitable (Table 5). As a result, there is now a focus on making SOEs profitable.

Figure 10. Internationalization of SOEs

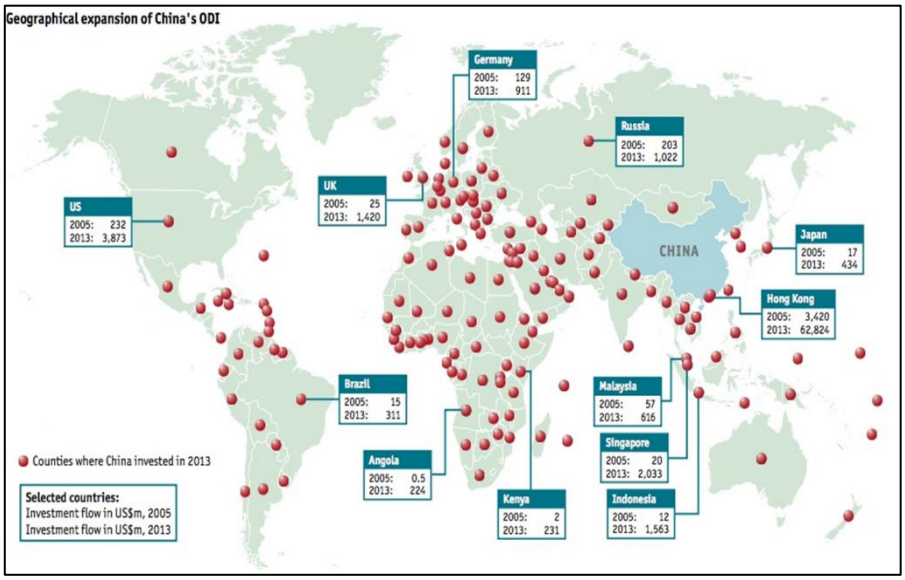


Table 5. Large SOEs outside China

1	中国石油化工集団 China Petrochemical
2	中国石油天然気集団 China National Petroleum
3	中国海洋石油 China National Offshore Oil
4	中国移動通信集団 China Mobile Communications
5	華潤(集団) China Resources(Holdings)
6	中国遠洋運輸(集団) China Ocean Shipping(Group)
7	中国中化集団 Sinochem
8	中国建築工程 China State Construcion Engineering
9	招商局集団 China Merchants Group
10	中国鋁業 Alminium Corporation of China
11	中国聯合網絡通信集団 China Unicom
12	華為技術 Huawei Technologies
13	中国化工集団 China National Chemica
14	中国五鉱集団 China Minmetals
15	中国中信集団 CITIC Group
16	中国交通建設集団 China Communications Construction Group
17	中粮集団 China National Cereals, Oil & Foodsuffs
18	中国航空集団 China National Aviation Holding
19	中国長江三峡集団 China Three Gorges
20	国家電網 State Grid Corporation of China

Fifth, anticorruption campaigns have had some achievements. Compared to the past, SOEs are more transparent and have fewer problems of this kind (Table 6). For instance, when representatives of SOEs must go overseas to visit their branches, they are subject to government regulations. They only get five days for each country and must adhere to extremely strict travel expenditure limits; for example, when going to the UK they only get GBP120 for daily accommodation.

Table 6. Anti-corruption investigations in China's banking sector

Year-quarter	Number of investigations	Number of affected industries	Number of peer firms
2012-4	1	3	201
2013-1	1	0	0
2013-2	6	8	520
2013-3	6	0	0
2013-4	11	2	65
2014-1	4	0	0
2014-2	14	9	447
2014-3	15	2	51
2014-4	9	5	216
2015-1	11	2	60
Total	78	31	1560

As to the challenges, this fourth reform of SOEs has had the side effect of reducing levels of productivity (Figure 11). Moreover, business activities are not as active as before. There has also been an increase in the number of firms making a loss because of the economic slowdown, with the total now standing at 30% of SOEs (Figure 12). Pollution is also an issue to consider; the government has tackled the problem by introducing tougher measures that have reduced the profitability of certain activities due to the cost of treating, removing, or reducing pollution (Figure 13).

Figure 11. Lower productivity of SOEs versus private enterprises

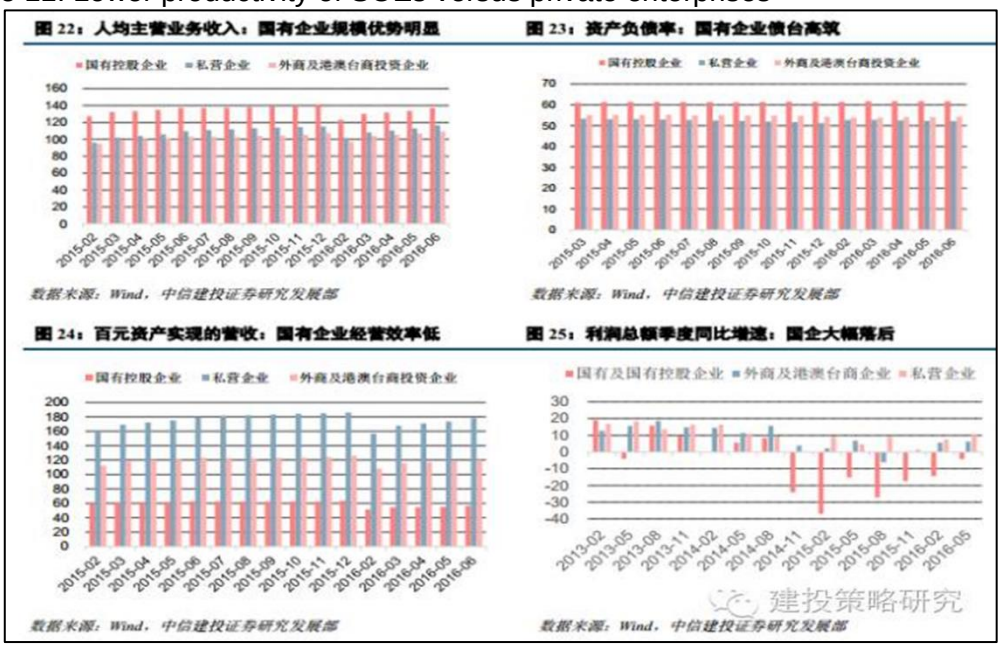


Figure 12. Rising number of loss-making SOEs

Figure 13. Pollution and the environment

Finally, China expects to recover its high growth rates based on certain indicators. It considers the number of listed companies that have seen a rise in their stock prices to be a good sign (Figure 14). Furthermore, after reducing non-productive capacity, the concentration ratio of loss-making firms increased. In other words, due to the increase in market concentration, the profitability of firms will probably follow the same path (Figures 15 and 16). Given these two indicators, China predicts that its economy has already bottomed out and that growth will return to around 7% in the coming years. This will benefit markets such as Peru if they take advantage of China's growth momentum (Figure 17). The fundamentals of the Chinese economy have become healthier, preparing the country for another round of high economic growth.

Figure 14. Inflection points for the Chinese economy

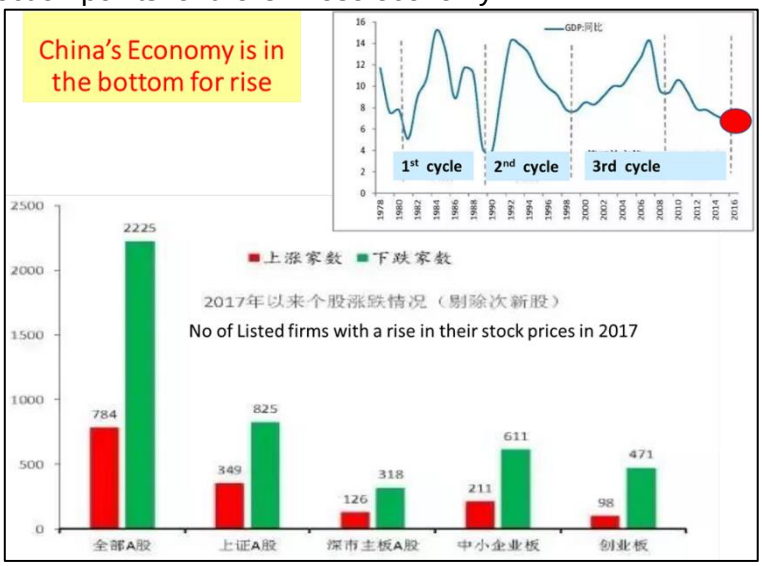


Figure 15. Increased concentration after over-capacity cut, I

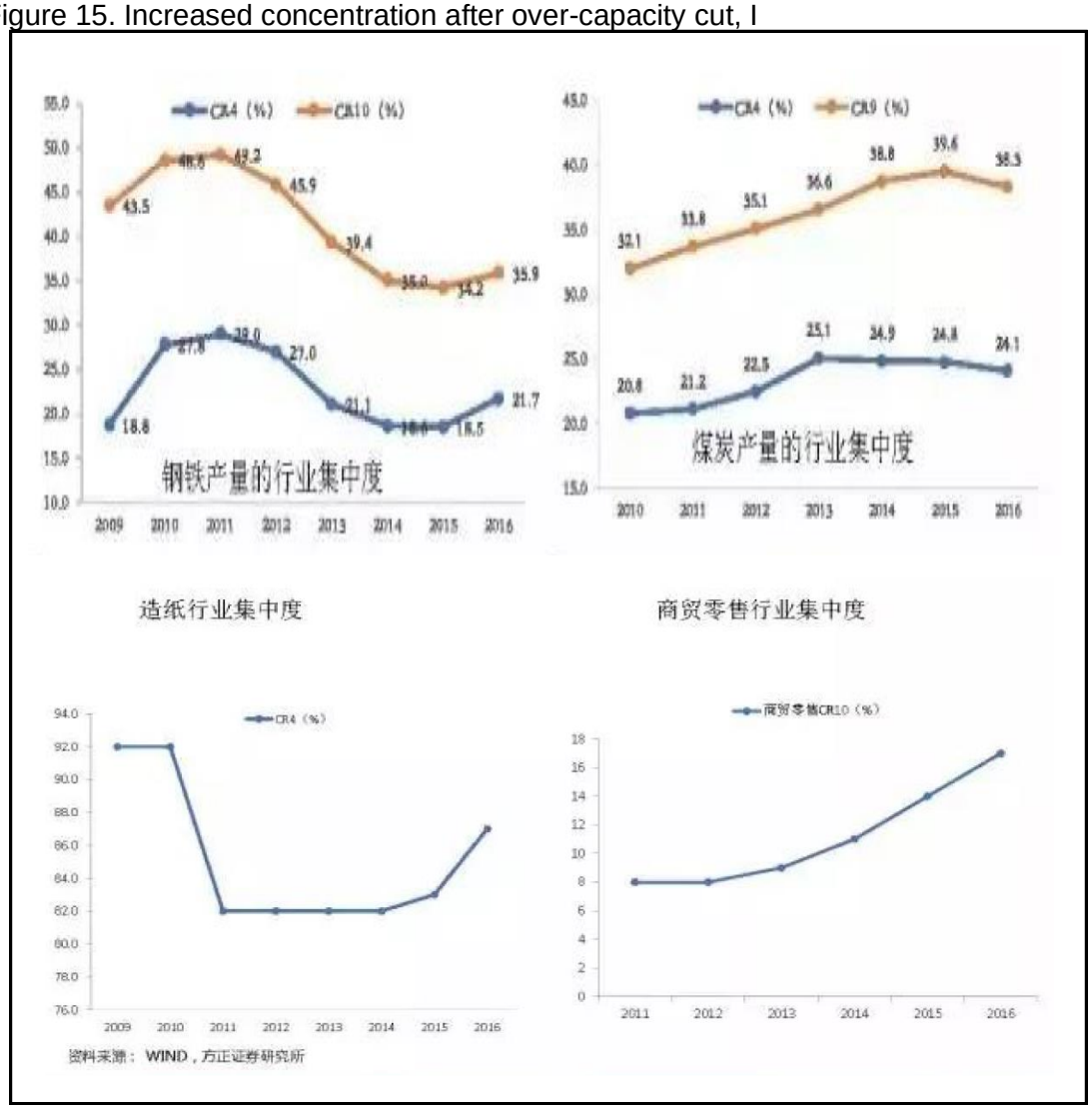


Figure 16. Increased concentration after over-capacity cut, II

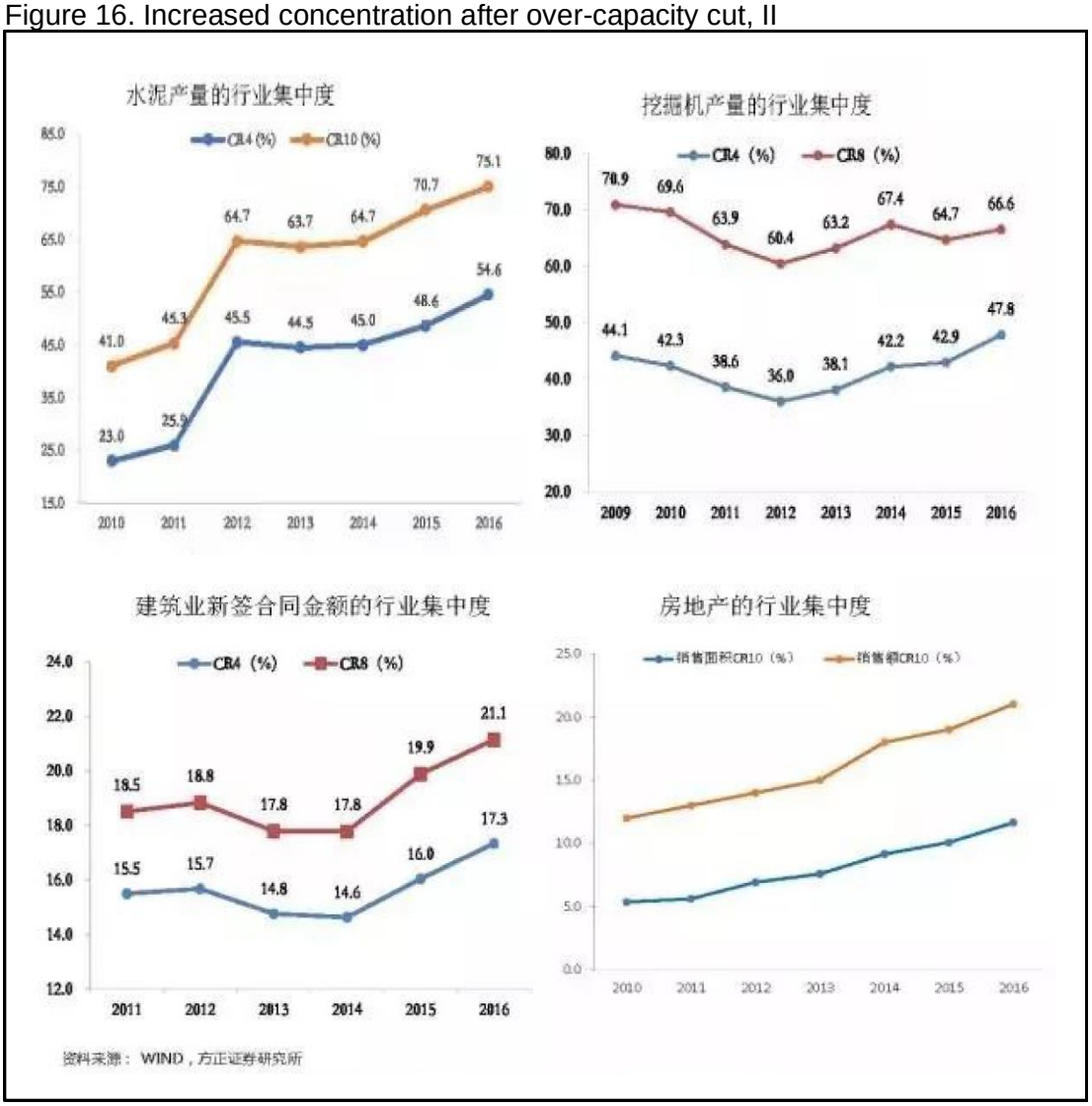
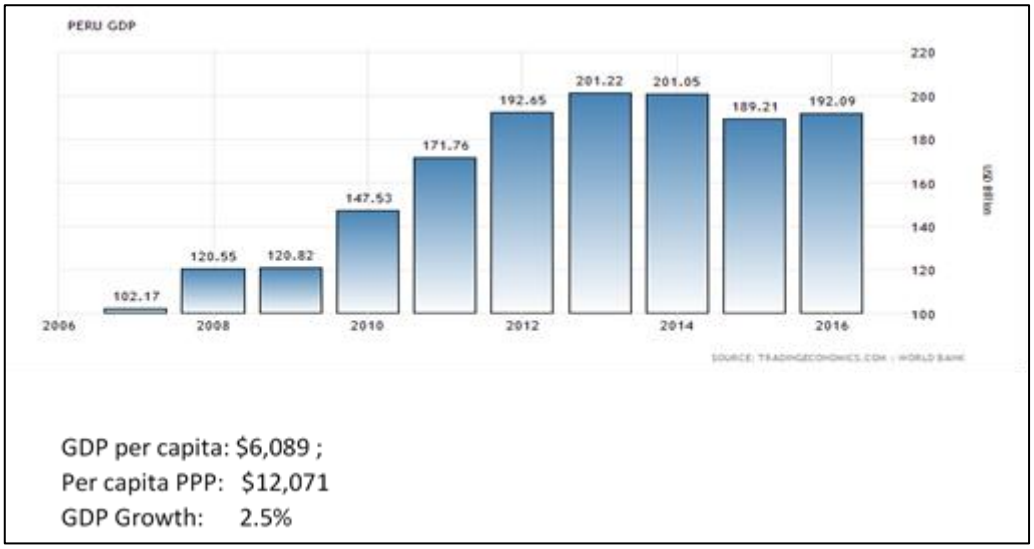


Figure 17. Peruvian GDP



4. Biography of the Author

Professor Liu Guy has a PhD in Economics from Oxford University. He specializes in industrial economics, with an emphasis on reform and development of Chinese enterprises. He holds the positions of Senior Professor and Head of the United Kingdom Campus at Peking University HSBC Business School (PHBS).

Moreover, he has advised the British and Chinese governments on policies for the reform of Chinese companies. His research has been widely published in renowned international journals. He is also a regular commentator on China's economy and business issues for the BBC.