State firms' Overhaul Endorsed

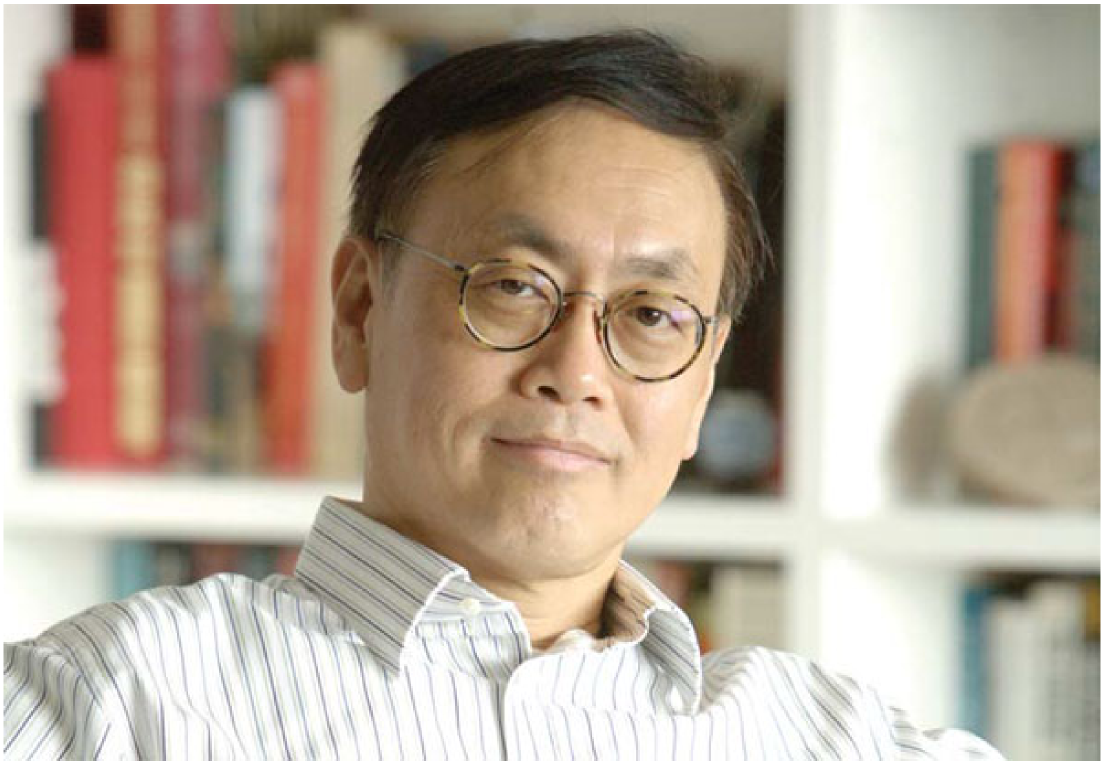
By Chen Yingqun (China Daily Europe)

Updated: 2015-10-02 09:44

Moves to reform china's monolithic state-owned enterprises have just been given a new fillip

As the world's media remained preoccupied with China's economic slowdown and the recent stock market crash, they all but ignored policy guidelines that the government issued on Sept 13 regarding the way state-owned enterprises are run.

Yet these guidelines have far-reaching implications for China and multinational companies, because they aim to retool the economy by giving entrepreneurs and market forces a much greater role, experts say.



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Wei Jianguo, vice-chairman of the China Center for International Economic Exchange and a former vice-minister of commerce

Wu Shanshan, a principal at Roland Berger Strategy Consultants

Wang Haifeng, a researcher with the Institute for International Economic Research at the National Development and Reform Commission

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"Most multinationals don't really understand the SOE reforms, and they really should pay more attention to them," says Edward Tse, one of China's leading management thinkers and founder and chief executive of Gao Feng Advisory Company.

"SOE reform is not just something that concerns people in China. It needs to be looked at from an international perspective."

The guidelines that the State Council issued on Sept 13 call for "decisive success" in forming a more rational management system for SOEs and cultivating a more capable generation of SOE entrepreneurs by 2020.

The importance of SOEs to the Chinese economy - and thus the world economy - can be gauged by the blockbuster revenue they had last year, 48 trillion yuan ($7.5 trillion), nearly double the GDP of Germany. Total profits of the 150,000 SOEs were $2.48 trillion, and they now have assets valued at more than $15.7 trillion. They employ more than 30 million people, nearly three times the population of Belgium.

SOEs in general enjoy a dominant position in the market, with easier access to credit and more policy support, and many international critics have long complained that this means they have an unfair market advantage. Such critics say SOEs are less efficient than private companies and that they lack the wherewithal to help counter the economic slowdown. One recent piece of evidence cited for this is that their profits fell 2.3 percent in the first seven months of this year.

Many people think China's economy is in decline, Tse says, but he says the dividends of the country's economic reforms are yet to be realized, and that those relating to SOEs will act as a new economic driver.

"China has great resilience. In the next round of economic development there will be several economic drivers: the dividends that SOE reform will produce, the innovation of private enterprises and entrepreneurship. You cannot just focus on a slowdown in the Chinese economy; you also need to look at what makes the country different. China has developed more quickly than many other markets, and multinational companies should be looking at where new opportunities will emerge and how to take advantage of them."

Guan Qingyou, director of Minsheng Securities Research Institute in Beijing, says that the economic downturn could not have been better timed for SOE reforms.

"Reform without crisis is just bumbling around. On the other hand, if you are trying to change things in the midst of a crisis you will get real changes. At a time of economic transition for China, SOE reform is urgently needed, whether based on internal factors or external factors."

The new guidelines clarify the principles underlying the diversification of the equity structure of SOEs. Entities are put into two groups: those that offer a public service and those that are profit-oriented. The guidelines encourage the mixed ownership of SOEs, the general aim being to make them more efficient and make them independent market players.

Eleven days after these guidelines were issued, the State Council issued more, telling SOEs to accept mixed ownership and to modernize. Foreign investors have been invited to take part in overhauling the SOEs, through overseas mergers, collaboration in financing and through offshore financing.

Wei Jianguo, vice-chairman of the China Center for International Economic Exchange and a former vice-minister of commerce, says this round of SOE reform is different from previous ones. China has established a more market-oriented mechanism, which calls for resources at home and overseas to be exchanged well, and for resources to be properly allocated globally, he says.

"In the new era, the SOEs seem to have been unable to open up properly, so it has become urgent to bring in various kinds of capital and better management."

Previous measures taken to free up SOEs have been superficial, failing to go to the root of the economic system, and the latest tranche deals with capital rather than assets, he says, and these will be useful in giving SOEs new impetus, particularly against the background of the anti-corruption drive that has been in full swing for some time now and of the new parameters that are being used to gauge the economy's health.

"Most of these SOE reform tasks will be completed within five years, and the more difficult ones will probably take longer."

Wang Haifeng, a researcher with the Institute for International Economic Research at the National Development and Reform Commission, says the new round of reform and the circumstances in which it is taking place is markedly different to what prevailed before because there will be a greater emphasis on the service sector as China's market economy continues to mature.

In addition, with these reforms there is no timetable, with changes taking place incrementally, he says. Another thing is that changes relating to mixed ownership need to be seen not as an end in themselves, but in how they fit in with reforms in finance, telecommunications, transport and other industries, he says.

"Everything will take place step by step, and it is going to be impossible to see results right away. Nevertheless, it will be part of the country's 13th Five-Year-Plan (2016-20), and we will see the effects in three to five years."

Private companies and foreign companies would be well advised to do research on the direction of China's SOE reform and pay close heed to specific regulations that will come out one after another from now on, Wang says.

They also need to see the reforms in the context of the Belt and Road Initiative, the development of free-trade zones, and China's outbound investment, in which SOEs and foreign companies will have more opportunities to work with each other.

Wu Shanshan, a principal at Roland Berger Strategy Consultants, says the curtain around deepening SOE reform has now opened and the latest policy will benefit industries such as oil and gas, utilities, aviation, railways, power, telecommunications and other strategic areas.

At first blush the guidelines look simple, but behind the scenes a lot of work has gone into them, he says.

They lay the foundations for the direction of development, which touch many interest groups, and have an impact on industry reforms and affect industrial competition and foreign capital's surviving space, he says.

At present the management of SOEs is largely divorced from the principles and strictures of market competition, he says. For example, talented people who work for the SOEs are not given appropriate incentives, and decision-making is comparatively inefficient and inflexible. That means that it would be difficult to apply to the SOEs methods that are routinely used in private companies, he says.

SOEs are keen to work with non-state companies to bring in new technology and new management methods, Wu says, and multinational companies should see clear opportunities in this. For example, with oil and gas industry reform, SOEs are happy to work with international brands and companies that are influential and own advanced technology and management capacity, which will help them increase their influence internationally.

Moreover, SOEs lag foreign companies in their technology and innovation in some areas, and mixed ownership will bring in new partners and make up for their shortcomings and problems.

"Foreign capital should seize the opportunities that lie in mixed ownership, and it should be more involved in managing companies. This will present great opportunities to foreign companies and help SOEs lift their game.

"Companies in China as either independent companies or joint ventures that don't grab the opportunities are going to face much stiffer competition. Market-entry companies will also get more opportunities to operate in areas in which it was impossible to do so before. None of these companies can afford to neglect what is happening in China because its future is likely to decide their future."

In contrast to the apparent enthusiasm of Tse, Wei and Wang for the guidelines, a UBS report calls the plan, which it says had been much anticipated, disappointing for the market. It is too preoccupied with trying to balance the interests of various interest groups, it says.

"The lack of specifics and a clear timetable, as well as wording on making SOEs bigger and stronger and preventing the loss of state assets dampened hope for major SOE divestment and restructuring."

Nevertheless, the UBS report still sees positive messages in the guidelines. In line with a blueprint issued by the Third Plenum of the 18th Central Committee of the Communist Party of China in November 2013, which was well received, it says, SOEs in competitive industries can have the state as a minority shareholder and it calls for the state to get out and set up state investment companies to help it move away from SOE management to state capital management; SOEs would be required to improve disclosure and governance, including by paying more dividends to state shareholders.

UBS says there are interesting investment opportunities but limited macro impact.

"As the government starts experimenting with SOE reforms in energy, transport and telco sectors, there could be interesting investment opportunities for investors. However, since major restructuring will be negative for growth and employment and will likely proceed gradually, we see limited impact on the macroeconomic front in the coming year."

Joerg Wuttke, president of the European Union Chamber of Commerce in China, says that from an international perspective the economic potential for China in SOEs remains dormant.

SOEs are robbing Chinese private companies of breathing space, he says, and if the SOEs turn out to be highly competitive, multinationals will have to perform a lot better. At the same time, if the market opens up more as a result of SOE reform, there will be more room for multinationals.

International observers have eagerly waited for SOE reform since the World Bank issued a report on the subject in 2012, the year before the Third Plenum, Wuttke says.

"I think SOE reform is also symbolic, showing how China takes on difficult issues, at what speed and to what extent."

SOE reforms would benefit the energy, banking and logistics industries, he says, but foreigners have not gained as much as they would like to. China needs to remove trade barriers, open up investment opportunities and open up more areas to foreign investors to benefit Chinese consumers, he says.

"Mixed-ownership is the first step in the right direction, but again you have to take the background into consideration. It is very difficult to get from A to Z in one straight line. Everything needs time. So I acknowledge this is a compromise.

"It is not that Chinese companies are not innovative. If they are exposed to market forces, and if they have to respond to market mechanisms, they will be really good."

Like the UBS report, Wuttke sees the Sept 13 guidelines as a product of compromises, and the most important thing is how it will be implemented, he says.

"It is not as candid as the (World Bank report of 2012), and it does not as narrowly define as the Third Plenum did what is required of an SOE. So some SOEs, more than we anticipated years ago, would still be in very powerful positions.

"I would have liked to see most of the local and regional SOEs totally privatized over a certain time. Competition would make these companies more profitable and more able to compete in global markets."

Tse, like UBS, faults the report for being light on detail, even if key issues are covered. Many people lack understanding of the implications of SOE reform, he says, and that is reflected in the different responses he receives when he raises the issue with clients.

For him, one of the key issues relating to reform is mixed ownership. In more open industries, multinationals, SOEs and private companies can intensively compete, but in other industries, market access is non-existent, and market players in those fields are keenly interested in SOE reform.

"It is not only state-owned capital that would be a shareholder in SOEs; non-state capital could also be there. There's a huge opportunity for multinationals to have a role in the growth of SOEs."

Multinationals closely related to SOEs, some of which are working partners, clients and suppliers, particularly in industries such as telecommunications, oil, gas and transport, are more affected by reform, he says, and much of the potential will also come from SOEs at the provincial or local level.

"Local governments differ in their attitudes toward the companies. Some are more conservative while others are more open and supportive of companies. I think there are good opportunities for local SOEs, and I guess local government would also like to accept that, because that goes in the right direction."

Whether SOE reform produces greater efficiency depends on how it is implemented, says Jonathan Koppell, dean of the College of Public Service and Community Solutions at Arizona State University in Tempe, Arizona.

"Of course, in theory, these changes could have a big effect on China's economy (particularly over time). SOEs still constitute a huge share of economic activity, particularly at the provincial or local level. So if this reform truly alters the SOE landscape - leading to mergers or layoffs or other changes heretofore unseen - the dynamics of economic activity would be altered."

Wang says many SOEs in important sectors, such as finance, telecommunications and energy, are mixed-ownership companies and many are listed, but the proportion of shares that non-state capital holds is still relatively low.

"The key question is to what extent reform will be carried out. If we make bold moves, for example, to reduce the equity share of state-owned capital from 50 percent to 30 percent, that would be big progress. When equity structure is successfully reformed, that will usher in better management.

"Now the state-owned capital equity share of many SOEs is about 80 percent. So if there is major reform in finance, energy, telecommunications, transport, education and healthcare, all these industries will be more open to the markets, and there will be a lot of room for private and foreign companies."

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