

STATE-OWNED ENTERPRISE

THE STORY SO FAR

Reforming state-owned enterprises (SOEs) is critical to improve the competitive environment within China's economy and in overseas markets where Chinese firms are engaged in trade and investment. Unlike other commercial entities, SOEs are tasked with economic and political objectives. The crux of SOE reform is delineating and separating these commercial and political activities. During the 1990s, Beijing tried to reform the state sector by consolidating state control over large SOEs while withdrawing from small ones, which contributed to private sector prosperity and a decade of strong economic growth. In the 2000s, Beijing redefined SOE "reform" as concentrating state control over key and pillar industries with strategic linkages to China's economic development and national security. In 2013, the Third Plenum further clarified SOE reform as transforming SOEs into modern corporations, with the state exercising influence in the same fashion as other shareholders. The Third Plenum also envisioned the state would reduce control of commercial SOEs, while pushing SOEs in strategic industries to focus on their "core" business areas.

- Starting in 2014, Beijing tried to improve SOEs' competitiveness using ad hoc measures, such as mergers and mixed ownership programs (similar to those used in the 1990s) involving the sale of minority shares to private firms. These piecemeal efforts continue today. However, none of these measures has been sufficient to reshape SOEs' incentives in line with market principles or redefine their role within the economy.
- In September 2015, the State Council published a new set of "guiding principles" for SOE reform. The document was more conservative than expected. Rather than allowing the market to decide the future of SOEs, the State Council proposed utilizing market mechanisms to make SOEs bigger, stronger, and more efficient, while maintaining control by the government.
- The 2015 guiding principles reiterated a 2013 Third Plenum goal to transform the government's role in managing SOEs from "managing assets" to "managing capital." The plan was to allocate state capital toward strategic industries and reduce direct intervention within SOEs' day-to-day operations, thereby improving efficiency. The government also stated that it would strengthen SOE corporate governance but made clear that it viewed Communist Party supervision as critically important.

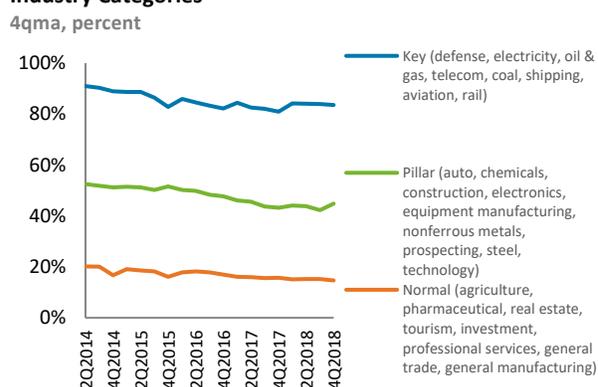
- Since 2017, the government has pushed to "corporatize" SOEs, including establishing boards of directors to replicate the structures of other commercial entities. But it also required all SOEs to institutionalize the role of Communist Party committees into their articles of association and give the Party oversight for all strategic decisions. As a result, boards of directors still lack de facto authority to manage SOE operations.

METHODOLOGY

We use China's own classification scheme to assess SOE reform progress. When information is available for listed companies, we gauge SOE revenue relative to all revenue in three clusters: (1) key industries (defense, electricity, oil & gas, telecom, coal, shipping, aviation, and rail); (2) pillar industries (autos, chemicals, construction, electronics, equipment manufacturing, nonferrous metals, prospecting, steel, and technology); and (3) normal industries (tourism, real estate, general manufacturing, agriculture, pharmaceuticals, investment, professional services, and general trade). As SOE reforms are implemented, the state firms' share of revenue should at a minimum decline in normal industries – those that Beijing has identified as suitable to market competition as the decisive factor. To supplement this primary indicator, we look at the share of all industrial assets held by SOEs, leverage ratios at state versus private firms, SOE versus private returns on assets, SOE versus private ability to cover interest payments, and the SOE share of urban employment.

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: Share of SOE Revenues in Different Industry Categories



Source: Bloomberg, Rhodium Group.

- SOE reform is not moving materially forward and our score remains negative — the weight of SOEs in China's industrial sectors was unchanged or increased modestly in 4Q2018 across all industry categories. Even a trend of

reduced SOE presence in pillar industries has now reversed.

- Data do show private firms are borrowing more and growing again, at least for now, as leaders respond to an anxious public backlash over deteriorating conditions for the private sector.
- Reform debate is still constrained by ideological commitment to a strong state presence: officials mostly reiterate existing policies while the economic risks of inaction rise.

THIS QUARTER'S NUMBERS

The continued massive role for state-owned firms in the economy remains one of China's most pressing reform challenges. At the 2013 Third Plenum, Beijing planned to reduce state influence in commercial industries. But we do not see a smaller role for the state in any of the three major industry categories assessed in our data.

Based on annual reports of listed Chinese companies, we calculate that SOEs generated 14.7% of revenues in normal industries, those for which Beijing has not offered a strategic rationale for state dominance and therefore should be suited to market competition. This number is only slightly lower than last quarter despite Beijing's repeated promises to accelerate reform. Our data also show that SOE revenue shares in pillar industries, which Beijing says are economically strategic to future competitiveness, are now increasing — reversing the trend of the past three years. The reversal was particularly notable in construction industries, as Beijing turned to SOEs and infrastructure projects again late last year to stabilize the economy. SOE revenue shares in key industries remain high, at around 84%, and have little chance of shrinking as these are the sectors Beijing views as most directly related to national security.

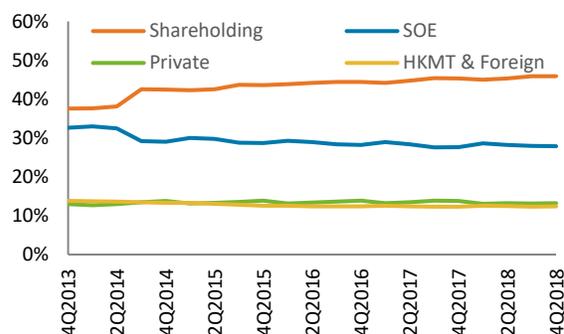
In the past two Dashboard editions, we noted that China's private sector was shrinking and its state sector growing, as policymakers emphasized the importance of state firms and deleveraging efforts reduced capital available to private interests. At least for the moment, this has reverted back. Policymakers called for increased private sector support in late 2018 and eased monetary policy to drive growth. This improved private sector credit conditions, primarily via short-term working capital loans. Private firms were able to borrow more in 4Q2018, driving a continued rise in private sector leverage relative to SOEs (see **SOE Leverage**). The return on assets for private firms also improved slightly to 7.1% in 4Q2018 from 7.0% in 3Q2018 (see **SOE Return on Assets**), likely a result of tax cuts and lower mandatory pension contributions.

Can this bounce in private sector activity last? We are not overly optimistic, because the improvement is mostly short-

term borrowing. As economic momentum accelerates in 2019, the central bank appears to be backing off monetary easing, which could translate into higher money market rates and higher private sector borrowing costs by the middle of the year. Despite renewed borrowing at the end of 2018, the private share of industrial assets held steady at 13.2%. This means SOEs are growing as well (see **Industrial Assets by Ownership**). If interest rates do start to rise, SOEs will benefit more because of their easier access to capital, as was the case in 2017–2018. Taken together, we expect the private recovery to be fragile and shallow unless leaders take more decisive actions to limit the activities of SOEs by reducing their political advantages.

Supplemental 1: Industrial Assets by Ownership

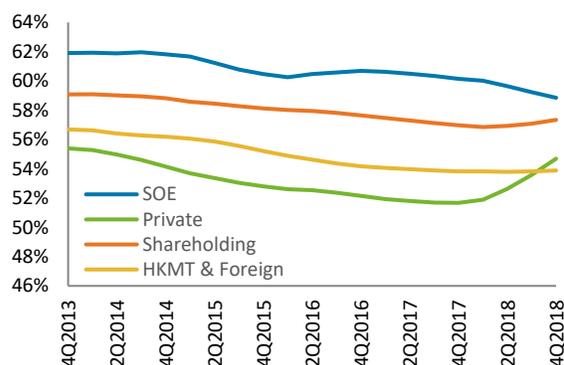
Percent



Source: National Bureau of Statistics, Ministry of Finance, Rhodium Group.

Supplemental 2: SOE Leverage

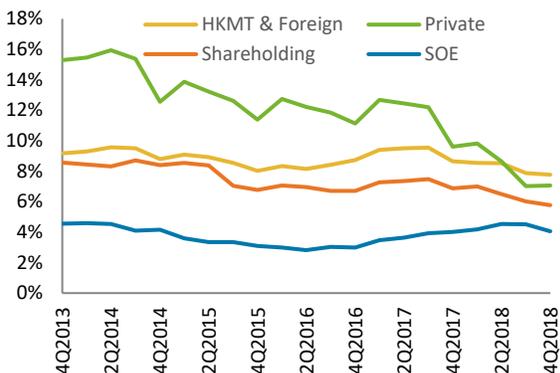
12mma, percent



Source: Ministry of Finance, Rhodium Group.

Supplemental 3: Return on Assets

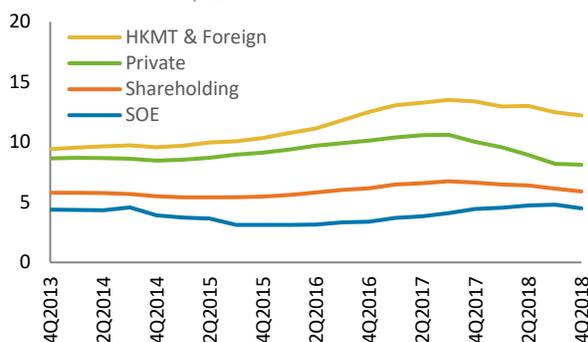
Percent



Source: State-owned Assets Supervision and Administration Commission, Rhodium Group.

Supplemental 4: SOE Interest Coverage Ratio

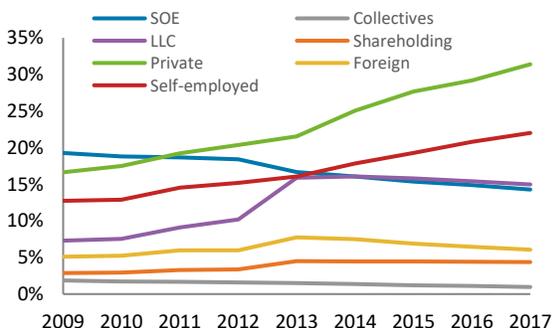
Profit to interest ratio, 12mma



Source: Bloomberg, Rhodium Group.

Supplemental 5: SOE Share of Employment

Percent



Source: National Bureau of Statistics, Rhodium Group.

POLICY ANALYSIS

Pruning state-owned firms would improve internal resource allocation and reduce international pushback. But leaders offered no compelling new reform designs this period. At the moment, leaders are more intent on influence over economic outcomes than greater efficiency and competition.

At the March National People’s Congress (NPC), Premier Li Keqiang did make an encouraging promise in his annual work report to better “balance the relationship between government and market.” This was the first time in five years that this phrase was prominent, suggesting that policies concerning the competitive environment and the treatment of SOEs are at least up for discussion again (see **Competition** section). However, Li has yet to advance any substantive new measures. His report merely promised to continue the mixed ownership trials for state-owned firms already underway and improve SOE corporate governance. Li did commit to accelerated restructuring for oil, electricity, and railway SOEs, but these plans are primarily about the regulation of SOE monopolistic pricing power rather than reducing their presence in these sectors overall.

Also during the NPC, a spokesperson for the National Development and Reform Commission (NDRC) stated that private investors would be able to acquire controlling interests in normal commercial SOEs, consistent with 2013 reform goals. But the NDRC did not propose any new details, such as making explicit which SOEs would be considered normal commercial SOEs or giving private investors assurances that they would be able to control these firms after acquiring a majority of shares.

There was one area of SOE reform progress during the NPC, but this ironically reflected the government’s intention to continue relying upon state firms for the foreseeable future. In its 2019 budget released on March 6, the Ministry of Finance (MoF) said that it would increase SOE dividend payments by an average of 16% in 2019, up from 7.7% growth in 2018. Requiring SOEs to pay more dividends to the state was an explicit 2013 Third Plenum commitment, so this does represent progress. But our analysis shows that 70% of these dividends are then *reinvested back into SOEs* themselves. So this policy will have little impact on the overall economy and may actually benefit many SOEs. In fact, squeezing more dividends out of SOEs could prove counterproductive to the Third Plenum reform objectives if policymakers try to maximize SOE profits at the expense of other private market players.