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 (used in the 1990s as well) 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.

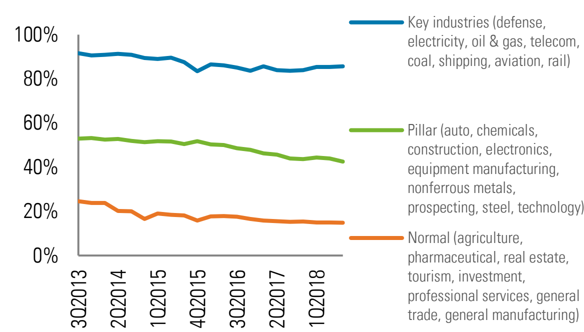
- Since 2017, the government has pushed to "corporatize" SOEs, including establishing boards of directors to replicate the structures of other commercial entities. But it also required all SOEs to institutionalize the role of Communist Party Committees into their articles of association and give the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

METHODOLOGY

We use China's own classification scheme to assess SOE reform progress. For listed companies where information is available, 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
4qma, percent



Source: Bloomberg, Rhodium Group.

- SOE reform is backsliding this quarter: our indicators show SOEs advancing at the expense of private firms, and policies focused on increasing Communist Party supervision instead of reform.

- SOEs did not withdraw from even the least strategic industries, while the private sector shrank within the economy as a result of capacity cuts and slowing credit growth.

- Policy developments point to risks ahead: Party supervision alone is not leading to SOE rationalization and has a chilling effect on competition both at home and in international markets.

THIS QUARTER'S NUMBERS

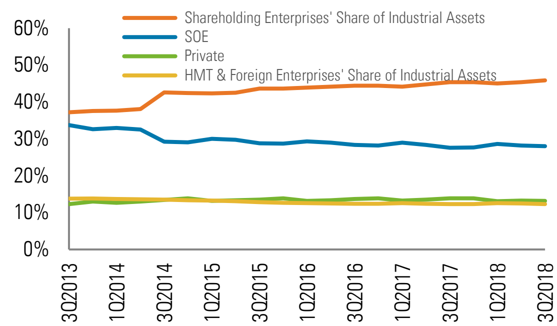
Our primary indicator tracks the share of SOEs in listed company revenues. It shows little progress in state sector reform. The 2013 Third Plenum Decisions defined reform as including withdrawal of state influence from SOEs in commercial sectors, but we find little change even within normal industries where the market should play a decisive role. In 3Q2018, SOEs enjoyed 14.8% of revenue in these industries, marking only a 0.1 percentage point decline from the previous quarter. Since 2016, the SOE revenue share in commercial sectors has declined only slightly, revealing a stall in progress toward 2013 goals.

In "pillar" industries where Beijing sees strategic linkages to the country's economic development, SOE revenue share declined by 1.4 percentage points from last quarter. In "key" industries that Beijing considers strategic and linked to national security, SOEs' revenue share *increased* by 0.4 percentage points this quarter. We do not expect SOEs' dominant role within these industries to change substantially in future quarters. The increase in revenue shares captured by state firms in key industries indicates that intentions to use "mixed ownership" trials to bring in private investment are not improving competitive conditions.

That SOEs are actually growing, not shrinking, adds to the current global fallout over the uneven playing field between private and foreign firms in China, a point frequently cited by the United States in the ongoing trade war. Private firms were hurt disproportionately by government-led capacity cuts and deleveraging, while SOEs were able to enjoy higher prices, maintain easier access to credit, and sometimes acquire troubled private firms. Only SOEs saw increased returns on assets (see **SOE Return on Assets**), lower leverage ratios (see **SOE Leverage**), and improved debt service capacity (see **SOE Interest Coverage Ratio**) this quarter, in line with last quarter's results. Private firms' leverage ratios rose because their assets declined, not because they had access to additional credit facilities. Growth in private firms' assets slowed significantly early in 2018 and dove into negative territory by June. As a result, private firms' share of industrial assets declined to 13.1% in 3Q2018 from 13.9% in the same period a year earlier (see **Industrial Assets by Ownership**).

Supplemental 1: Industrial Assets by Ownership

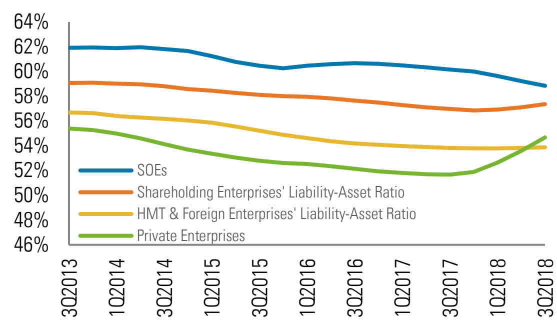
Percent



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

Supplemental 2: SOE Leverage

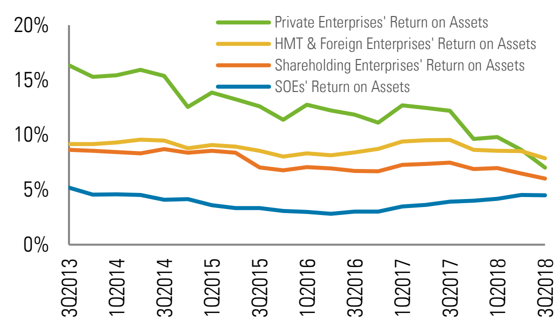
12mma, percent



Source: Ministry of Finance, Rhodium Group.

Supplemental 3: Return on Assets

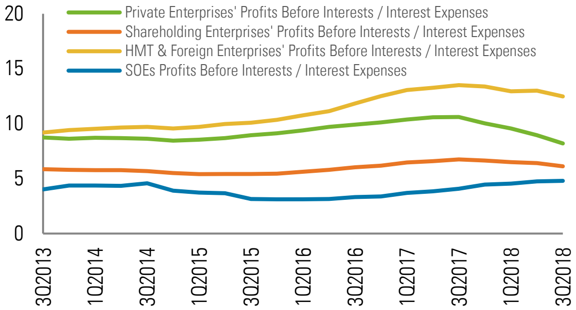
Percent



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

Supplemental 4: SOE Interest Coverage Ratio

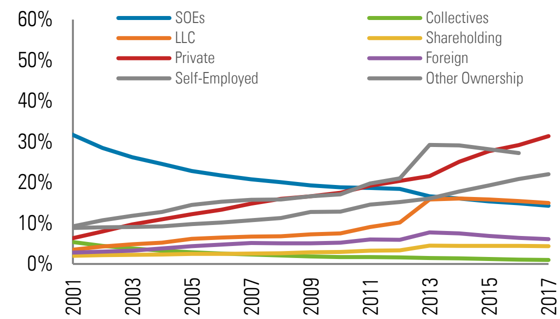
Profit to interest ratio, 12mma



Source: Bloomberg, Rhodium Group.

Supplemental 5: SOE Share of Employment

Percent



Source: National Bureau of Statistics, Rhodium Group.

POLICY ANALYSIS

Policies announced in the review period strengthened Party supervision over SOEs rather than invigorating market-oriented reforms. In September, the China Securities Regulatory Commission (CSRC) updated guidance concerning corporate governance for companies listed in China, requiring all firms to support Party-building activities and listed SOEs to codify Party leadership into their articles of association. SOE Party Committees were directed to serve a "leadership core" function and to ensure compliance with national strategies by strengthening control over personnel appointments and major decisions, taking precedence over the authority of boards of directors. (For more details, please see our latest report on SOE governance published with the Asia Society of Northern California). In short, these actions move in the opposite direction from 2013 Third Plenum reform goals to *withdraw* state influence from commercial SOEs.

The call for private firms to support Party-building activities is particularly concerning. Beijing attempted to clarify these requirements with more detailed Party documents during the review period, which stated that Party Committees of private firms are not authorized with the same "leadership" function as in state firms. Instead, their role is to ensure private firms' compliance with laws and regulations. However, tasking the Party to police private firms from inside is no way to transparently discipline market participants.

Beijing is particularly strengthening supervision of SOEs in the financial sector. In October, the State Council reported on state assets to the National People's Congress. For the first time, the report covered not only nonfinancial SOEs governed by the State-owned Assets Supervision and Administration Commission (SASAC) but also financial SOEs governed by the Ministry of Finance and other state assets held at central and local government levels. The report highlighted the size of China's financial SOEs: together they hold RMB 241 trillion ($34 trillion) in assets and RMB 217 trillion ($31.4 trillion) in liabilities, compared with nonfinancial SOEs' RMB 183 trillion ($26.5 trillion) in assets and RMB 118 trillion ($17 trillion) in liabilities. To put these numbers in context, China's state-owned financial assets are worth around half of global GDP at current exchange rates.

Beijing is clearly concerned about the scale of these financial SOEs and potential risks associated with their rapid expansion over the past decade, which explains why they were included within this stocktaking exercise. It remains unclear what Beijing will *do* with these giants, which are large enough to present systemic risks not only to China's system but also to the global economy writ large.

In November, policymakers responded to growing concerns about the retreating Chinese private sector. President Xi Jinping made two widely publicized speeches during the month praising private entrepreneurs and assuring them of official support. On November 9, Guo Shuqing, the central bank's party secretary and the head of China's Banking and Insurance Regulatory Commission (CBIRC), proposed that 50% of all new corporate lending would go to private firms within three years (see Financial System). And on November 16, the tax bureau announced that it would defer tax collections for private companies struggling with financial distress.

While these commitments reflect rising concerns among policymakers about falling private sector growth, they are a far cry from serious reform. Setting lending targets for financial SOEs on this scale is not only inefficient but also dangerous – Guo's 50% commitment immediately encountered backlash in the domestic financial sector over fears of additional bad debts on banks' balance sheets. The backlash made clear that it is increasingly difficult for Beijing to demand both rapid growth and political control given the size of China's economy today and the extent of its integration with the global market.