Privatization:
The Key to Higher Investment Efficiency in China

By C. H. Kwan

Since beginning its "open-door" and "market-oriented" reforms in the late 1970s, China has achieved an average annual growth of nearly 10%. This is primarily the result of growth in investment even though investment efficiency has remained relatively low. Sustaining economic growth requires reforming inefficient state-owned enterprises and banks through privatization, and China's securities markets are expected to play a more and more important role in this process.

State-owned Enterprises: Major Source of Inefficiency

The fundamental cause of the Chinese economy's low efficiency is the still large presence of state-owned enterprises. The inefficiency of state-owned companies is a common problem in all countries, and China is no exception. In fact, since China started its reform process in the late 1970s, a strong negative correlation has been observed between provincial GDP growth and the share of state-owned enterprises *(Chart 1)*.

In addition, China's financial system, which has so far been tightly controlled by the government, has failed to efficiently transform savings into investments.

In the area of indirect finance, corporate governance has remained weak at the four leading state-owned commercial banks that form the core of China's banking sector. Like the state-owned enterprises that receive the bulk of their loans, these banks are not acting to maximize profits for the Chinese people, who are supposed to be their ultimate owners. Loan interest rates have been set low as a way to subsidize the state-owned enterprises that receive the financing, and the banks have failed to allocate funds to the highest-yielding projects. Government officials, particularly those from local governments, intervene in the business activities of the state-owned commercial banks, including in personnel and lending decisions, resulting in rising nonperforming assets.

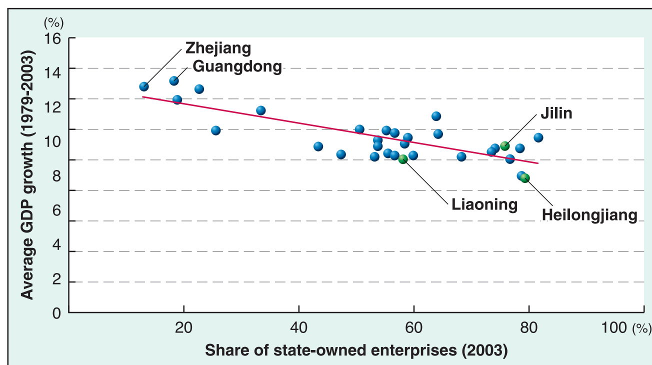
Meanwhile, in the area of direct financing, securities markets have also become dysfunctional, as evidenced by the fact that share prices remained stagnant between 2003 and 2005 despite a booming economy, as investors had lost faith in China's securities markets amid a series of scandals involving listed companies. This abnormal situation can be attributed to the fact that most listed companies are state-owned enterprises where the government is the shareholder with absolute control. Although the companies are listed, the majority of their shares is still owned by the state and cannot be traded on the market. As the largest shareholder and owner of a majority of the voting rights, the state (more accurately, a bureaucrat entrusted by the state) effectively controls the general shareholders meeting, the board of directors, the auditors, and the selection of the management team. The state widely abuses its shareholder status to trample on the rights of minority shareholders. As a reflection of this, a large number of listed companies in China report a substantial worsening of earnings, or become unprofitable, shortly after their listing.

The Need for Privatization

The inefficiency of state-owned enterprises reflects first of all a failure of corporate governance. To fix this situation, ownership in state-owned enterprises must be transferred, through a process of privatization, to private-sector investors who take a strong interest in the earnings generated by those enterprises.

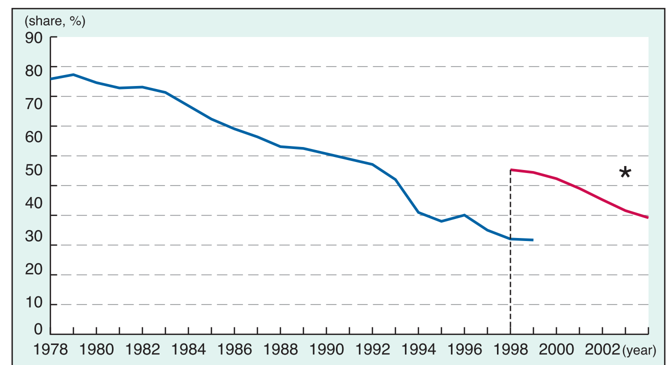
In contrast with Eastern Europe and Russia, economic reform in China has

Chart 1 Negative correlation between provincial GDP growth & share of state-owned enterprises



Source : Compiled by the author based on China Statistical Yearbook

Chart 2 Declining share of SOEs in industrial production



*Note : * Since 1998, only companies with annual sales over 5 million yuan have been included, and the share of state-owned enterprises so calculated has risen.*
Source : China Statistical Yearbook

avoided the privatization of state-owned enterprises but instead retained a system of public ownership, the core feature of socialism, as it has pursued the transition from a planned economy to a market economy. Nevertheless, behind this government facade of "adhering to a system of public ownership," China has made steady progress in privatizing state-owned enterprises in recent years. Combining this with the growth of private companies and foreign firms, state-owned enterprises' share of industrial production has been following a downward trend *(Chart 2).*

Under the planned economy prior to China's open-door reforms, not only did the government own nearly every company, it directly participated in their management, making the firms state-run enterprises in both a nominal and real sense. As a result of decentralization in the 1980s and the separation of administrative from corporate functions, the government's role now stops at ownership, and the companies have expanded considerably their management prerogatives. Because of this, the term "state-run enterprise" was replaced with the term "state-owned enterprise" in the early 1990s. Subsequently, from the mid-1990s the government began privatizing state-owned enterprises under the concept of "seizing the big and freeing the small," and the policy of "strategic realignment of state-owned sectors of the economy." The latter allows state-owned enterprises, including large ones, to exit from sectors where market competition should be the norm, while only keeping industries associated with national security, infrastructure and other important public goods and services, as well as leading companies in key and high-tech industries, as state-owned.

Since then, many small and medium-size state-owned companies have been privatized through such means as management buyouts and mergers with private-sector companies, but further reform of the securities market is required before the privatization of large state-owned enterprises can move forward.

In a capitalist country, the most common method of privatizing a state-owned firm is to convert it into a corporation, list its shares, and then gradually reduce the state's shareholdings. Typical examples of this in Japan are the listings of Nippon Telegraph and Telephone Corp. (NTT) and the companies of the Japan Railways (JR) group. In China, however, the fact that state-owned shares make up the majority of shares issued, and are not allowed to float on the market, has acted as a bottleneck preventing the securities market from fulfilling its expected role as a vehicle for privatization. Fortunately, full-scale reforms of the non-tradable shares since 2005 have gone a long way toward resolving this problem, and this should accelerate the privatization of large state-owned firms.

Photo: Kyodo News

Investors crowd the office of a securities company in Shanghai. Information disclosure for individual investors makes little progress in the Chinese stock market, with irregularities occurring one after another.

Commercial Banks May Also Be Privatized

Improving investment efficiency will require reform of not only securities markets but also of the banking sector, the lead provider of indirect financing. To achieve banking-sector reform, the Chinese government is moving forward with plans to inject public funds into the banking system, dispose of nonperforming loans, turn the four largest state-owned banks into joint-stock banks, and then list their shares on overseas markets. The plan aims to attract strategic investors from overseas to improve management efficiency. Meanwhile, foreign financial institutions are looking to enter the Chinese market through capital tie-ups with local banks. Three out of China's four major state-owned banks, namely China Construction Bank (CCB), the Bank of China (BOC) and Industrial and Commercial Bank of China (ICBC), have been successfully listed on Hong Kong's stock market, and the remaining Agricultural Bank of China (ABC) will be following suit.

The final goal of state-owned bank reform is likely to be privatization, whereby both the government's ownership and its management will be phased out step by step. The ongoing shareholding reform and listing of the Big Four banks is no more than the first step toward that end. Even after shareholding reform, listing the shares, and forming a rules-based system of corporate governance within the bank, it does not mean that an actual incentive system and a management oversight mechanism are effectively functioning within the bank. A bank can be transformed into a joint-stock bank with a board of directors, a board of auditors, a general shareholders meeting, and other management structures, but as long as the government remains in control as the largest shareholder, the usual problems are unlikely to be solved. This is why it is important, once the Big Four have listed their shares, to start reducing the government's stake and put privatization within reach. Foreign investment in Chinese banks is currently limited to no more than a 20% stake per investor and less than a 25% stake by all foreign investors combined, but this restriction could easily be loosened in the future, paving the way for their privatization. JS

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