Fit for purpose?

What are SOEs for exactly, asks China-based banker Peter Fuhrman

His was a deceptively simple question. "What exactly is the purpose of a Chinese SOE?"

I had just finished speaking to the Asian management committee of Air Liquide, one of the more successful Fortune 500 companies operating in China. Air Liquide has done profitable business with large SOEs (state owned enterprises) in China for years. That business has begun to evaporate. Having just heard me summarise the deteriorating situation at many SOEs, and the decision last month by the Chinese government to quietly shelve plans for a root-and-branch restructuring, one senior Air Liquide executive wanted to know what the SOEs are now in business to do. Make money? Provide and protect jobs? Project national power?

I reminded him Chairman Mao was a keen student and devoted follower of Lenin. He fully embraced the Leninist concept of the state and Party controlling the "commanding heights" of the economy. China's SOEs are still very much in that business: owning most – and sometimes all – of China's large-scale assets in petroleum, gas, electricity generation and distribution, coal, banking and finance, transport, steel, aluminium and a wide range of industrial chemicals.

But the executive reminded me that Mao has been gone a long time and that Deng Xiaoping began dismantling state power 35 years ago to create the conditions in which today's vibrant private sector could emerge. These private firms are China's best companies and the source of all net new job creation in China. They contribute far more to GDP than the SOE segment. What, the executive, insisted, were SOEs in business to do?

Chengdu Airlines celebrates receiving its long-overdue ARJ21 aircraft

Photo Source: Imagine China

It was obvious he wasn't going to accept an answer based on Leninist theory. "Why don't they just privatise the state-owned sector?" he pushed back. That, I told him, was out of the question, at least for now.

Looking for time to collect my thoughts, I steered him towards the coffee machine. Above all, I told him again, an SOE is an instrument to achieve the policy goals of the Chinese government and the Party. This is as true today as it was at their origin. Sometimes those policies, at least originally, were high-minded, even socialistic, like providing energy at an affordable price to everyone. But while energy is plentiful in China today, it's not cheap. Subsidies have been eliminated and prices hiked to levels generally well above those in the US. The money paid to the petroleum and power monopolies is a transfer of private wealth to the state, or in other words a mechanism for hidden tax collection.

Most SOEs – especially those in heavy industry, shipping, steel, coal – are not quite so lucky. Rather than earning monopoly profits, they are chronic lossmakers. They rely on subsidies from other SOEs, mainly China's state-owned banks. The banks too were originally conceived as a way to provide a safe home for the masses' savings. But over time, the SOE lenders have evolved into a machine that shovels up those private savings and hands them over, in the form of subsidised loans, to other SOEs. And the beneficiaries of this mispriced bank credit have done what other institutions often do when they are offered deals like this – they use the subsidised lending to invest in projects with limited scope for profit, leaving them progressively less capable of repaying the loans.

Since the bankruptcy of an SOE is not an outcome that's possible in the current system, the less solvent SOEs become, the more the SOE banks need to lend to them. SOE banks exist, in part, to throw good money after bad.

In a few distinct cases, the socialist vision for SOEs is still untainted. I'm thinking here of China Mobile and its two sibling SOE mobile networks, China Unicom and China Telecom. They all offer good service, with a reliable signal anywhere you go in China, from trains and highway tunnels to office elevators, on the climb up Mount Everest and even on the half-submerged Spratley Islands now patrolled by the Chinese navy. Prices for voice and data packages are still lower than the US or just about anywhere else too.

Providing jobs, both lowly and prestigious, is another important SOE function. SOE bosses are usually chosen from senior bureaucrats, often as a reward for loyal service, and top executives get a big bump in pay when they become chairman or senior manager. The fact that most of them have no experience in that industry, or in running a large, complex enterprise, is not cause to be disqualified for consideration. Rather, it's often seen as a plus.

The revolving door can move in the opposite direction: after a fixed period at the top of generally four to six years, many of the same bosses go back into government, sometimes as the heads of the regulatory bodies that oversee their former employer and its competitors.

For ordinary Chinese who land jobs at an SOE – something that's becoming more difficult as state firms cut back on hiring – the jobs tend to be less well-paid than in the private sector, but they offer a cosier guarantee of lifetime employment, lighter workloads, and ancillary benefits that might include subsidies for housing, healthcare and schooling for children.

A workers' paradise? Hardly, but still a kind of frozen-in-amber reminder of how most Chinese spent their working lives until about 20 years ago when the private sector began its remarkable ascent.

It would be tempting to say that everything about China's SOE sector is a living fossil. But at least one SOE monopoly has done a great job of changing with the times. Broadcast media, especially China's 60-plus television stations, was originally started to give the Party and government a way to circulate news and propaganda. But SOE broadcasters these days carry only a few hours of mandated programming each day. Instead, they fill up all their airtime with popular variety shows and racy tele-serials larded with advertising. The SOE broadcasters rake in money. TV ads are among the most expensive anywhere in the world.

Another example of a highly lucrative industry monopolised by SOEs is alcoholic drinks. The major beer and spirits brands are all state-owned. China is the world's largest market in volume terms. Tobacco is another SOE monopoly. Over 40% of the world's cigarettes are made and smoked in China, and virtually every one is produced by a single SOE, China Tobacco. There is no more valuable licence to print money in the world than to be China's monopoly cigarette company. Why the state wants to manufacture and sell, rather than just tax, sin products is a conundrum. But the goal certainly does not appear to be to discourage their use.

SOEs also occasionally operate as tools through which the state seeks to achieve goals related to China's prestige and national security. A notable example was this month's debut of China's first home-produced mid-sized jet aircraft, the Comac C919. The jet is designed to compete with the Boeing 737 and Airbus A320. If things go to plan, the first C919 will take to the air with paying passengers in 2019. But the same SOE has been working on a smaller jet, the ARJ21, for years. Its launch has been plagued by long delays and it is still uncertified to fly anywhere outside China (Chengdu Airlines says it will begin flying the ARJ21 domestically in the next few months).

At least these two new aircraft made it off the drawing board. The same can't be said of one of the highest-profile SOE engineering projects of all, a decades-long multi-billion-dollar effort to produce a Chinese-made jet engine for civilian and military aircraft. Years overdue, and still untested, the engine programme has turned into a significant embarrassment and a colossal money sink. Had it been allowed to try, China's private sector would likely already have an engine in service, at one-tenth of the cost in time and money.

All the more reason, the Air Liquide executive concluded, to privatise China's SOEs. After all, privatisation worked wonders in turning around similarly-feeble state-owned companies in eastern and western Europe, as well as Japan and Korea.

Impeccable logic. But privatisation happens when a government, usually driven by fiscal or ideological reasons, decides it wants to cash out. China's government simply doesn't feel the need. It will continue to tinker around, selling minority stakes through IPOs at home and in Hong Kong while talking up the value of private sector investment. But the SOEs will stay on the government balance sheet because they are assets whose value is calculated in terms of enhancing state power and economic control, not generating shareholder returns. ■

Fuhrman is Chairman and Chief Executive Officer of China First Capital and a longtime reader of WiC.