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Special report: ***Business in China***

Reform

The good, the bad and the ugly

The bloated state-owned sector must be reformed so that private firms can compete on equal terms

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The future is private

“THE PURPOSE OF SOE reform is not to get rid of them from the market; on the contrary, we want to make them bigger…we need to maintain the status of state ownership as the dominant power in the Chinese economy.” Fu Chengyu, then the boss of Sinopec, a state-owned oil giant, was speaking exactly a year ago, at the Summer Davos conference, an annual gathering in China of global business executives and Chinese leaders organised by the World Economic Forum (this year’s meeting is taking place this week). His remarks prompted a sharp response from Dong Mingzhu, the chairman of Gree Electric, a state-owned firm and the world’s largest manufacturer of domestic air conditioners. She noted that Sinopec operated in a “monopolistic industry” whereas Gree had to fight for customers as a “private, market-oriented company”. She went on: “What we really need is an environment of free competition instead of support from the government.”

The two bosses’ exchange illustrates official China’s competing visions for SOE reform. The leadership is painfully aware of flagging economic growth and soaring debt and knows it must boost productivity and innovation. That is why it has formally committed itself to giving market forces a “decisive role”. But as Mr Fu’s statement made clear, not all SOE bosses agree on what that means.

Both the number and the output of China’s SOEs is shrinking, but they remain politically powerful. By gobbling up a disproportionate share of resources, especially credit, they crowd out the private sector. They are also responsible for many of China’s economic excesses, ranging from poor investment decisions to too much leverage. The IMF calculates that the SOEs’ average debt-to-equity ratio rose to roughly 1.6 in 2014, from about 1.3 in 2005; the ratio for private firms in 2005 was also around 1.3, but by last year it had fallen below 0.8.

If Chinese leaders want to put the economy on a sounder footing and develop the private sector's full potential, they must embrace Ms Dong's version of SOE reform. That will require an effort on three fronts: first, speeding up financial liberalisation so that credit goes to the most dynamic firms, not the best-connected; second, enforcing the rule of law so that all firms, domestic or foreign, are treated equally; and third, encouraging competition across the economy, including in "strategic" sectors.

China's progress on these three fronts can be summed up as good, bad and ugly. The good news is that China's reformers have, in fits and starts, begun to ease the state's iron grip on finance. In the past, ordinary Chinese often got negative returns on their savings so that SOEs could enjoy subsidised capital from state banks. Private companies were largely left out. A World Bank report published in June said that in China "the state has interfered extensively and directly in allocating resources through administrative and price controls, guarantees, credit guidelines, pervasive ownership of financial institutions and regulatory policies. These interventions have no parallel in modern market economies." The report quickly disappeared from the bank's website, to be replaced later by a more anodyne version.

Still, things are getting better. The authorities are liberalising interest rates and have introduced a useful deposit-insurance scheme. They have encouraged private firms to experiment with online finance. And in August they heeded the IMF's advice by moving (bumblingly) towards what looks like a more flexible exchange-rate regime. Much more needs to be done, but the outline of a market-based financial sector is emerging.

Progress on the rule of law has been much more halting. Business in China would clearly benefit from a move to a fair and transparent legal system. Michael Spence, a Nobel prize-winning economist at New York University, points out that such a reform would improve the enforcement of contracts, encourage new entrants and help reduce financial fraud. Last October China's leadership agreed on the importance of "comprehensively advancing the rule of law", but many observers are sceptical. The law still bars private Chinese firms from operating in many sectors, and foreign firms have suffered from an uneven and unfair application of the anti-monopolies law, among others.

Competition remains the ugliest aspect of market reform. Extreme competition and none at all exist side by side. Peter Fuhrman of China First Capital, an investment bank, describes competition among private firms as so ruthless that "parts of China may be the most capitalist place on Earth." At the same time large swathes of the economy controlled by the zombies of the state sector are not subject to any competition at all.

Over 100 big state firms are controlled centrally, and many thousands more are in the hands of provincial and local government. Having observed the looting of Russia's assets by oligarchs, China's leaders strongly oppose outright privatisation, and indeed a "big bang" sale of SOEs would probably line the pockets of princelings. Officials have dabbled in partial privatisation, but that has done nothing to boost competition.

Yet SOEs are a drag on growth and innovation that China cannot afford, so if privatisation is not workable, other ways must be found to make them more effective. The most promising approach is to end state protection for all SOEs. As Andrew Batson of Gavekal points out, any such reform must allow state firms to go bust. SOEs should also be allowed to recruit professional managers and pay market wages. Together, such changes would expose state firms to competition from new entrants, forcing them to improve or die.

Unfortunately, however, the government seems set to reduce competition still further. It has recently merged the big SOEs in nuclear-power construction and in train manufacturing. There are strong rumours that it wants to consolidate the 100-odd central SOEs into 40 or 50 mega-zombies. It is keeping party hacks in the most senior jobs at these firms—and cutting their salaries, a sure way to discourage top talent from the private sector.

Demands for genuine market reform are growing louder. In a report on China's economy published in August, the IMF noted that the country is making progress on structural reforms, but warned that a huge amount of work remains to be done. Mark Schwartz, the head of Goldman Sachs in Asia, is hopeful about China's future but thinks progress will take time: "I see this as the beginning of a 30-year historic period of reform."

The biggest reform needed is a change in mindset. *Caixin*, an influential Chinese financial magazine, recently ran a striking editorial arguing that, despite official promises, the private sector still suffers legal discrimination in market access, finance and investment. China needs "a transformation" to become more innovative and efficient, it said, which "requires a break from the old practices of a planned economy".

Shaking the world

China shakes the world, its admirers liked to say of the country's meteoric economic rise in recent years. Alas, the stomach-churning volatility of Chinese markets this summer, and the global shockwaves this has caused, have given the phrase a new meaning.

Western experts once praised China's state planners for their technocratic brilliance, but their faith has been shattered by the government's ham-fisted attempts to boost the stockmarket and its inept moves to liberalise its currency. All this has prompted former boosters to conclude that China's economy is destined for disaster and the good times for business are over.

This special report has made a different argument. China's economy is indeed in a tight spot, and its handlers are hardly inspiring confidence. But beyond the storm clouds, there are still good reasons to think that business has a bright future in China.

Double-digit economic growth was never going to be sustainable indefinitely. For an economy that in purchasing-power-parity terms is already the world's largest, continued growth of even a more modest 5-6% would still mean rapid progress. Thanks to that, and to increasing urbanisation, the middle class, until recently just a small sliver of the population, is expanding fast and will soon make up the majority. Investment-led growth is giving way to growth driven by domestic consumption. And the opening of the long-repressed services sector could represent, on one estimate, a $12 trillion prize in the longer term.

But the biggest reason for optimism is the emergence of China Inc as a powerhouse of innovation. If the country is to sustain strong growth in the future, it must rely on fresh waves of entrepreneurialism and innovation of the kind that have recently propelled it forward. As this report has shown, such dynamism has not, and will not, come from stodgy state firms. It can be delivered only by the private sector.

For this to happen, though, the government must push ahead with difficult reforms to curb the power of the state and improve the rule of law. It must expose state firms to the discipline of genuine market competition and the scrutiny of independent antitrust regulators.

Entrepreneurial private firms in China, both local and foreign, have demonstrated their vibrancy and resilience. If the government embraces bold reforms that let them compete on equal terms, they will remain the engine of China's success

http://www.economist.com/news/special-report/21663333-bloated-state-owned-sector-must-be-reformed-so-private-firms-can-compete-equal