What is the Future for China's State-Owned Enterprises?
—A Tentative Evaluation of the Effects of Reform on Growth Sustainability—

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Summary

1. The Xi Jinping administration embarked on the reform of state-owned enterprises (SOEs) in 2014, and it was expected that the reform process would accelerate in 2015. The reforms are based on three main concepts: (1) the creation of a mixed-ownership structure through the partial sale of SOE shares and capital to the private sector, (2) the reorganization of large SOEs into holding companies known as state-owned capital investment companies and the development of state-owned capital management systems to improve the efficiency of state-owned capital, and (3) the redeployment of state-owned capital with the level of public interest as the criterion, and the establishment of a modern company system to improve corporate governance.

2. Pilot initiatives by central and local governments have brought moderate progress toward the establishment of a mixed-ownership system, the creation of state-owned capital investment companies, and the development of a modern company system. The reforms are also having an effect in the financial sector, including the establishment of five private banks. The central government is actively indicating the scope of the reforms, including the announcement of "four pilot reform programs" targeting enterprises under the control of the State-owned Assets Supervision and Administration Commission (SASAC), and the creation of public-private partnerships (PPPs).

3. However, careful scrutiny of the results of these reforms reveals that the SOE reform process is not moving forward entirely smoothly. The mixed-ownership structure is supposed to create a win-win relationship between SOEs and private enterprises, but the areas in which the aims of both sides align are limited. Furthermore, private enterprises have become nervous about the mixed-ownership system because of growing concerns about outflows of state-owned capital.

4. While the Singaporean SOE Temasek is thought to be the model for the reforms, it is unlikely that China will be able to emulate Temasek's success in terms of the separation of government from business and the recruitment of outside experts. Sources of concern about the future of the reform process include the ambitious goal of raising the percentage of dividends paid to treasury to 30% by 2020, the fact that private capital has been introduced successfully in only a limited number of sectors, such as telecommunications, and a lack of progress on the redeployment of capital. The reform process is taking the path of least resistance. For example, the Chinese government has postponed action on its negative list and is focusing instead on the creation a PPP project list.

5. The Xi Jinping administration launched the reform program in response to the worsening financial performance of SOEs, including declines in both operating revenues and profit. As a result of the economic slowdown, the total capital turnover rate of SOEs is expected to drop to the level during the 2009 global financial crisis.

6. In addition to the SOE reform process, the Chinese government is also moving forward with the merger of large SOEs under the control of SASAC. These efforts reflect the government's desire to improve business competitiveness under national economic concepts, such as the "One Belt, One Road" and "Made in China 2025." However, these mergers are expected to lead to government-business integration and dysfunctional corporate governance. In addition, the earnings of state-owned commercial banks are expected to deteriorate due to interest rate liberalization, further compromising the efficiency of SOEs.

Introduction

In May the International Monetary Fund (IMF) released its economic outlook for China[(1)], in which it identified 6.5-7% as the appropriate growth range. The IMF further said that if growth exceeds 7% the government should take early steps to eliminate vulnerabilities, and that if the growth rate falls below 6.5% it would be necessary to underpin the economy through fiscal stimulus measures. Moreover, the IMF said that China should accept a growth rate of 6-6.3% in 2016, which is the year designated for the realization of the comprehensive reform program adopted at the Third Plenum (the third plenary session of the 18th Central Committee of the Communist Party of China).

China's influence on the world economy has increased with each passing year, and it is not surprising that China's growth rate in the next quarter or the next year has become the focus of intense media interest. However, we cannot predict the future direction of the Chinese economy simply by studying statistical forecasts, since the future of the economy will be determined by the reform initiatives of the Xi Jinping administration.

While the IMF acknowledged that China had made good progress on exchange rate and fiscal system reforms, it expressed concern about the slow progress of SOE reform. SOE reform is a core part of economic reform in any country and is often the factor that determines whether a government will survive or fall. In China, too, SOE reform is closely linked to fiscal and monetary reforms, as well as to the decline in investment efficiency, which is a source of concern for the government. For this reason, the success or failure of the SOE reform process will have a major influence on the sustainability of China's economic growth.

As awareness of these issues spread within the Communist Party and the government, the Xi Jinping administration began to tackle SOE reforms. This is the second time that the leadership has taken the scalpel of reform to the SOEs. The first round of reforms was led by former premier Zhu Rongji, who reduced the number of SOE employees by 20 million during his time as premier (1998-2003). Although there were problems, including a worsening employment situation and the outflow of state-owned assets, these reforms resulted in a significant streamlining of the SOEs.

However, the SOE reform process subsequently bogged down, in part because China was basking in the glory of its high growth rate. Under the Hu Jintao administration, the expansion of SOEs in monopolistic or oligopolistic positions was actually seen as evidence of improving competitiveness. The Hu Jintao administration ultimately used up the legacy of the Zhu Rongji period and left the bill for the Xi Jinping administration to pay.

The SOE reform process is still continuing. For these reasons, previous studies have mostly been limited to a partial introduction of the system. The purpose of this article is to provide a general picture of the reforms, and to evaluate the results achieved. The assessments are only tentative, but given the magnitude of the impact that the success or failure of the reforms will have on China and the world economy, we cannot afford to wait until the results of the reforms become fully apparent.

Part 1 provides a general overview of the SOE reforms that are implemented under the Xi Jinping administration. In Part 2 we will consider how these reforms should be assessed, while in Part 3 we will look at the situation that prompted the Xi Jinping administration to launch the reform process. This will be followed in Part 4 by an analysis of moves to merge major SOEs in parallel with the SOE reform process. We will also consider whether the sustainability of economic growth will be enhanced by these changes.

1. SOE Reforms under the Xi Jinping Administration

In what direction is the Xi Jinping administration taking China? The answer can be found in the "Decision on Several Major Issues Concerning the Comprehensive Deepening of Reforms" ("the Decision"), which was adopted at the Third Plenum in November 2013. The aim of the following analysis is to provide an overview of the SOE reforms contained in the Decision, and to examine the four "pilot reforms" introduced by the central government for implementation on a trial basis.

(1) Reform Policy from the Third Plenum—Three Pillars of SOE Reform

The Third Plenum was the first venue in which the newly appointed General Secretary of the Communist Party of China was able to present his own basic policies, and the Decision can be seen as a policy framework for the first term of the Xi Jinping administration. The SOE reform policy presented in the Decision basically consists of the following three components.

First there is the promotion of the mixed-ownership system. Mixed-ownership is a new ownership system that combines public and private ownership. In simple terms, mixed-ownership means the partial sale of the stock or capital of SOEs to private enterprises or foreign companies, and this process is referred to as "mixed-ownership reform." Since many listed companies are substantially controlled by non-listed holding companies (SOEs) (Szamosszegi and Kyle [2011]), OECD [2009] [(2)], this is not really a new approach to reform. The emphasis on the mixed-ownership system reflects the intention of the leadership to introduce private capital into a wider range of industries.

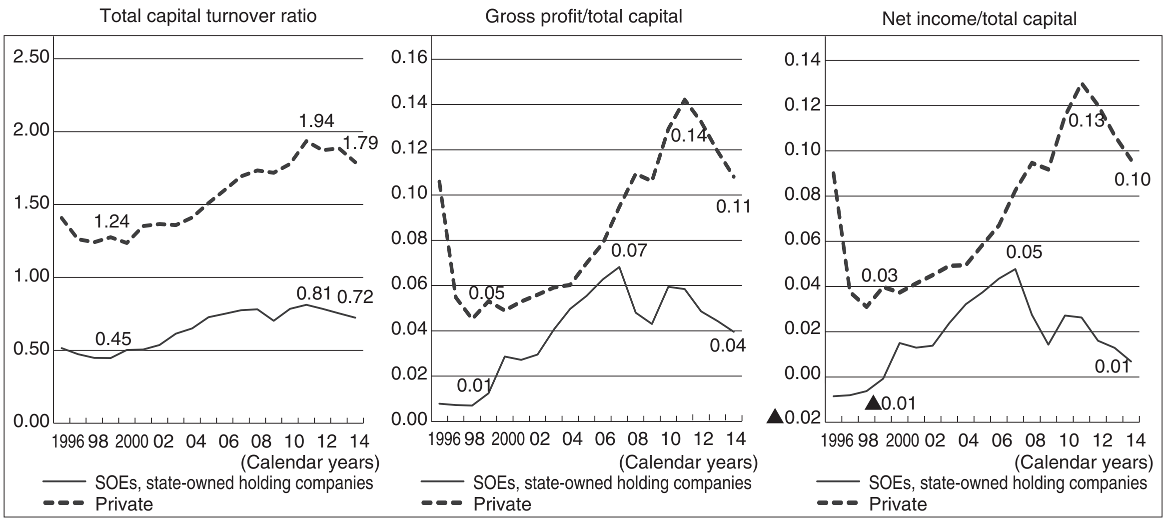
The second component is the development of a state-owned capital management system. State-owned capital management means that the government reduces its involvement in business management and instead focuses exclusively on the supervision of state-owned capital purely as an investor. This approach is based on lessons from past experience, which teaches that when the government strengthens its intervention in business management, supervision becomes proportionately more difficult, ultimately leading to deterioration in the financial performance of SOEs. In 2003 the Chinese government established the State-owned Assets Supervision and Administration Commission (SASAC) as an administrative organization responsible for capital management. In addition, State-owned Assets Supervision and Administration Commissions were also established at the provincial level and in lower-level administrative units. (To distinguish them from the central government SASAC, the names of these organizations are preceded by the names of regional governments to which they belong.)

The basic role of the SASACs is to maintain and increase the value of state-owned capital by methods through the appointment and dismissal of managers and the application of rewards and penalties[(3)]. However, this approach has not been very effective. The capital efficiency (earnings per unit of capital) of industrial SOEs and state-owned holdings companies (hereinafter referred to as "SOEs") has fallen, and SOEs have tended to lag further behind private enterprises. The gap has widened most in terms of operating revenues from core activities, followed by gross profit and net income. The net income of SOEs has fallen to one-fifth of the 2007 peak (Fig. 1). This trend can not be explained entirely through differences in the industry distribution of state-owned and private enterprises, and it suggests that there are serious problems within the SOEs.

For this reason, the Decision called for a shift from the two-tiered management structure consisting of SASAC and the SOEs, to a three-tiered structure: SASAC—state-owned capital investment companies (known as "state-owned capital management companies")—SOEs. What are state-owned capital investment companies? Some researchers divide them into three types: (1) financially-oriented investment companies that focus on returns, (2) policy-oriented investment companies that focus on areas of public importance, such as the military and some types of public services, and (3) entrepreneurial investment companies that need to be competitive in the market. The first type of company aims to improve capital efficiency, the second to achieve policy objectives, and the third to achieve both goals[(4)]. However, to date there seems to no analysis that includes a definitive explanation as to why the establishment of state-owned investment companies will lead to the achievement of any of these goals.

In Shanghai, which has been in the forefront of these changes, the following simple explana-

Fig. 1 Capital Efficiency of Industrial Companies by Ownership Type



Notes: Total capital turnover ratio = operating revenues from core activities/total assets, Gross profit/total capital ratio = gross profit/total assets, net income/total capital ratio = net income (gross profit – taxes and charges)/total assets
Source: Compiled by JRI using CEIC data

tion was provided concerning the role of the state-owned investment companies. According to the Shanghai government, the state-owned capital investment companies are like sheepdogs that help to the shepherds (SASACs) to manage the sheep (SOEs) [(5)]. There is a limit to the capacity of the SASACs to manage state-owned enterprises, of which there are around 140,000. The role of the state-owned capital investment companies is to improve management efficiency.

The state-owned capital investment companies are not newly established but rather created through the restructuring of existing major SOEs. Specifically, SOEs engaged in entrepreneurial activities within the groups of major SOEs selected by the government are reorganized and given the role of maintaining of supervising SOEs from the perspective of maintaining and increasing state-owned capital.

The third component is the development of a modern enterprise system. Under a modern enterprise system, state-owned capital would be concentrated into areas of high public importance, while the percentage of state capital employed in other areas would be reduced through the mixed-ownership system and other methods. In other words, the market would play a greater role in resource allocation. China's leadership regards this as vital to China's ability to adapt to changes in its environment, including economic marketization and internationalization. Key goals include the establishment of management decision-making standards, the maintenance and improvement of capital value, fair participation in competition, the improvement of management efficiency, and the improvement of corporate vitality.

In what areas will the government reduce the amount of state-owned capital? The Decision calls for the application of a model based on the separation of enterprises from the state, even in "natural monopoly" industries in which state-owned capital holds over 50% of shares, and on the separation of networks and operations (separation of infrastructure ownership and development from operating businesses in such areas as railways and electric power). The aim is to reduce areas monopolized by the government by moving SOEs out of industries that are suitable for competition. The Decision also calls for the improvement of enterprise management under a modern enterprise system through the selection of professional managers from China and overseas, and through the introduction of performance-linked compensation systems with the aim of rationalizing salary systems.

(2) Rapid-Fire Introduction of Specific Measures

By October 2015, the Xi Jinping administration will have completed three full years in office. While the administration appears to have tightened its grip on power by continually implementing unprecedented initiatives, such as anti-corruption campaigns, it made no significant moves in relation to SOE reform until 2013. The mixed-ownership system, the state-owned capital management system and the modern enterprise system cannot be described as new concepts, since all were mentioned in the policy framework presented at the Third Plenum in 2003 by the previous Hu Jintao administration.

The 4 trillion yuan stimulus package implemented by China after the Lehman shock was seen as a trigger for the "state advance, private sector retreat" phenomenon. However, the number of SOEs and their shares of employment and industrial added value were all falling, and the package did not emerge as urgent issue requiring action on SOE reforms. In fact, the growing number of Chinese SOEs included in *Fortune* magazine's Global 500 list of the world's top companies in successive years suggested that China's competitiveness was improving.

However, the Xi Jinping administration is concerned about the unprecedented deterioration of investment efficiency (Miura [2013], [2015]). For an administration that is committed to a shift away from an investment-led economy and has told local governments not to identify heroes on the basis of GDP, the deep faith in quantitative expansion that evolved under the reform and opening policy appears to be nothing more than a tumor that is eating away at the Chinese economy. As its power base become firmer, the Xi Jinping administration finally started work on SOE reform, and related government agencies and the SOEs at last began to take action. The SOE reform process has gathered speed significantly since 2014.

① Implementation of Mixed-Ownership System Starting with Large SOEs

The implementation of the mixed-ownership system has begun with large SOEs under central government control, as well as a few local governments. First targeted among SOEs under SASAC jurisdiction, which are as known as *Yāngqǐ* (central government SOEs), was China Petroleum & Chemical Corporation, or Sinopec. In September 2014, Sinopec raised 107.1 billion yuan from 25 Chinese and overseas investors by selling 30% of shares in its wholly owned subsidiary, Sinopec Sales Co., which sells petroleum products(6). In the same sector, China National Petroleum Corporation (CNPC) sold six units involved in oil refining, pipeline construction, financing and other areas to private capital in April 2014(7). In May it revealed that it was planning to raise funds from the private sector for use in oil field development in the Xinjiang Uyghur Autonomous Region(8).

China International Trust and Investment Corporation (CITIC) has also attracted attention in relation to mixed-ownership reforms affecting major SOEs. CITIC is one of China's leading conglomerates with business activities that include finance and energy, real estate, retailing and publishing. It became the focus of attention because of the speed with which it adopted the mixed-ownership system. In May 2014 CITIC Pacific, a core CITIC subsidiary listed in Hong Kong, secured equity investment totaling approximately Hong Kong$39.5 billion from 15 strategic investors, including Japanese companies(9).

CITIC also became the first major Chinese SOE to shut down its unlisted intermediate holding company as part of a pioneering initiative to list its entire group. Many Chinese SOEs have listed several of their group companies in Shanghai or Hong Kong, but they are controlled by unlisted holding companies. In September 2014, the CITIC Group achieved group listing (*Zhěngtǐ shàngshì*) by bringing together all group companies under CITIC Pacific, which was then renamed as CITIC Ltd.

After listing, CITIC also received major equity investment from foreign companies. In January 2015, it agreed to form a business partnership with Itochu and the Charoen Pokphand Group, an ethnic Chinese conglomerate in Thailand. Investment by the two foreign companies reached HK$80.3

billion, and they appear to have acquired around 20% of voting rights[10]. Based on these developments, CITIC is now seen as a trailblazer for the mixed-ownership reforms[11].

The leaders among local governments have been Shanghai City, Guangdong Province and Chongqing City. Of these, Guangdong has set the clearest targets for the adoption of the mixed-ownership system. The Guangdong Province State-owned Assets Supervision and Administration Commission announced in February 2015 that 49% of shares in Gree Electric would be sold. A fund associated with Yale University in the United States emerged as a candidate strategic investor in the company[12], which has built a global business based mainly on air conditioners. The following March, Guangdong announced a target of bringing in private sector capital totaling 100 billion yuan by converting 80% of SOEs in 13 industries, including transportation, construction materials, metallurgy, mining, electric power, travel, finance/investment, healthcare and sanitation, to the mixed ownership system by 2020[13].

② State-Owned Capital Management System—Shanghai's State-Owned Capital Mobility Platform

There are also signs of progress toward the restructuring of SOEs as state-owned capital investment companies. There are two routes for restructuring as state-owned capital investment companies in China: one led by SASAC, and the other by the Ministry of Finance. CITIC is under the jurisdiction of the Ministry of Finance, in part because its group includes financial institutions. For this reason, there is a pyramid structure with the Ministry of Finance at the apex.

However, the announcement of reforms affecting central government SOEs under SASAC jurisdiction came in July 2014, which is considerably later than moves by the Ministry of Finance. Reforms by SASAC will be examined in detail in the next section, and the aim of the following analysis is to clarify the kind of management structure that the government is trying to build for state-owned capital. Pioneering moves to restructure enterprises as state-owned capital investment companies in Shanghai will be used as case studies.

In December 2013, a month after the Third Plenum, the Shanghai Municipal State-owned Assets Supervision and Administration Commission issued a 20-item opinion on SOE reforms calling for realization of the Decision[14]. This opinion listed three goals: (1) that, Shanghai should act as the vanguard for SOE reforms, (2) that 80% of state-owned capital should be concentrated in strategic emerging industries and sectors that would contribute to the improvement of living standards, and (3) that returns on state-owned capital should provide one-third of the fiscal resources for industrial development, infrastructure development and social security.

After announcing its 20-item opinion, the Shanghai Municipal State-owned Assets Supervision and Administration Commission held discussions with SOEs and subordinate administrative units. It completed a draft policy ("the Draft Policy") on the classification of SOEs in July 2014[15]. In the Draft Policy, SOEs were divided into ① enterprises that would maintain their SOE status as affiliates of state-owned capital investment companies, ② SOEs or state-owned holding companies that would ensure the provision of infrastructure and public services, ③ joint stock companies that would play a core role in strategic emerging industries, advanced manufacturing industries or modern service industries in which state-owned holding companies or the government have a relative advantage, and ④ enterprises in industries in which competition is possible and from which state-owned capital should be withdrawn. This accords with the position of SASAC[16].

At the end of 2014, the Shanghai Municipal State-owned Assets Supervision and Administration Commission nominated the Shanghai International Group and the Shanghai Guosheng Group as state-owned capital investment companies under an accelerated reform process covering the next half-year[17]. The former is involved primarily in finance, including banking, securities and insurance, while the latter is a pure holding company with other SOEs in its group. Shanghai refers to this process as the "state-owned capital mobility platform" in the sense that SOEs will be restructured and placed under state-owned capital investment companies.

③ Development of a Modern Enterprise System—Opening up of Markets Monopolized or Dominated by SOEs

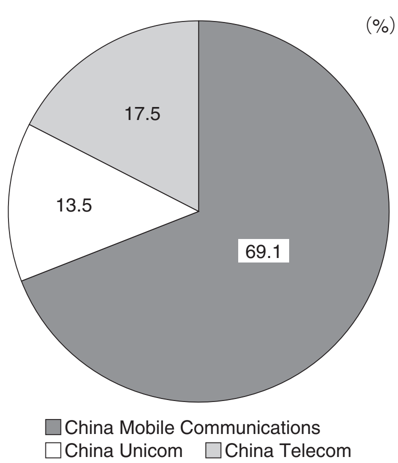
Before developing a modern enterprise system, China is first opening up markets that have been monopolized or dominated by major SOEs. This process began with the telecommunications sector. The mobile telecommunications market is dominated by three companies: China Mobile Communications, China Unicom and China Telecom (Fig. 2).

The Internet connection service market is similarly dominated by three companies. In Fig. 3, the market appears to have moved further toward competition than the mobile telecommunications market. However, the company with the largest market share (2.4%) in the "Others" category is China TieTong Telecommunications (CTT). CTT originated as an SOE in the railways sector, but in 2008 it became a wholly owned subsidiary of China Mobile Communications, so we can reasonably conclude that this market is also dominated by SOEs.

In May 2013, the Ministry of Industry and Information Technology decided to open up the mobile telecommunications market to the private sector(18), and at the end of December it allowed 11 private enterprises to enter the market(19). More companies have since moved into the market, and by March 2015 the total had reached 42(20). This pattern has also spread to the broadband Internet connection service market. In December 2014, the Ministry of Industry and Information Technology announced a policy of allowing private enterprises to enter this market in 16 cities (Taiyuan, Shenyang, Harbin, Shanghai, Nanjing, Hangzhou, Ningbo, Xiamen, Qingdao, Zhengzhou, Wuhan, Changsha, Guangzhou, Shenzhen, Chongqing, Chengdu) (21).

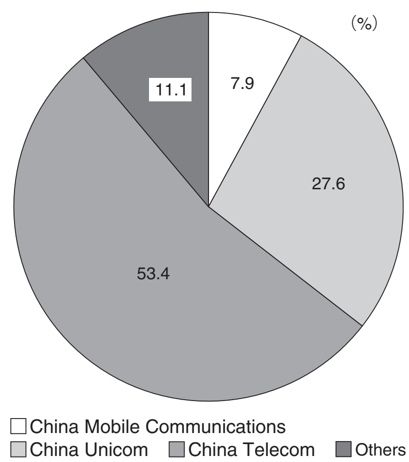
The civil aviation market is also being opened up to the private sector. In February 2014, the Civil Aviation Administration of China responded to the growing worldwide popularity of low-cost carriers (LCCs) by announcing a policy designed to encourage LCC participation in the market(22). China's first LCC, Spring Airlines Co., Ltd., was established in August 2005. By April 2015 the number had risen to six(23). China has three state-owned airlines operated by SOEs under the

Fig. 2 Shares of Mobile Communications Market for University Students



Notes: The survey covered 14,500 students selected randomly from approximately 200 universities.
Source: Youth.cn, *Dàxuéshēng shǒujī shìchǎng fēnlei: Yídòng yuē zhàn qī chéng* [Shares of student mobile handset market: China Mobile accounts for 70%], April 3, 2014 (http://news.youth.cn/gn/201404/t20140403_4969997.htm)

Fig. 3 Shares of Internet Connection Market



Notes: As of April 2014, including narrowband
Source: *Sì yuè guónèi wǎngluo jiē rù shāng fēnlèi dòngtài: Zhōngguó liántōng jiàngfú zuìdà* [Market shares of network access providers in April: Largest decline recorded by China Unicom], idcps.com, May 16, 2014 (http://www.idcps.com/news/20140516/73221.html)

SASAC: the Air China Group, the China Eastern Airlines Group, and the China Southern Airlines Group. However, local carriers have been established successively in various regions, and the market share of the three SOE groups in terms of passenger traffic shrank from 61.3% in 2010 to 55.2% in mid-2013 (Fig. 4). The entry of more LCCs into the market is expected to end the dominance of the SOEs and take the market into an era of mega-competition.

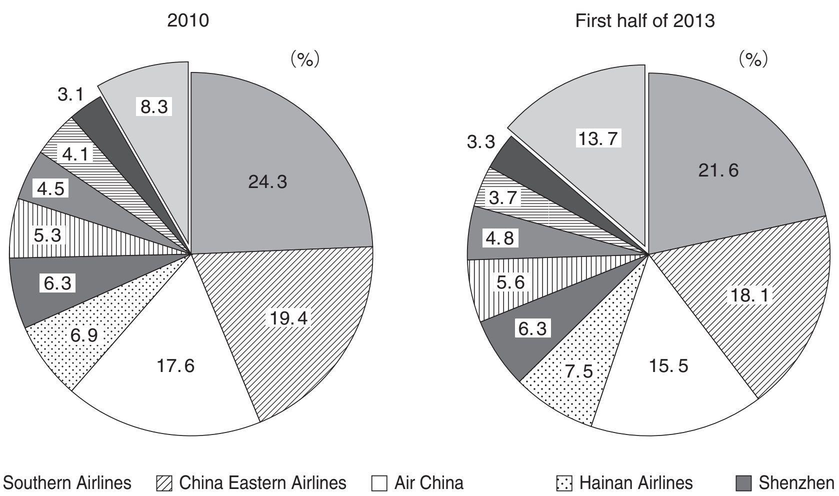
We will conclude this analysis by looking at private sector involvement in the financial services market. Prior to the Decision, the government issued a 10-point guiding opinion in July 2013. This opinion called for the promotion of private sector involvement in financial services with the aim of improving access to finance for small and medium enterprises and the responding to the changing financial needs of consumers(24). The aim of this policy appears to be the enhancement of financial services for private enterprises and individuals by using the market to allocate resources through the provision of services by private banks.

In China, the government agency responsible for banking supervision is the China Banking Regulatory Commission. In November 2013, the Commission defined the requirements for participation in the banking business in accordance with the State Council's 10-point opinion on finance(25), and by September 2014 the first five private banks had been approved (Fig. 5). In addition to the big five state-owned banks (Chugoku Bank, Industrial and Commercial Bank of China, China Agricultural Bank, China Construction Bank, and Bank of Communications), there are believed to be over 100 private banks in China. However, these banks have received equity investment from SOEs(26), and although they are private banks, they have different characteristics from the five banks approved by the China Banking Regulatory Commission.

(3) Central Government Turning away from Gradualism

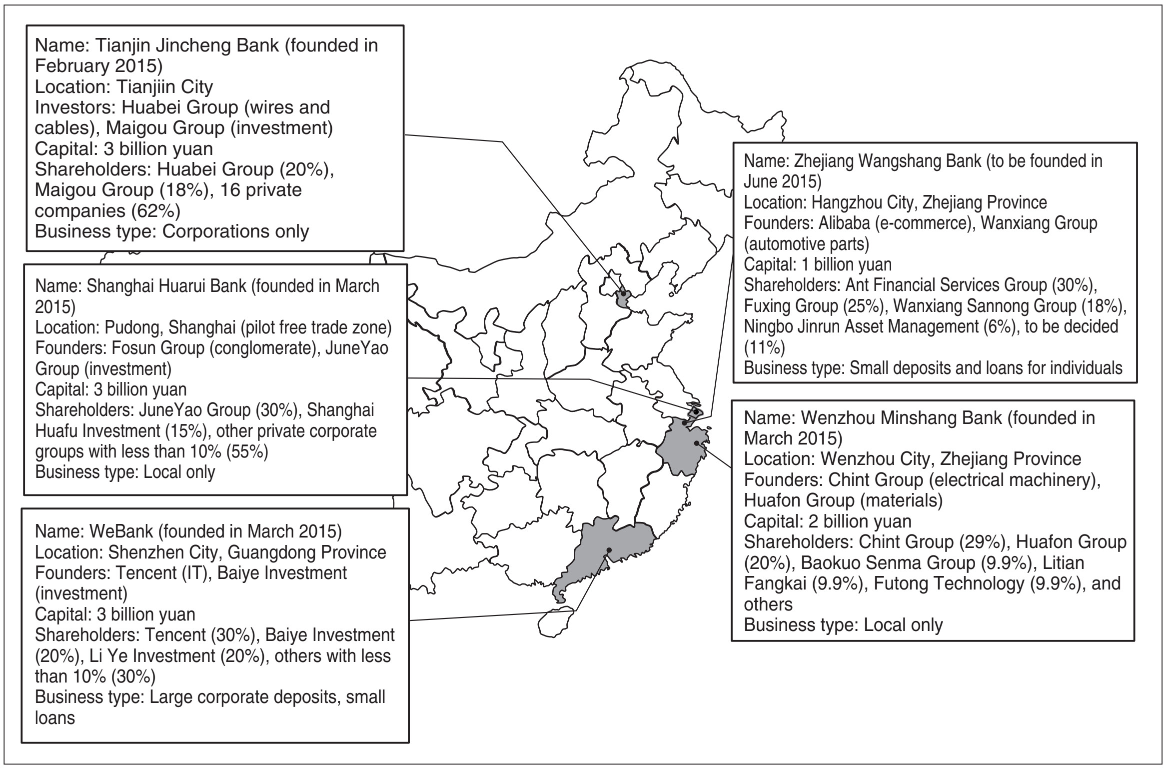
China's approach to the reform and opening process has been described as "gradualist." After trialing reforms in a number of regions and carefully analyzing the lessons learned, the central government would then proceed to implement reforms at the national level. Compared with the "big bang" approach, which emphasizes universal and simultaneous change, the advantage of the gradualist approach is that the risk of disruption can be reduced through repeated experimentation at the local level. The disadvantage is the slow pace and limited scale of reforms due to a tendency to focus on what is achievable rather than what needs to be done.

Fig. 4 Changes in Market Shares of Airlines



Source: *Sān dà háng qiě zhàn qiě tuì hángkōng shìchǎng qúnxióng hùnzhàn huò jiāng láilín* [Battle for three major airlines, turmoil likely in the crowded aviation market], Carnoc.com, July 29, 2013 (http://news.carnoc.com/list/257/257647.html)

Fig. 5 Approved Private Banks



Notes: The Fosun Group, which was one of the founders of the Shanghai Huarui Bank, decided not to invest.
Source: Compiled by JRI using local media reports (as of the end of May 2015)

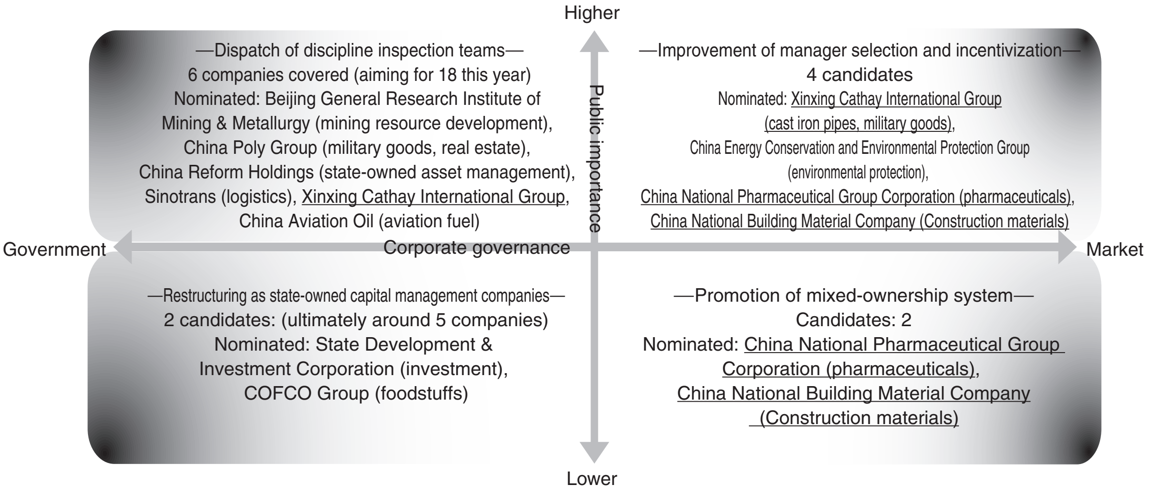
The aim of the gradualist approach to reform is to minimize risk. In this sense, it can be likened to a person trying to cross a river by carefully searching for stepping stones. With the gradualist approach, which has clearly been one of the foundations of China's long-term economic development, the role of the central government is not to lead reforms, but rather to keep watch and make adjustments by judging whether or not reforms implemented at the local level are suitable for universal implementation. In the case of SOE reforms, however, the central government and central government SOEs are themselves the targets of the reform process, and the central government seems to be irritated by the fact that progress cannot be achieved unless the government itself sets the example.

A symbolic example of this situation is the four pilot reform projects announced in July 2014 for SOEs under the SASAC(27). The four pilot reform projects are ① the promotion of the mixed-ownership system, ② the restructuring of SOEs as state-owned capital investment companies, ③ the improvement of manager selection and incentivization, and ④ the dispatch of discipline inspection teams. In Fig. 6, the four projects have been categorized according to whether corporate governance relies on the market or the government, and according to the public importance of each company.

As is apparent from the fact China Pharmaceutical Group Corporation and China National Building Material Company have been assigned to both the "Promotion of mixed-ownership system" and "Improvement of manager selection and incentivization" groups, it is not possible to divide the companies into clearly defined categories. The mixed-ownership system has been placed in the lower right because the system can be seen as a transitional step toward the goal of privatizing SOEs(28). The four reforms are not mutually exclusive, and in many cases they should be seen as overlapping or complementing each other.

The central government's strong commitment to

Fig. 6 4 Reforms for Central Government SOEs



Notes: Underlining indicates that a company has been nominated in multiple categories.
Source: Compiled by JRI using media reports (as of May 28, 2015)

SOE reform is apparent from the call by SASAC Chairman Zhang Yi at a December 2014 meeting of central and local SASACs for the Decision to be put into effect in 2015. Zhang Yi presented a number of directives. First, the reform process should begin with the categorization of SOEs by function. Second, the implementation of mixed-ownership system must not be allowed to end simply with the creation of a formal mechanism for bringing in private capital. Third, companies should be selected for the introduction of the mixed-ownership system, including the establishment of employee shareholder schemes. Fourth, state-owned capital must be rigorously valued, and outflows of state-owned capital must be prevented. Fifth, provincial SASACs must guide SASACs established by lower-level administrative units and report progress on reforms to the central government SASAC[(29)].

Moves to encourage private investment also began early. This aspect is under the jurisdiction of the National Development and Reform Commission rather than SASAC. In April 2014, the government announced a policy of encouraging private investment in large-scale infrastructure projects[(30)], and in May the National Development and Reform Commission issued a list of specific project areas covered by the policy, including transportation (24), telecommunications (2), clean energy (36), pipeline construction and oil and gas development (10), and industrial facilities for coal chemistry and petrochemicals (8) [(31)].

In May 2015, the National Development and Reform Commission published a list of 1,043 public private partnership (PPP) projects involving total investment of 1.97 trillion yuan[(32)]. While there is some duplication with the project list issued in April 2014, the new list represents significant progress for a number of reasons, including a major increase in the number of projects, the amounts invested in individual projects, and the provision of specific information about the PPP methods to be used, such as build-operate transfer (BOT) and the establishment of joint venture companies.

At the end of each year, China holds the Central Economic Work Conference to review economic trends in the year just ended and set the direction for economic policy in the following year. The 2014 Conference was the first since the establishment of the Xi Jinping administration at which SOE reform was discussed, and 2015 was seen as a year in which the reform process would accelerate. SOE reform means taking a scalpel to a massive structure of rights and interests, and there is strong resistance. The Xi Jinping administration appears determined to put the reform process on track by starting with what is achievable.

2. Assessing SOE Reform—Verification of Initial Benefits

The SOE reforms examined in Part 1 are only government policies. The extent to which those policies have been realized is a separate issue not only in China, but also in developing countries. In Part 2 we will attempt to assess the reforms in terms of the benefits that have been achieved, and the contribution that the reforms have made to the sustainability of economic growth.

(1) The Realities of the Mixed Ownership System

The mixed ownership model referred to in the Decision is seen as an attempt to combine the advantages of state and private ownership with the aim of opening up a path to prosperity for both through the establishment of a win-win relationship that will bring benefits to both SOEs and non-state enterprises. In fact, when China Petrochemical Corporation (Sinopec) sold 30% of shares in its wholly owned sales subsidiary, Sinopec Sales Co., there was keen interest from private investors, who placed a high value on its nationwide network of gasoline stations and the network linking those outlets. At the regional level, the Shanghai Municipal State-owned Assets Supervision and Administration Commission attracted attention with its decision in March 2015 to list 100% shares in Shanghai Electric Group Co., Ltd.(33), creating the world's biggest integrated equipment manufacturer(34).

However, the transition to a mixed ownership economy has not always gone smoothly. While the Sinopec IPO was successful, China National Petroleum Corporation (CNPC) has faced an uphill struggle. It sought private investment for oil refining and other projects, and for development in the Xinjiang Uyghur Autonomous Region, but there was no tangible progress even by May 2015(35). In contrast with Sinopec, investors appear to have been discouraged by concerns about the risks of upstream investment in energy development.

If we examine the details of the mixed ownership model proposed in the "four reforms," it becomes apparent that instead of central government SOEs taking the initiative and providing an example, enterprises have been selected for the reform process. China Pharmaceutical Group Corporation (Sinopharm) has actively formed joint ventures with foreign capital and private enterprises since the 1980s, including 22 joint ventures with foreign capital alone(36).

Similarly, the China National Building Material Company (CNBM) Group consists of 16 companies, including wholly owned subsidiaries and a holding company(37), of which six are listed. The holding company, China National Building Material Company, which is listed in Hong Kong, accounts for 43% of the group's operating revenues, 92% of its total profit, and 83% of its total capital as of 2013. The percentage of CNBM shares held by the group has already fallen below one-half to 46.7%. The CEO of CNBM was appointed by another company in 2002 to restructure the group. These two factors explain why CNBM was chosen for the mixed ownership structure and the improvement of manager selection and incentives under the "four reforms" (38). Since the mixed ownership system affects the nature of ownership itself, it can be regarded as the most significant reform since the SOE reforms implemented by former Premier Zhu Rongji(39). However, the "win-win" concept appears to have remained just a slogan, and the reform process now seems be meandering without a clear destination in sight. The Bank of Communications attempted to shift to a mixed ownership structure in August 2014. However, The Hong Kong and Shanghai Banking Corporation holds 18.7% of its shares, while the Hong Kong Exchanges and Clearing, which is the equivalent of the Japan Securities Depository Center, has another 20.1% on a proxy basis. The remainder are held by corporations and individuals in China and overseas, leaving the government with just 26.5% held by the Ministry of Finance and another 4.4% by the Social Welfare Fund(40). The bank itself says that it is still unclear about how it will approach mixed ownership reforms and what it will achieve through those reforms(41).

Another source of increasing concern is the government's warning against outflows of state-owned capital. Three methods are envisaged for the transition of SOEs to mixed ownership structures. The first is equity investment by private enterprises in response to share offerings and similar mechanisms. The second is employee share ownership. And the third is acquisition by managers under a process equivalent to a management buyout[42]. The most promising of these methods is the introduction of capital from private enterprises. However, the government expressed strong warning against the outflow of state-owned capital in its May 2015 "opinion on the deepening of economic reform in 2015" ("the Opinion") [43] and directed local State-owned Assets Supervision and Administration Commissions to step up efforts to prevent capital outflows[44].

In any country, including China, it is essential to maintain a high standard of transparency surrounding the method used to value and sell state-owned capital as part of the ownership reform process for SOEs. During the SOE reforms of the second half of the 1990s, there appears to have been rampant conversion of state-owned capital from smaller SOEs to private ownership under the policy of retaining control of large companies while letting go of smaller ones (*zhua da fang xiao*). There is still strong concern that the mixed ownership model will follow the same path. In fact, in October 2014 a private investor who invested in a financially struggling SOE called *Zhongdian Xinan* after serving as the company's president was convicted of pilfering from state-owned capital. According to the *Economic Information Daily*, private enterprises became more cautious about investing in SOEs as a result of this incident[45].

(2) Will Improvements in Capital Efficiency be a Trump Card for Private Enterprises?

SOE reforms are expected to improve the efficiency of SOEs. This is because multiple shareholders will exert increased pressure for improved management, while state-owned investment companies are expected to supervise SOEs in place of the SASACs.

However, the emergence of multiple shareholders will not necessarily result in increased pressure for improved management if there is no change in the structure of voting rights. Nor is it certain that state-owned investment companies will be able to act as "sheepdogs." It is possible that they will instead become a redundant "roof over a roof."

The basic requirement for restructuring into state-owned capital investment companies is the ability to assess state-owned capital objectively on the basis of the public interest and efficiency. Capital efficiency cannot be improved simply by redeploying existing state-owned enterprises under state-owned capital investment companies. However, there has been little progress toward the classification of existing state-owned enterprise by function. While the Shanghai Municipal State-Owned Assets Supervision and Administration Commission moved ahead of SASAC by announcing a policy of dividing state-owned enterprises into four categories based on a 20-point reform program for state-owned enterprises in Shanghai, it has not revealed any specific company names or the areas from which state-owned capital should withdraw because there is scope for market competition.

The same is true of the State-owned Assets Supervision and Administration Commission of the State Council (SASAC). In January 2015, SASAC said that it would announce a concrete and systematic policy to speed up the reform of state-owned enterprises in the first half of the year[46]. However, to date it has not revealed the sectors from which state-owned capital will withdraw.

Only three industries—electric power, oil and natural gas, and salt manufacturing—were mentioned in the May 2015 "Opinion." This suggests that the achievement of a consensus within the government is taking time.

It also appears that central government SOEs will not be the models for the restructuring of SOEs into state-owned capital investment companies, as indicated in the "four projects." When SASAC was established, State Development & Investment Corporation and China National Cereals, Oils and Foodstuffs Corporation (COFCO) were selected as central government SOEs specializing in the management of state-owned capital under the parent company management system[47], and they have already developed structures similar to those of state-owned investment companies.

SASAC has indicated that companies to be restructured into state-owned capital investment companies must meet certain criteria. First, they must have net sales of 10-50 billion yuan. Second, most of their subsidiaries must be listed companies. Third, they must have ample liquid capital. And fourth, they must be conglomerates[48]. The names of the second batch of companies have not yet been announced, but China Merchants Holdings International, which lists transportation, finance and real estate as its main areas of activity, is seen as a likely candidate.

The model for state-owned capital investment companies, especially with regard to financial characteristics, appears to be Temasek Holdings, a government-affiliated financial investment company based in Singapore[49]. Temasek's total shareholders' return (TSR), which is an indicator of shareholder value, is extremely high with an average of 16% over the past 40 years.

Central government SOEs are expected not only to maintain the value of state-owned capital, but to increase it significantly. Can central government SOEs selected for restructuring into state-owned capital investment companies emulate Temasek? The key will be corporate governance.

Temasek[50] is an SOE. It is a major shareholder in SOEs that support backbone industries, such as Singapore Airlines. It is entrepreneurial and is very similar to an investment company in character. Like Chinese companies, Temasek also has an autocratic side. For example, its CEO is the wife of Prime Minister Lee Hsien Loong. However, only 31% of Temasek's investments are in Singapore. Temasek has also invested in a wide range of sectors, including financial services (31%), telecommunications and media (23%), and transportation and manufacturing (20%) (all Temasek data based on 2014 figures). It does not rely on income from the SOEs in its portfolio and has many characteristics in common with an investment fund.

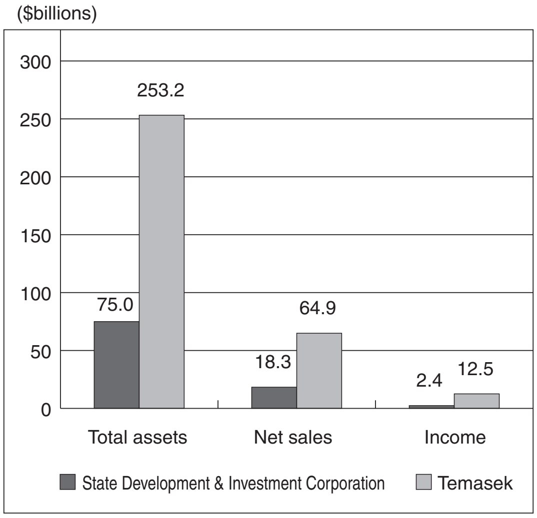
Temasek also actively recruits people from outside of its organization. In August 2013, it appointed former World Bank President Robert B. Zoellick to its board, and in January 2015, Peter Voser, former CEO of Royal Dutch Shell, became a director. Temasek's work force of just 460 people is an elite multinational team drawn from 29 different countries. The company has stated that investment decisions are made by its board of directors without any intervention by the Prime Minister or Ministry of Finance. The factors supporting its high rate of return are strict government-company separation and investment strategies created by teams of experts.

Comparisons between China's central government SOEs and Temasek are difficult because of the extremely small amount of disclosure information available concerning central government SOEs. State Development & Investment Corporation, which is regarded as a blue chip among central government SOEs, has a capital turnover ratio (net sales/total capital) of 24.4% and a return on sales ratio (income/net sales) of 12.9%. These figures are not especially low compared with the corresponding figures of 25.6% and 19.3% respectively for Temasek (Fig. 7). However, State Development & Investment Corporation's payroll of 80,000 employees is 173 times bigger than Temasek's.

While State Development & Investment Corporation has not yet been restructured, it is extremely overstaffed for a company that is supposed to have adopted the parent company management system. This underscores the difference in character between the Chinese company and Temasek.

Another source of concern is forecasts of worsening business conditions for central government SOEs. In 2014, the aggregate profit of central government SOEs increased by 4.2% year on year to 1.4 trillion yuan[51]. However, this was followed by a 9.9% decline in the January-March quarter of 2015 compared with the same period in 2014. At a time when China's latent growth rate and investment efficiency are both declining, the dividend ratio (percentage of after-tax income) that central government SOEs are required to pay to the government as a return on investment will be phased up from 15% at present[52] to 30% by 2020[53]. Obviously there are doubts about whether central

Fig. 7 Financial Performance of State Development & Investment Corporation and Temasek (2014)



Notes: Renminbi (yuan) and Singapore dollar amounts have been converted into U.S. dollars at the average exchange rate for 2014.
Source: Compiled by JRI using *Temasek Review 2014* and *Company Introduction, State Development & Investment Corporation* (Chinese) (http://www.sdns.sdic.com.cn/cn/gygt/gsjs/A010101index_1.htm)

government SOEs can achieve financial results on a par with Temasek in this environment. Another problem for central government SOEs is the fact that they are required to improve their competitiveness in international markets[(54)]. If they seek tangible and intangible government assistance in achieving this goal, corporate governance will become dysfunctional, and there will be no improvement in capital efficiency.

(3) Will Market Opening Stimulate Private Sector Activity?

The most important message in the Decision is that markets will play a decisive role in the allocation of resources in place of the government. The opening of markets is seen as a driving force for an accelerated shift to a mixed-ownership structure and a market-based economy. Newly privatized banks are expected to achieve reasonable financial results by concentrating their resources into areas that have been mostly overlooked by state-owned commercial banks such as small transactions with individuals via the Internet[(55)]. A second batch of private banks is expected to be approved in the near future, and rumors about which banks will be chosen are spreading through the media.

The benefits of opening up industries to private sector participation are becoming apparent in the area of mobile telecommunications. A privately owned company called Zhongyi Xinlian has moved into the mobile telecommunications market in Wuhan City, Hubei Province. Its financial performance is excellent, with net sales estimated to have reached 80 million yuan (approximately ¥1.38 billion) and net income 10 million yuan (approximately ¥170 million) in 2014[(56)]. The opening up of the market for broadband Internet connection services to private sector participation has also had a significant effect on the market. In May 2015, the three biggest companies in this field all moved in quick succession to announce policies calling for further speed increases and reductions in connection charges[(57)]. In addition to providing opportunities for private sector companies, market opening is also yielding by-products in the form of improvements in the management efficiency of SOEs, and increased benefits for consumers.

Telecommunications is the first industry in which the mixed-ownership system has been used successfully to bring in private sector capital. In May 2014, China Telecom transitioned four of its subsidiaries, including a games distribution company, to the mixed-ownership system. This process is believed to have brought in 700 million yuan[(58)]. In November, China Unicom created by new company by spinning off a subsidiary involved in games distribution and other activities[(59)]. This is believed to be the first time that China Unicom has applied the mixed-ownership model. China Mobile also announced in December that it planned to spin off a number of businesses, including a distribution company for games, cartoons and comics, and to establish a new company[(60)].

However, the range of areas opened up remains limited, and the process is certainly not affecting the market as a whole. The Decision called for the creation of negative lists of areas that were closed to participation by private enterprises. However, the response has been slow at both central and local government levels, and apart from Shanghai, which has been designated as a free trade zone, the only place where such a list has been produced is Chengdu City(61). Chengdu's negative list differs little from that of Shanghai, which was severely criticized for falling far short of the expectations of private enterprises, including foreign capital, and there is doubt about whether the original goal of allowing the market to play a decisive role in the allocation of resources can be attained.

This situation is not unrelated to the fact that China has started to lose its sense of direction concerning the mixed-ownership system. As noted earlier, not only the central government but also Shanghai, which is in the vanguard of the reform process, have failed to reveal the companies from which state-owned capital should be withdrawn because of the potential for market competition(62). This concept is the opposite of the negative list, since it indicates the areas in which the non-state-owned sector will play a dominant role. Because of this lack of progress on the compilation of negative lists and this failure to reveal areas in which the non-state-owned sector will dominate, the reform process is now characterized by an expanding gray zone between the two.

At the same time, governments are working at a feverish pace to create the systems needed to encourage the participation of private capital in infrastructure development through PPPs. The central government has already issued 11 announcements and notices concerning this aspect, while another 20 have been issued by the Ministry of Finance. The National Development and Reform Commission, the Ministry of Housing and Urban-Rural Development and the China Banking Regulatory Commission have issued nine, five and eight notices respectively(63). The PPP model has already been used with some success in such areas as sewage treatment(64). Now that financial and fiscal support is being provided, and clear rules have been established for each sector, there is potential to expand the method into such areas as low-income housing and the construction of toll roads.

However, these moves are not necessarily targeted toward the realization of the fundamental goals contained in the Decision. For example, while the National Development and Reform Commission allows SOEs to participate in PPPs, the Ministry of Finance does not(65). Progress on the development of systems has been driven in part by competition for leadership among the various government agencies involved. Moreover, even within China, there have been reports that local governments are trying to attract the interest of private investors by setting unrealistically high rates of returns for projects(66). The government is focusing on ways to mobilize private capital, and increases in the total number of projects could reduce the number of projects that result in the establishment of win-win relationships.

3. Has the Efficiency of SOEs Improved?

Why has the Xi Jinping administration initiated an SOE reform program? We will look at the background to this decision from the perspectives of SOE operating revenues and profits and capital efficiency.

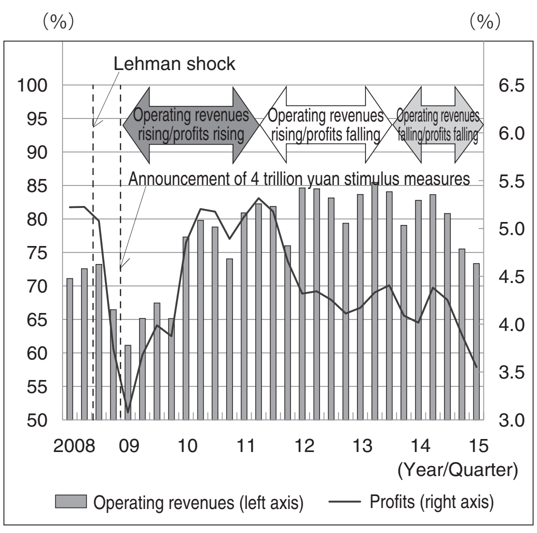
(1) Why SOE Reforms Now?

The financial performance of China's SOEs has deteriorated in step with the economic slowdown. According to the Ministry of Finance, the operating revenues (sales) of SOEs (excluding financial institutions) in the January-March quarter of 2015 shrank by 6.0% compared with the same period in 2014 to 10.3 trillion yuan, while profits were 8.0% lower at 499.7 billion yuan(67). This decline in financial results was mainly attributable to major SOEs under the central government (including not only SASAC but also individual ministries, the same below). Major SOEs under central government account for 60% of the operating revenues and 80% of the profits of all SOEs. Their operating revenues have fallen by 4.6% and profits by 9.9%, which are even bigger than the declines recorded by regional government SOEs (4.2% and 0.4% respectively). The last time that Chinese SOEs recorded negative growth rates for both operating revenues and profits was in January-September 2009 during the global financial crisis triggered by the Lehman Brothers collapse.

The urgency with which the government moved to implement SOE reforms, albeit starting with the easiest tasks first, and the fact that the enterprises are responding to calls for reform, are explained by this decline in financial performance. However, we cannot fully understand the reasons for why the government has launched SOE reforms at this stage solely on the basis of operating revenue and profit figures released by the Ministry of Finance. We need to verify how the position of SOEs has changed by looking at their operating revenues and profits as percentages of GDP (Fig. 8).

Close analysis of SOE operating revenues and profits shows that the SOEs have gone through three phases since the global financial crisis ("Lehman shock"). During the first phase, from the January-March quarter of 2009 to January-June 2011, both operating revenues and profits were rising. In the second phase, which lasted until January-September 2013, operating revenues rose but profits fell. The third phase, down to the January-March quarter of 2015, brought declines in both

Fig. 8 Operating Revenues and Profits of SOEs and SOE Holding Companies as Percentages of GDP



Notes: Nominal basis, quarterly data based on quarterly cumulative totals
Source: Compiled by JRI using data from the Ministry of Finance and the National Bureau of Statistics

operating revenues and profits.

Although the financial performance of SOEs is stagnating at present, their balance sheets have not deteriorated. In the 10 years to 2013, their debt ratios (cumulative total liabilities/cumulative total assets) and liquidity ratios (current assets/current liabilities) remained stable at around 65% and 105% respectively. However, the outlook is not entirely rosy. While Ministry of Finance statistics only go back as far as 2008, the fact that average wages in the state-owned sector have risen consistently since the early 2000s suggests that this is the first time, apart from the period immediately after the start of global financial crisis, that there have been conspicuous declines in both operating revenues and profits. Furthermore, this trend is likely to be prolonged by the effects of a falling latent growth rate and worsening investment efficiency.

One of the four pilot reforms calls for the improved selection of managers and stronger incentivization. The fact that performance-linked compensation could be introduced as a core part of this reform suggests that earnings are expected to deteriorate on a scale that would not have been tolerated under the old compensation system. Why is the government actively applying the mixed-ownership model to SOEs? Why is it hastening to develop systems to support PPPs? The reason appears to be the fact that mixed-ownership and PPPs will be the only ways to prevent further deterioration of investment efficiency if operating revenues and profits continue to decline at a time when the government is tightening supervision of local government financing vehicles and other financing routes, and local government debt.

(2) Declining Investment Efficiency—Down to "Lehman Shock" Level if Growth Falls to 6%

How will the worsening performance of SOEs impact on the economy? The latent growth rate will certainly rise if a growing sense of alarm on the part of government and SOEs leads to the opening up of previously closed markets, allowing private enterprises, including foreign capital, to use the full potential of their financial resources, ideas and know-how. However, there is no definitive evidence that the SOE reform process is moving in that direction.

Although China professes to be building a socialist state, private enterprises account for a growing share of the economy, and on this basis it is possible to conclude that the deteriorating performance of SOEs will not have a major economic impact. In fact, the emergence of private enterprises has brought steady growth in new employment in urban areas, so it is unlikely that declines in the performance of SOEs will cause any immediate downturn in employment (Miura [2015b]).

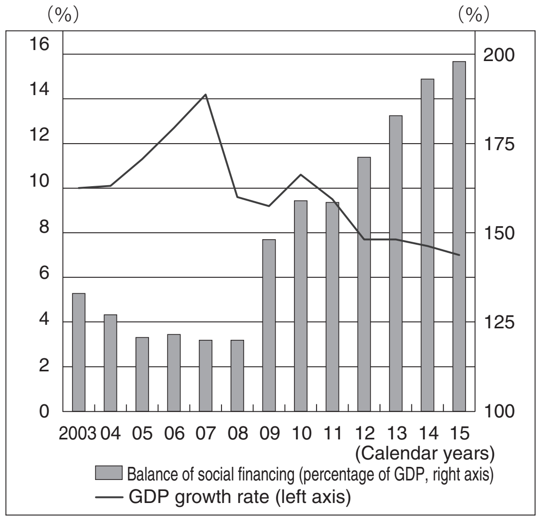
The problem is the efficiency of SOEs or state-owned capital. As shown in Fig. 1, the real culprits in the deterioration of capital efficiency in China are the SOEs. Unless China can improve the efficiency of state-owned capital through reforms, the government will be unable to implement stimulus measures based on fiscal resources. Like pressing the accelerator in a car that is leaking fuel, that would cause investment efficiency to worsen and the latent growth rate to fall. However, there are no signs at present that the situation is improving. While the growth rate is falling gradually, the supply of funds to the real economy through social financing, including shadow banking, continues to expand (Fig. 9).

China is trying to change its economic development model by shifting from an investment-led economy to one led by consumption. However, this is a major reform, equivalent to replacing the engine in a car, and it will not be achieved overnight. What is needed now is emergency action to find and fix the fuel leak before the car runs dry and stalls. However, despite a growing sense of alarm within the government, the SOEs, especially those in heavy industries, have been slow to react. For example, in 2012, the operating rates for the iron and steel, cement, electrolytic aluminum, plate glass and shipbuilding were 72%, 74%, 72%, 73% and 75% respectively[68], and the SOEs have not even found a starting point for efforts to solve this problem (Miura [2014b]).

In December 2012, the government revised the performance assessment criteria for managers with the aim of improving the management of central government SOEs[69]. Just as local governments were told not to identify heroes on the basis of GDP, the government is telling SOE managers to target not quantitative expansion but rather qualitative improvement in their management. Of particular significance is the fact that the total capital turnover ratio has been included for the first time as an indicator for assessing the performance of managers during their terms of office. The total capital turnover ratio is calculated by dividing income from core activities (three-year average) by total capital (three-year average). A low figure indicates that there is wasted capital that is not generating any income. Furthermore, the figure will not rise even if there is an increase in income from non-core areas, such as real estate.

An analysis of annual data since 2001, which is the earliest year for which statistics are available, shows that the capital turnover ratio peaked in 2006 and then began to decline. It fell sharply during the global financial crisis ("Lehman shock"), with the ratio for local SOEs declining to one-half of its former level (Fig. 10). This reflects the stagnation of income from core activities due to the economic slowdown. Despite the implementation of the aforementioned changes to the performance criteria in 2013, the total capital turnover ratio has

Fig. 9 Balance of Social Financing and GDP Growth Rate



Notes: January-March quarter data used for 2015
Source: Compiled by JRI using data from the People's Bank of China the National Bureau of Statistics

continued to fall. Because there is a positive correlation between the real GDP growth rate and the total capital turnover ratio[70], the ratio fell to 0.43 in 2014 and is expected to hit 0.40, which was the level during the global financial crisis, if the growth rate declines to 6%. The present downtrend in the growth rate is attributable not to a fall in the potential growth rate due to such factors as a decline in the working population. It is primarily the result of deteriorating capital turnover ratios.

To raise the total capital turnover ratio, it will be necessary to categorize capital according to earning potential as well as public benefits, and sell capital in either category that has a low turnover rate to private enterprises, including foreign capital. However, the sale of capital would result in the conversion of state-owned capital to private ownership and affect China's ability to maintain an economy based on public ownership, which are sensitive issues. For this reason, the leaders appear to have taken a compromise approach by basing their SOE reforms mainly on mixed-ownership reforms and PPPs. If this interpretation is correct, the outlook for the reform process becomes extremely opaque.

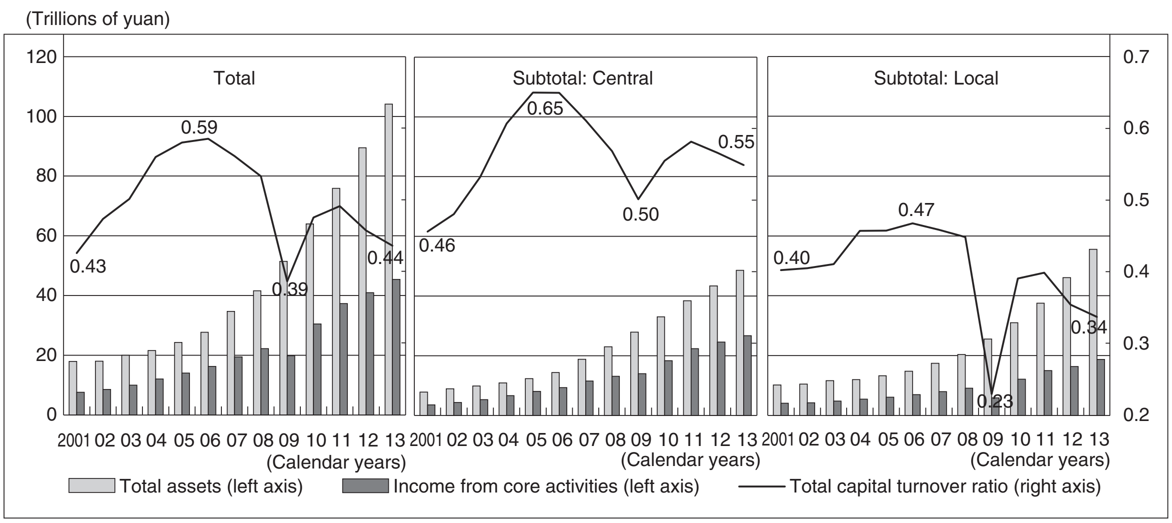
If the reforms move forward successfully, the total capital turnover ratio of SOEs will inevitably rise. In addition, investment opportunities for private enterprises are likely to lead to improvement in China's overall capital efficiency and help to raise the sustainability of its economic growth. However, there is also a diametrically opposite scenario under which the reforms could bog down, creating a situation in which both capital efficiency and the sustainability of growth will deteriorate.

Expert opinion in China on the latent growth rate during the next five-year plan (2016-2020) varies from 5.7% to 7.0%[71], but none of the experts have denied that the growth rate will decline. A decline to 6% growth is not something that is expected to happen in the distant future. Moreover, even if the total capital turnover ratio falls to the same level as during the global financial crisis, China will be unable to implement large-scale stimulus measures, which means that the Chinese economy will gradually weaken. Whether or not the worst-case scenario can be averted depends solely on effectiveness and speed of the SOE reforms.

4. Will the Creation of Giant SOEs Improve Competitiveness?

SOE-related policies that were not mentioned in the Decision and mergers among central govern-

Fig. 10 Total Assets, Income from Core Activities, and Total Capital Turnover Ratio of SOEs and State-Owned Holding Companies



Source: Compiled by JRI using Ministry of Finance, *Statistical Yearbook* (various years) ment SOEs are now attracting attention in China. In Part 4 we will analyze the progress made and consider why central government SOEs are being merged, and how those mergers will affect the economy.

(1) 100 Chinese Companies in the Global 500

The mergers occurring among central government SOEs have been described as a "merger tide." This trend began with a media report in September 2014 stating that two major central government SOEs—the railway rolling stock manufacturers CSR Corporation and CNR—were moving toward a merger(72). There was intensive media speculation about how central government SOEs would merge and how far the process would expand. However, action had preceded policy, and it was not until the publication of the *Guó zī Bàogào* (State-Owned Assets Report) by SASAC in May 2015(73) that the government revealed its basic thinking on central government SOE mergers.

The merger moved forward rapidly. SASAC gave formal approval for the merger between CSR and CNR(74) in March 2015, and three months later China Railway Rolling Stock Corporation Limited (CRRC) was listed on the Shanghai and Hong Kong exchanges. In June, it was decided to merge two of the six central government SOEs involved in the power generation business: China Power Investment Corporation and State Nuclear Power Technology Corporation(75). SASAC has been working to reduce the number of central government SOEs, which has shrunk from 196 in 2003 to 113 in 2015(76). It has stated that the merger process will be accelerated with the aim of reducing the number of companies to between 30 and 50 over the next 5-7 years(77).

This reflects the central government's strong determination to strengthen the international competitiveness of central government SOEs. In 2014, 100 Chinese firms were included in the Fortune 500 Global 500 list, which are the top-ranking companies in terms of operating revenues. China is already far ahead of Japan, which is ranked third with a total of 57, and is rapidly catching up the United States, which is the leader with 128 companies in the list(78). Given China's potential growth rate and the market dominance of the central government SOEs, the scale of these companies is likely to expand still further in the future. As their scale increases, the SOEs are also becoming an increasingly significant presence as global enterprises. They are using low prices to establish a position for themselves as major players in the world infrastructure market. For example, central government SOEs have won contracts for a subway line in Boston(79) and a nuclear power plant in Argentina(80).

At the same time, there is increasing concern within the government that central government SOEs are engaged in a war of attrition with each other. Evidence for this includes competition for high-speed railway construction contracts in China, and duplicated investment in mobile telecommunications base stations(81). The two real aims of mergers among central government SOEs are to avoid a war of attrition resulting from harmful competition, and to strengthen international competitiveness and investment efficiency.

In addition, mergers among central government SOEs are also closely linked to the "One Belt, One Road" economic concept, which was introduced by the Xi Jinping administration with the aim of achieving shared prosperity and harmonious coexistence between China and its neighbors by developing sea and land infrastructure to link the region with Europe and the Middle East (Miura [2015c]). There also close links between central government SOEs and the China Manufacturing 2025 strategy(82), which aims to strengthen the international competitiveness of manufacturing industries over the next 10 years.

Before their merger, neither CSR nor CNR qualified for the Global 500 list. The combined pre-merger operating revenues of the listed companies was $34.6 billion(83) 2014, which would have placed them around 340th in the list, and their inclusion in the list is seen as a certainty in 2015. The operating revenues of CRRC are expected to be the highest in the world, surpassing Siemens at $12.8 billion(84), the Canadian company Bombardier at $9.6 billion(85), and the French company ALSTOM at $4.3 billion (comparisons based only on rail vehicles) [86].

A similar phenomenon is occurring in the electric power sector. With operating revenues of $31.1 billion, China Power Investment Corporation was ranked 393rd on the Global 500 list in 2014. State Nuclear Power Technology Corporation was not included in the list, but its listed subsidiary had operating revenues of 44.8 billion yuan ($7.27 billion) in 2014[87]. The new company's operating revenues of $38.4 billion puts it ahead of Kansai Electric Power ($33.2 billion), which ranked 358th in the Global 500, and close to Korea Electric Power Corporation ($49.1 billion) in 212th position.

At the end of 2014, National Development and Reform Commission raised the amount of investment for which prior examination was required from $1 billion to $2 billion[88] and indicated that it would actively promote overseas expansion by central government SOEs.

(2) Central Government SOEs may become a Drag on the Chinese Economy

Even within China there is doubt about whether mergers among central government SOEs will lead to improvements in management and capital efficiency. The outcomes of these mergers remain to be seen. But the SOE reforms have already descended into a situation that is conspicuously lacking in balance, and the scenario of central government SOE mergers and the creation of giant corporations leading to improved competitiveness appears to be based on hasty conclusions. The leadership expects central government SOEs to become an economic driving force as a result of the mergers. As discussed below, however, there is a greater risk that they will become a drag on the economy.

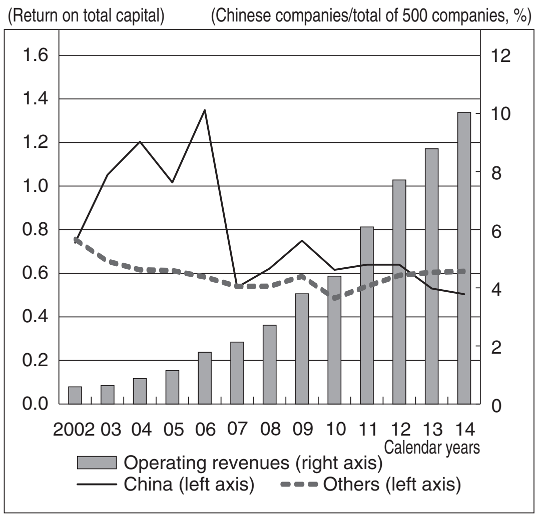
First, mergers are in no way a solution to the governance problems of central government SOEs. As shown in Fig. 10, while the total capital turnover ratio of central government SOEs is still higher than that of regional SOEs, it peaked out in 2006 and is now on a downward trend. The sole reason for this is the fact that SOEs have increased their capital without generating any increase in core business revenues. This is one of the factors that are lowering the capital efficiency of SOEs and China's overall investment efficiency. The capital turnover ratio was introduced as a performance indicator with the aim of solving this problem, but this is not expected to result in an improvement in the ratio.

Instead it is possible that a decline into dysfunctional corporate governance will cause the total capital turnover ratio to fall further. Because of their inclusion in the "One Belt One Road" concept, China's national vision of an economic sphere, government intensions have become another management indicator for central government SOEs in addition to the total capital turnover ratio. This is resulted in a significant number of failed overseas projects, including oil development in Libya and Sudan, and an expressway in Mexico (Miura [2015c]). From the viewpoint of the central government SOEs, these failures were the result of government intentions and not the responsibility of the SOEs themselves. Instead of separating enterprises from the state, the mergers have become an opportunity to link the state and enterprises more closely.

Second, the competitiveness of central government SOEs as global enterprises is gradually declining. An analysis of Bloomberg's Global 500 list, which ranks companies listed on the world's stock markets according to operating revenues, shows that number of Chinese companies in the list has since, along with their share of total operating revenues, which has risen from 0.6% in 2002 to 10.0% in 2014. However, the rate of return on total capital fell sharply in 2007, and by 2013 it was below the level for global enterprises from countries other than China (Fig. 11). Giant SOEs under the control of the central government were once feared as the embodiment of state capitalism. Now they are no longer anything special. The operating income ratios of China's top 500 is less than one-half of that of the top 500 American companies, and the fact that these companies are big but not strong is now seen as a problem[89].

The capital efficiency of major SOEs under

Fig. 11 Rankings of Chinese Companies in the Global 500 List



Notes: Return on total capital = Operating revenues/total capital. Figures for "Others" were calculated by subtracting the figures for companies registered in China and Hong Kong from those for the Global 500 (excluding pure Hong Kong companies). The Global 500 are the top 500 companies listed on the world's stock markets by operating revenues.
Source: Compiled by JRI using Bloomberg data

central government control is expected to fall further. This is because the earnings of state-owned commercial banks, which account for around 20% of the operating revenues of Chinese global enterprises, as shown in Fig. 11, are expected to worsen as a result of interest rate liberalization. The government abolished the floor for lending rates in July 2013[90]. China is steadily preparing for liberalization. For example, the variable ceiling for deposit interest rates was raised from 1.1 times the standard rate to 1.2 times in November 2014 [91], and in May 2015 a deposit protection system was introduced[92]. Interest rate liberalization will inevitably create a dead-end for the business model of state-owned commercial banks, which earn their profits on interest rate spreads.

Third, there is little progress toward the separation of network infrastructure maintenance and operations, which was one of the goals identified in the Decision. Starting in 2015, the government will calculate electric power infrastructure maintenance costs and operating costs in Shenzhen under a pilot reform program for power transmission and distribution, which is based on unregulated pricing[93]. In March, the government announced its basic policy on electric power sector reform[94]. There has been some progress toward the separation of network infrastructure maintenance and operations. For example, in June Inner Mongolia was selected as a new pilot region for the power transmission and distribution reform program[95]. However, the pace of progress has been extremely slow compared with the mergers among central government SOEs. Furthermore, there are no signs that the scope of these changes will spread to the oil, natural gas and railway industries. The policy on transportation sector reform, which was announced in May 2015[96] provides further evidence that the government is more interested in the use of PPPs to expand investment than in the separation of network maintenance and operations, indicating the reform process is tending to flow along the line of least resistance.

Conclusions —Can China Break Through the Limits of Gradualism?

Mōzhe shítou guohé (crossing a river by searching for stones to stand on) is a phrase commonly used to describe the approach of the Communist Party and the government to reform. This approach has certainly yielded benefits as one of the factors that allowed China to switch to market economy more successfully than other socialist countries, such as the former Soviet Union. However, it is possible that the SOE reforms will fail to achieve the same level of success because of resistance to the reform process, and because the flow of the river is so fast that some will never reach the other side and will be swept away as they look cautiously for the next stepping stone.

The leadership is responsible for some of the factors that are causing some to be swept away. China has crossed a number of rivers since adopting an opening and reform policy, but the river that it is now trying to cross is a raging torrent. To make the crossing successfully, structures should have been created to minimize resistance. However, Xi Ping believes the mobilization of central government SOEs is essential to the realization of his “One Belt, One Road” concept, and so the reform process has gone ahead. By expanding the scale of SOEs, the government aims to improve their competitiveness. This makes sense in terms of the “One Belt, One Road” concept, but it has become a hindrance for the SOE reform process. This is because policies that treat central government SOEs differently lack consistency and have inevitably caused resistance to the leadership to increase.

Another important step is to indicate the destination of the reform process. The promotion of the mixed-ownership system, the restructuring of SOEs into state-owned capital investment companies, and the opening up of markets to private enterprises all lack a sense of direction and are inevitably seen as half-way measures. This situation has arisen because the leadership has failed to present a clear vision about changes in the state-owned sector’s share of and role in the economy as a result of the SOE reform process. The Xi Jinping administration needs to reveal that the ultimate destination of the SOE reform process is privatization.

To be more specific, the leadership needs to provide a roadmap for a reform process under which the government will focus exclusively on those areas in which it will continue to provide goods and services, while handing over other areas ultimately to the non-state economy, even though this may take time. Without such a roadmap, there will be an endless tug-of-war between the government, which wants to reduce the gray zones, and the SOEs, which want to move into those areas, and the mixed-ownership system, market opening and PPPs will become a convenient cornucopia for the government and the SOEs, while the state-owned capital holding companies will simply build a roof over a roof. It is very strange that, despite the emphasis on the role of market in resource allocation, the word “privatization” does not appear once in government documents relating to the reforms.

Both the Chinese constitution and the rules of the Communist Party stipulate the maintenance of the independent status of the state-owned economy. This would seem to make it very difficult to state that the final destination of the SOE reform process is privatization. However, in 2012, the SOEs are estimated to have contributed about 36.0% of China’s GDP (Marukawa [2015a]). Based on this percentage of GDP, the concept of maintaining the independent status of the state-owned economy appears to exist in name only. The same applies to the shareholder structures of major SOEs under central government control, such as China National Building Material Company and the Bank of Communications.

What is meant by the “independent status” of the state-owned economy? Is it measured by the GDP contribution of SOEs, by the SOEs’ shares of industries that the government has identified as important, or by the percentages of shares in those enterprises that are held by the government? The Xi Jinping administration can accelerate the SOE reform process by redefining these questions. In January 2015, *China Youth Daily* conducted an opinion poll based on an analysis of the content of over 1.8 million blogs. The results showed that there were strong expectations toward SOE reform and a high level of interest in the separation of the state and enterprises, the implementation of concrete reforms, and the mixed-ownership system(97). This indicates that there is strong public support for the reform process.

The SOE reform process also has important implications for Japan’s strategy toward China. The reforms could facilitate access to the vast Chinese market and provide major business opportunities. A number of SOEs that have been targeted for reform have been introduced in this article. Some Japanese companies have started to invest and form business alliances with these enterprises as their partners. However, the reform process is not moving ahead smoothly under full sail, and it will be necessary to proceed with caution while gauging the direction of the reforms and the opportunities that lie ahead.

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