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**Response of SOEs (State-Owned Enterprises) to Economic  
Liberalization in China**

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*Visiting Research Fellow Monograph Series*

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## **Response of SOEs (State-Owned Enterprises) to economic liberalization in China**

**Abstract:** The purpose of this paper is to find the response of SOEs toward economic liberalization in China, confronted with the competition of domestic, international and regional market. SOEs reform is a gradual and evolutionary process, and now China should promote the restructuring of large SOE sector, the closing of inefficient SOEs, the reform of corporate governance, and the developing of big enterprises and company groups with international competitiveness.

**Keywords:** economic transition, SOEs reform, fiscal subsidy, large size SOEs

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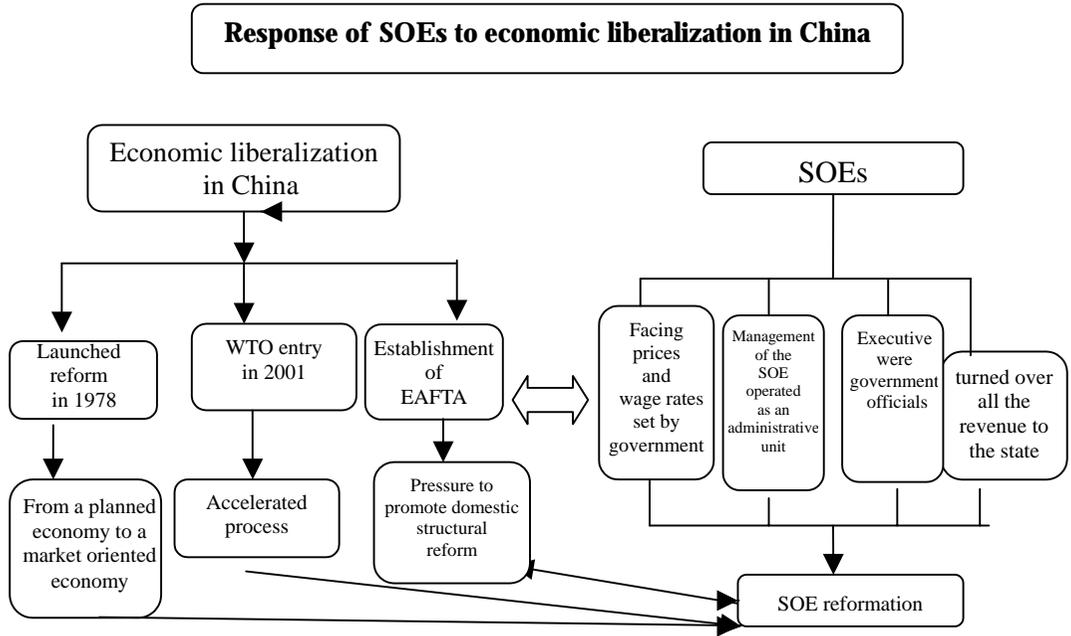
## **I. Introduction**

Economic liberalization is a set of economic policies undertaken within a country, which relies on market mechanism to determine allocation of productive resources. Privatization and commercialization are important items in the economic liberalization policy agenda. China launched economic reform (economic transition process) in 1978 and it has experienced gradual and significant economic changes that have transformed it from a traditional economy to a market oriented economy. WTO entry is accelerated process of economic liberalization for China. The broadening and depending linkages of national economies integrated into a world market can likewise help China continue its future growth. Meanwhile, in establishing EAFTA (East Asian FTA), China has been active in forming closer economic ties with other East Asian economies after joining WTO (Zhang Yunling, 2005). FTA with East Asian countries will provide substantial benefits, as it enables China to have closer economic relationship with these countries. Moreover, EAFTA has more pressure on economic liberalization and it would promote domestic structural reform in China.

In general, the key point of China's economic reform is the restructuring and reorganization of SOEs (Satya J. Gabriel. 2003). SOEs are modelled as controlled by the members of the enterprise who determine output and target levels, while facing prices and wage rates set by government. The government, not the markets, determined the prices charged and the quantities produced. That is, the management of the SOE operated as an administrative unit, not a market entity (Zhang Yuyan, 1995). Executives were promoted as government officials. The SOE submitted an annual budget. Decisions on employment, investment, and wage compensation had to be approved by several levels of government. Moreover, the SOE turned over all the revenue to the administration, which then made the decision on how much to give back to the SOE. Under such a system, it is evident that the SOE sector did not have the incentives, or the ability, to be efficient (autonomy in decision making).

The attempt of this paper is to find the response of SOEs toward economic liberalization in China, including countermeasure of participation in domestic market competition and the attitude of participation in international competition (not only China's accession to the WTO, but also establishment of EAFTA). The structure of paper is as follows. Section II describes reform history of SOEs during economic transition in China, while Section III presents the further reform of SOEs after entry into WTO in China. Section IV analyzes attitude of SOEs to EAFTA and its reason. The last section summarizes the main conclusions of the study. Figure1 indicates the relationship between of SOE reformation and economic liberalization.

**Figure1: Relationship between of SOE Reformation and Economic Liberalization**

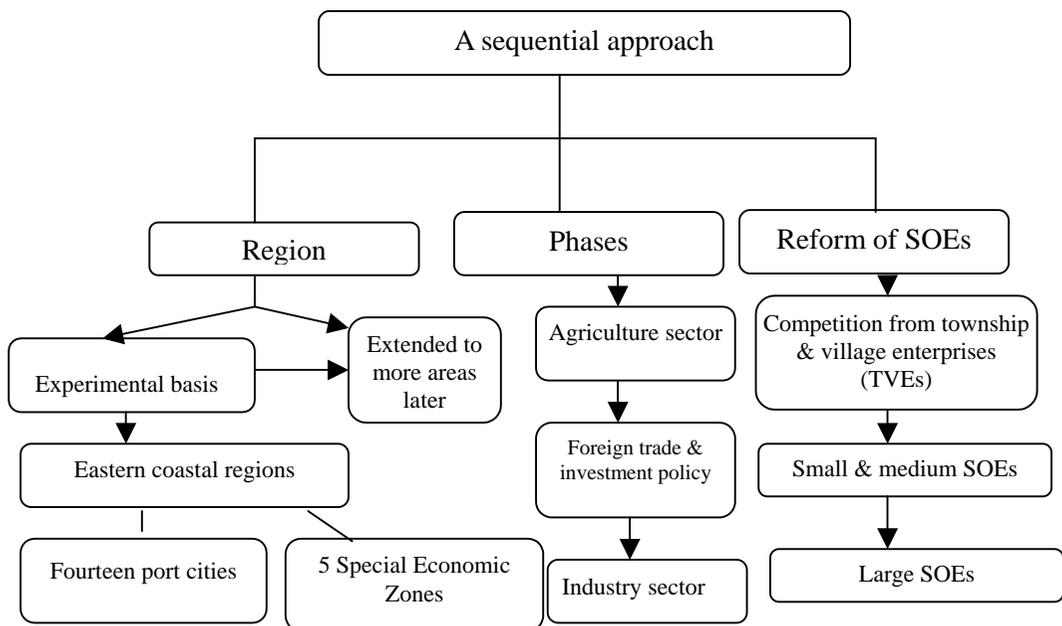


## II. Economic Liberalization and Reform Process of SOEs in China

### 1. A gradual and evolutionary approach to economic liberalization

Chinese economic reforms were homegrown and the government had complete control over the contents, schedule and the phases of reform program. It is different from other developing countries that they launched economic reforms when their economies were faced with serious economic and financial crises, such as balance-of-payment crisis or debt crisis. But in case of China, it faced no such crises when it launched reforms. China has adopted a gradual, evolutionary approach to the transition from the planned economy to a market economy starting at the end of 1978. The initial reforms were introduced as means of experimental basis only in the eastern coastal regions, such as fourteen port cities and five Special Economic Zones (SEZs) (Shenzhen, Zhuhai and Shantou in Guangdong Province, Xiamen in Fujian province and Hainan). Based on the successful outcomes of these experiments, such zones were extended to more areas later on. Meanwhile, China followed a sequential approach to economic liberalization, and economic reforms were introduced in phases. From Figure 2, we can see this sequential approach of SOE reformation. Firstly it is started in agriculture sector, followed by foreign trade and investment policy, and thirdly in industry sector. Likewise, China followed a same way to deal with the reform of state-owned

**Figure 2: A Sequential Approach of SOE Reformation**



enterprises. Instead of privatizing SOEs on a massive scale, the Chinese government exposed these units to more competition through township and village enterprises (TVEs), owned collectively by townships and villages.<sup>1</sup> All these developments took place within appropriate legal and regulatory framework to ensure that competition is promoted and monopolistic tendencies are curbed. This policy is helpful in introducing competition in the domestic economy.

## **2. Review of the reform history of SOEs in China**

The China government adopted a “catch and overtake” strategy to realize industrialization by mobilizing all resources to develop SOEs since the 1950s. That strategy of industrialization was efficient and China’s economy developed very quickly during that period. The production of SOEs was dictated by mandatory plans and furnished with most of their material inputs through an administrative allocation system. They did not have any autonomy over the employments of workers, the use of profits, the plan of production, the supplies of inputs, and marketing of their products. Managerial discretion was potentially a serious problem because of the lack of market mechanism. Hence, SOEs did no longer work so well after the 1960s.<sup>2</sup> China started the economic system reforms in 1978, by introducing market mechanism, opening up and encouraging the development of private economy. Roughly, the reforms of China’s SOEs have experienced four stages (Figure 3).

The first stage (1979-1983), China pursued economic restructuring to stimulate the dynamism of economy, the process did not involve mass privatization, and SOEs maintained its dominant role in the industrial sector. By the end of 1983, 98 percent of collective agriculture in China has adopted the new system, household responsibility system. At the same time, the government also initiated reform of SOEs in the management system. China emphasized several important experimental initiatives that were intended to enlarge enterprises autonomy and to expand the role of financial incentives within the traditional economic system. These measures included the introduction of profit retention and performance-related bonuses and permitted the SOEs to produce outside the mandatory State plan. The enterprises involved in exports also were allowed to retain part of their foreign exchange earnings for use at their own discretion.

In the second stage (1984-1986), the emphasis shifted to a formalization of financial obligation of the SOEs to the government and exposed enterprises to market influences. From

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<sup>1</sup> TVEs was initially based on collectively owned assets (land, pooled capital and in some instances the remnants of commune-owned industrial plants) and collective management, with the active participation of local officials in accessing credit, developing business plans, sales and distribution.

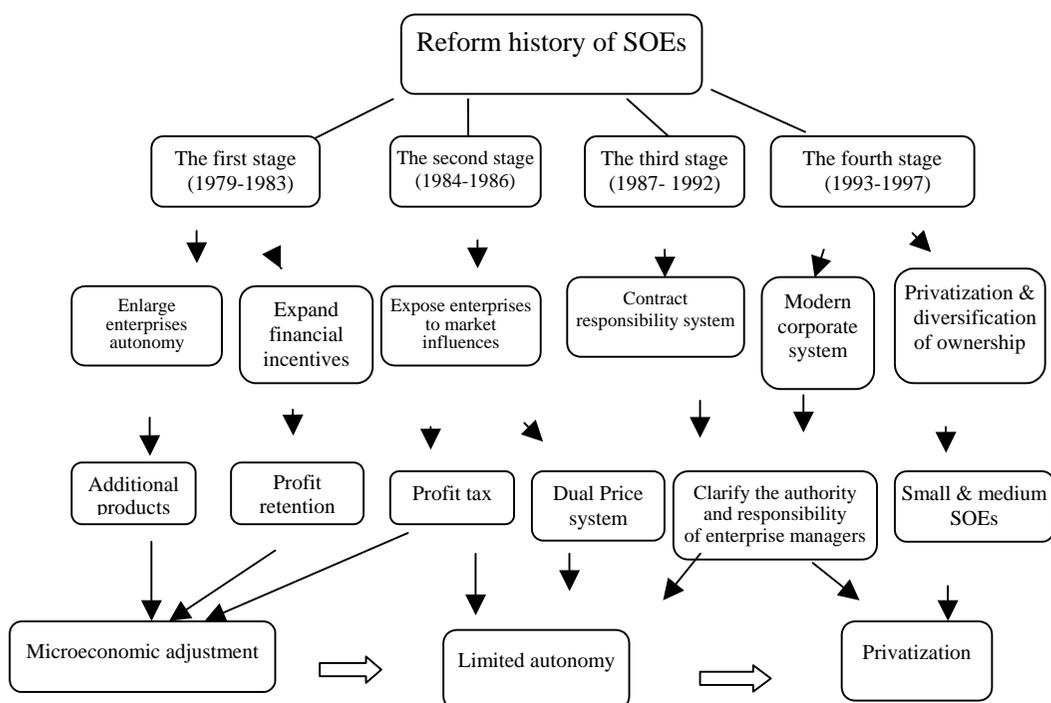
<sup>2</sup> China had a centrally planned economy including three components: a planned allocation for productive materials, such as credit, foreign exchange, and other; a macro-policy environment with featured mandatory interest rate, low nominal wages rates; a traditional micro-management system of State-owned enterprises and collective agriculture.

1983, profit remittances to the government were replaced by a profit tax. In 1984, the government allowed SOEs to sell output in excess of quotas at the negotiated prices and to plan their output accordingly, thus establishing a dual price system. At the same time, China started to aggressively deregulate price controls. China continued to encourage the establishment of collective enterprises and jointly-established private enterprises. The non-SOE sector continued to increase rapidly, becoming a direct market competitor to the SOE<sup>3</sup> sector in some areas of the economy where the SOE had previously enjoyed monopoly power.

The contract responsibility system, which attempts to clarify the authority and responsibility of enterprise managers, was formalized and widely adopted during the third stage (1987- 1992).

In the fourth stage (1993-1997), the government attempted to introduce the modern corporate system to the SOEs. In 1993 the reform of the SOE sector entered a new era. For the first time, the reform agenda called for the privatization and diversification of ownership for the small and medium SOE. Furthermore, SOE that were incurring big losses were allowed to merge or go bankrupt.

**Figure 3: Reform History of SOE**



<sup>3</sup> The Central Committee of CCP's Decision on Economic Institutional Reform, 1984, the third meeting of the 12th National Convention of CCP.

### **3. Valuation: reform of SOEs confronted with domestic market competition**

Through different stages the SOEs reform went from microeconomic adjustment, to limited autonomy, to privatization; and from giving no economic incentive to workers and managers, to giving partial incentives, to full incentive in case of privatized SOEs. In each stage of the reform, the government's intervention was reduced further and the SOEs gained more autonomy. Reform measures of market mechanism in the micro-management systems, such as replacement of profit remittance by a profit tax, the establishment of the contract responsibility system, and the introduction of the modern corporate system to SOEs, were response to competitive pressure from TVEs and other non-state enterprises.

Therefore, no matter how reluctant the government was, the only sustainable choice was to reform the macro-policy environment and make it consistent with the reform in micro-management system. The first change in the macro-policy was started in the commodity price system. With the exception for a few raw materials and coal, fuel, and transportation, the prices for most commodities and services have been liberalized in 1996. The second major changes occurred in the foreign exchange rate policy, the climax of it was the establishment of a managed floating system and unification of the dual rate system in 1994, by the time, 80 percent of foreign exchanges has already allocated through the swap markets.<sup>4</sup>

From the above discussion, it shows market mechanism from micro-management systems to macro-policy environment was begun to establish gradually. In the process, the efficiency of the SOEs was improved through greater autonomy and by meeting competition from the non-state sectors. But, the transition is not complete yet. This stage of the reform was completed rather satisfactorily for small enterprises, but it was implemented in much less extent for the medium and large size SOEs.<sup>5</sup> As a result, the majority of medium and large size SOEs did not improve their efficiency or profitability.

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<sup>4</sup> Interest rate policy is the least affected area of the traditional macro-policy environment.

<sup>5</sup> In 1993 the reform of the SOE sector entered a new era. For the first time, the reform agenda called for the privatization and diversification of ownership for the small and medium SOE. Furthermore, SOE that were incurring big losses were allowed to merge or go bankrupt.

### **III. China's WTO Accession and Its Effect on State-Owned Enterprises**

Undeniably, China's entry into WTO would pose new challenges to the Chinese government. Instead of steering economic liberalization on its own pace, the earlier strategy of experimentation in selected areas has to be replaced by well-defined time-tables covering almost every sector of the economy.

#### **1. The challenge of WTO to the China government**

*(1) The relevant accession documents that affect the SOE sector*

China fully signed the "Agreement on Subsidies and Countervailing Measures" (SCM), which specifically deals with government subsidies to the SOE sector.<sup>6</sup> In particular, according to article 1 of the SCM Agreement, SOE subsidies are considered "specific subsidies". According to Article 6.1 (b) (c) (d), "subsidies to cover operating losses sustained by an industry" or the forgiveness of debts to an unprofitable enterprise are considered a serious prejudice.<sup>7</sup> SOE are explicitly mentioned in paragraphs 172 and 173 of the Report, where China pledges that "China's objective is that state-owned enterprises, including banks, should be run on a commercial basis and be responsible for their own profits and losses," even though an official timetable for the elimination of SOE subsidies is not set.

In the WTO accession agreement, China committed to largely open up its financial sector, and table 1 is the timetable for opening the financial sector under WTO commitments, Foreign banks can begin to offer all kinds of services in domestic currency until 2006. The WTO accession package also allows market access to many service sectors in which the SOE originally had monopoly status, like the distribution services sector. These sectors were previously closed to both domestic private firms as well as foreign firms. Under the WTO agreement, as private firms enter the market, the SOE will face increasing competition which will force them to restructure.

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<sup>6</sup> The document of China's accession to the WTO consists of more than 900 pages with many provisions that, directly or indirectly, affect the SOE.

<sup>7</sup> As indicated in the same 171st paragraph of the Report, China will "reserve the right to benefit from the provisions of Articles 27.10, 27.11, 27.12 and 27.15 of the SCM Agreement". These provisions require the disputing member to drop the investigation if the subsidy does not exceed 2% per unit (3% for the initial eight years of accession). The fact that China agreed to such terms can be interpreted as China's being prepared to give up the majority of its subsidies to the SOE sector.

**Table 1: Timetable for Opening the Financial Sector under WTO Commitments**

Foreign banks can begin to offer services in domestic currency			
By Geography	Foreign companies and foreign individuals	Chinese domestic companies	Chinese individuals
Open Shanghai, Shenzhen	1996	2003	2006
Open Tianjing, Dalian	2001	2003	2006
Open Guangzho, Qingdao, Nanjing, Wuhan	2002	2003	2006
Open Jinan, Fuzhou, Chengdu, Chongqing	2003	2003	2006
Open Kunming, Zhuhai, Beijing, Xiamen	2004	2004	2006
Open Shantou, Ningbo, Shenyang, Xian	2005	2005	2006
Lift all geographical restrictions	2006	2006	2006

Source: WTO and Deutsche Bank Research (2004)

Banking services in foreign currency were liberalized in all regions immediately after WTO accession

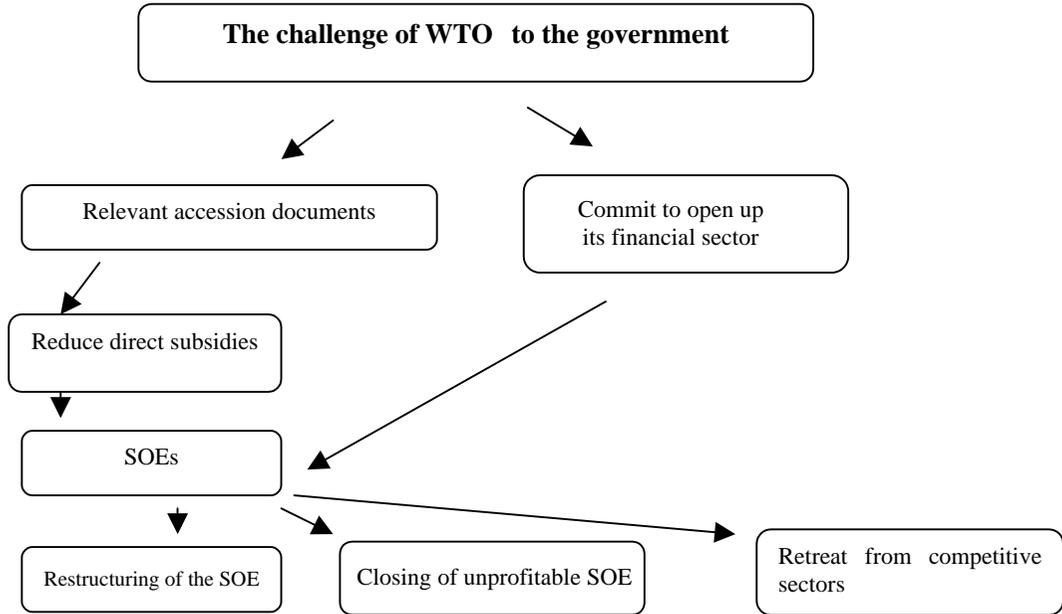
*(2) China government should establish a new relationship with the SOEs*

The WTO and globalization will force the China government to shift its function and to establish a new relationship with the SOEs.<sup>8</sup> The government should establish national treatment and non-discrimination to all firms; especially to establish a fair market according to the international practice, all the players including foreign players must have equal opportunity of competition in China. All the business that private firms are able to do must be done by the private firms rather than by the government, and the government mainly present in the public fields that the private firms are unable to do. Therefore, the state-owned enterprises would eventually retreat from competitive sectors to the public fields completely, which will provide big space for the development of private firms.

As the government gradually reduced the direct subsidies to the SOE sectors, financial support from state-owned banks played an increasingly important role in sustaining unprofitable SOE. But, a more open financial sector will force the state banks to be more profit oriented, as a result, to substantially reduce financial support to SOE in the form of low interest rates and preferred access to credit. Both factors combined will promote the restructuring of the SOE sector and the closing of unprofitable SOE. From Figure 5, we can see this challenge of WTO to the government. By bundling the domestic reforms together with the provisions in the WTO agreement, the SOEs reforms become a duty to fulfill an

<sup>8</sup> In the past two decades, the power to conduct reforms was totally controlled by the government. The decisions whether or not to reform, how to reform and what extent to reform were completely made by the government. However, that case has been gradually changed after China's entry into the WTO since 2001. In some sense, the government's behaviors have to be subject to the treaty of the WTO.

**Figure 4: The Challenge of WTO to the Government**



international commitment. As a result, fundamental reform of the SOE sector becomes much easier to implement after China's WTO accession.

## 2. Reform of SOEs in era of WTO: peel off policy burden gradually

Government Policy burden refers to that government can mobilize most of the economic resources to the SOEs like before, mainly referring to direct subsidies (Table 2) (Lin Yifu, 2005). The WTO agreement makes direct subsidies to SOE more difficult to implement. The government cannot subsidize the competitive SOEs and intervene the firm. Also, the budget constraint of the SOEs imposed by the government will turn into hard as well.

**Table 2: The Subsidies to SOE by the Central and Local Governments**

(Unit: 100 million Yuan)

	Local	Central	Total	Percentage of SOE output
1990	460.87	118.01	578.88	4.4
1992	290.62	154.34	444.96	2.5
1995	281.01	46.76	327.77	1.0
1997	272.75	95.74	368.49	1.0
1998	258.81	74.69	333.50	1.0

Source: WTO Accession Documents Submitted by China.

*(1) Stage (from 1997 to 2004) of “grasp the big and let go of the small” (“Zhua Da Fang Xiao”)*

The government realized that the state is unable to look after so many SOEs after the efforts to improve the performance of SOEs achieved little effect. It has adopted further reforms and recognized the necessity of clarifying property rights, to separate ownership and management in the biggest SOEs, and to privatize most of the small and medium size enterprises (SMEs). Hence, the core problem is that the SOEs should retreat from the competitive sectors. Between 1997 and 2001 the number of SOEs controlled by central government fell by 9,000, while the number controlled by local government declined by almost 80,000. State sector retreat from SMEs almost completely in 2004.

Diversification of ownership structure of large size SOEs already started in 1999. Government selected 100 large SOEs for reform experiments, as many as 80 enterprises out of 100 in the end had the state as a single owner. There are three examples as follows. The state telecommunication monopoly was broken up early that year. Among them, China Telecom (Hong Kong) was already listed on the Hong Kong Stock Exchange, and other three companies were preparing to be listed abroad. With the abolition of oil and chemical ministries, the reorganization produced two national petrochemical companies, namely, the China National Petroleum Corporation (CNPC) and the China Petrochemical Corporation (SINOPEC). The third example concerns Legend Group, the largest PC maker in China. Established in 1984, the company was 100% state owned. Early that year, the company distributed 35% of its shares to its managers, engineers, and other employees. Legend Group has set up an example for other state high-tech companies to distribute shares to their employees.

Actually, the China government has mainly adopted three measures in the strategy of “grasp the big and let go of the small”. We will review them respectively. Firstly, restructuring the SOEs to modern corporate system, and thereby establish the efficient corporate governance according to the international standard. But so-called modern corporate system has not been really established.<sup>9</sup> Secondly, disintegrating the big SOEs to introduce competition. The monopolistic SOEs will face fierce competition imposed by private firms and foreign ventures after China’s entry into the WTO. The Chinese government expects to improve the efficiency of the SOEs by disintegrating the monopolistic big SOEs into several smaller SOEs, without reforming the ownership structure of the SOEs. However, the so-called competition among the disintegrated SOEs is not real competition. Most probably, the present profitable SOEs will eventually lose money, or go bankruptcy when they lose their monopolistic position. Thirdly, restructuring the traditional SOEs as share holding companies

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<sup>9</sup> The efficient corporate governance is based on the well-defined property. The fact is that the efficient corporate governance in most of the SOEs that claiming having established the so-called modern corporate system has not been really established.

and the state maintains absolutely dominant stake. There are two cases. One is that the state holds dominant stake. All the problems in the SOEs will still remain there, and the restructured companies are not likely to be efficient. Another one is that the private shareholders own dominant stake in the restructured companies. The efficient corporate governance is most likely to be established. However, it is not enough to partially privatize the SOEs. In a word, the core problem is that the SOEs do not want retreat from the competitive sectors. They do not want to give up the monopoly to the sectors and do not allow the entry of private capital and foreign ventures.

*(2) Launch reform of the state-owned commercial banks (from 2003 to present)*

Banking sector is the most important player of the Chinese financial system. In 2004, bank loans represented 83% of the funds raised by the non-financial sector, while stocks were only 5% and bonds 12% (11% for government bonds and 1% for corporate ones) (Alicia García-Herrero, 2005). The banking system is the main financier of unprofitable SOEs so that bank reform will have a direct impact on SOEs (See table 3). Restructuring of banking sector currently aims at changing the state-owned banks (most notably the “big four”) from mechanism of politically-oriented credit rationing to efficient agents for capital allocation.

In 2003, under the steering of the central government, reform of the state-owned commercial banks was officially launched, with important progress already made on various fronts. In particular, the Industrial and Commercial Bank of China, the Bank of China, China Construction Bank and the Bank of Communications have all completed financial restructuring and been transformed into joint-stock companies. The Bank of Communications and China Construction Bank successfully went public. Diversification of banks’ ownership structure is to make them truly commercial banks, and further to build up their corporate governance. Through the reform measures, financial situation of these banks evidently improved.

**Table 3: The SOEs’ Loan in the Total Loan in China (%)**

	Long-term loan	Short-term loan	Total
1994	17.4	24.9	42.3
1995	16.2	23.3	39.5
1996	14.9	23.2	38.1
1997	14.8	22.1	36.9
1998	14.0	20.6	34.6

Source: Liu (2001)

**Figure 5: Restructuring of Banking Sector**



*(3) State-monopolized sectors was opened to private investors (both domestic or overseas) via mergers and acquisitions (M&A)*

The regulatory framework for using foreign capital in restructuring SOEs is encompassed in four new regulations introduced since 2002: (1) Provisional Regulation on the Use of Foreign Capital Restructuring SOEs; (2) The Management Rules on Acquisition of Listed Companies; (3) Circular on Issues Concerning the Transfer of State-owned Shares and Legal Person Shares of Listed Companies to Foreign Investor. (4) The Management Rules on Foreign Strategic Investment on Listed Companies.<sup>10</sup> With reference to these regulations, foreign investors can purchase both “state-owned shares” (i.e. shares held by the state itself) and “legal person shares” (i.e. shares held indirectly by other Chinese entities typically controlled by the state) in SOEs, and there is no limit on the size of the shareholdings that foreign investors may acquire except for those industries of importance to national or economic security as subject to the Catalogue Guiding Foreign Investment in Industries.

In 2004, the China government operated “Revitalization of Northeast China” strategy to revitalize the old industry base of Northeast China -- Liaoning, Jilin and Heilongjiang, which can be as an experiential test of further reform of large size SOEs. Heilongjiang, Jilin and

<sup>10</sup> The Ministry of Commerce, China Securities Regulatory Commission, National Tax Bureau, State Administration of Foreign Exchange and State Administration for Industry and Commerce published the rules jointly on December 31, 2005. Overseas investors will be allowed to buy exchange-traded A shares provided they acquire at least a 10 per cent stake and hold the stock for three years.

Liaoning, the three provinces are regarded as the last stronghold of the former planned economy in China. The shares of state-owned enterprises were among the highest in China, there are at least 70 percent of enterprises are SOEs. About 10 per cent of the country's large and medium size state-owned enterprises (SOEs) are in Liaoning alone. The shares of state-owned enterprises in industrial output in Liaoning, Jilin and Heilongjiang were among the highest in all Chinese provinces, which were 62.4%, 77.9% and 79.6% respectively in 2002 as compared to a national average of 40.8%. Revive the Northeast strategy called for deepening reform and stepping up the reform of the share-holding system of the large state-owned enterprises. Foreign investment is welcomed to restructure the SOEs, even the large and profitable SOEs that were kept out from foreign participation in previous reforms.<sup>11</sup> In July 2003, Grandtour Tire (China) Investment Company Limited, a unit of Singapore's Grandtour Tire Group, acquired a 44.3% stake, or 151.07 million state-owned legal person shares, in Heilongjiang's Hualin Tire Company Limited for RMB 97.89 million (US\$11.84 million). This was the first M&A of an SOE by a foreign investor in China.<sup>12</sup>

The government launched the strategy to revive its traditional industrial centers in the three northeast provinces, promoting shareholding reform in large size state-owned enterprises (SOEs).<sup>13</sup> Moreover, based on the successful outcomes of these experiments, China government will extend to more areas later on. *The Management Rules on foreign Strategic investment on Listed Companies* was published In December 31, 2005, which will plug a gap in regulations left by the disappearance of listed companies' nontradable equity. Reform agenda called for the privatization and diversification of ownership for the large size SOEs will be started in 2006.<sup>14</sup>

### 3. Performances and problems of ongoing SOEs reform

The reform process of China's SOEs has been accelerating, covering almost all types of industrial enterprises.<sup>15</sup> Now there are two types of SOEs. The first group comprises 169

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<sup>11</sup> Revitalization of Northeast China through SOEs reform--Hong Kong's Position and Strategy. <http://www.tdctrade.com/econforum/tdc/tdc040803.htm>

<sup>12</sup> One of the latest and most important initiatives of the current phase of SOEs reform is that most of the state-monopolized sectors, except for some backbone industries or those concerning national security, will be opened to private investors (both domestic or overseas) via mergers and acquisitions (M&A). Thus help the country's large and competitive SOEs including Daqing Oilfield Company Limited, Anshan Iron and Steel Group Corporation and China First Automobile Group of the Northeast, to become internationally competitive.

<sup>13</sup> To attract M&A of SOEs, local governments in the Northeast region have introduced incentives such as exemption of value-added tax (VAT) for equipment in eight heavy industries, namely equipment manufacturing, petrochemical, smelting and pressing of metals, ship building, automobile manufacturing, agricultural products processing, military equipment and high-tech industry.

<sup>14</sup> From National Bureau of Statistics of PRC, large size enterprises criterion is: number of employment is 2000 people or more than 2000 people, volume of Sales is 300 million Yuan or more than 300 million Yuan, total assets is 400 million Yuan or more than 400 million Yuan. There are 1588 large SOEs in 2005.

<sup>15</sup> China's SOE restructuring involves bankruptcies, liquidations, listings, debt-for equity swaps, auction, and etc.

large SOEs group overseen by the State Assets Supervision and Administrative Commission (SASAC),<sup>16</sup> which is to retain control of strategic industrial sectors, including China Mobile, China Shipbuilding Industry Group, COSCO, Sinopec, Minmetals, COFCO, China Resources, China Merchant Ship Navigation, Baosteel, China Eastern Airlines, China Southern Airlines, Air China and China National Offshore Oil Corporation (CNOOC). Most of these companies have extensive subsidiary holdings, through which they have joint assets with other companies, or have listed spin-off companies, but the holding company is in the hands of the state through its ownership of nontradeable shares. Second group consists of all other SOEs, 138,000 companies in 2005 (see table 4).<sup>17</sup>

**Table 4: Number of SOEs in 2003**

Unit: number

	Total	Overseen by SASAC	Department management	Local enterprises
Total	149988	15546	6064	128378
Agriculture, forestry and fishery products	9047	190	618	8239
Industries	38622	5481	1085	32056
Construction	6928	1574	315	5039
Land and water perambulation	1602	295	72	1235
Transport, storage	26378	1622	364	24392
Post and telecommunications	451	230	81	140
Wholesale and retail trade, restaurants	36204	2581	673	32950
Real estate activities	5296	516	180	4600
Information technology service	787	206	175	406
Social service	14093	1426	1398	11269
Sanitation, sporting activities and welfare	304	37	43	224
Education, cultural, broadcast	4046	122	539	3385
Science Research and technology service	3198	1175	493	1530
Organ, community and Others	3032	91	28	2913

Source: State Assets Supervision and Administrative Yearbook 2004.

<sup>16</sup> The total number of SOEs Supervised by SASAC is 15546. Source: State Assets Supervision and Administrative Yearbook 2004.

<sup>17</sup> The number of total SOEs dropped 40 percent from 1996 to 2005.

Though China's SOE sector is still large, the importance of the SOE sector has declined in terms of its contribution to output and employment since the beginning of the economic reform. In terms of urban employment, the SOE share decreased much faster, from 78% in 1971 to 31% in 2001.<sup>18</sup> There are totally 42.28 million people of SOEs employment in 2005, including 10.29 million people in the 169 group companies (see Table 5), and the number has very little change in 2005. In the past, one key justification for the existence of the SOEs is to provide employment. This decline in employment should be interpreted as a sign that the government priorities have shifted to efficiency instead of employment generation (see Table 6).

**Table 5: Number of Employment of SOES in 2003**

Unit: Ten Thousand

Item	Total	Overseen by SASAC	Department management	Local enterprises
Total	4228.2	1029.1	586	2613.1
Agriculture, forestry and fishery products	464.2	3.4	173.6	287.3
Industries	2058	648.4	36.5	1373.1
Construction	371.7	149	8.5	214.2
Land and water perambulation	17.6	8	0.7	8.9
Transport, storage	564.3	36	249.8	278.4
Post and telecommunications	177.7	112.7	62.6	2.5
Wholesale and retail trade, restaurants	288.2	25.8	32	230.4
Real estate activities	33.3	5.2	1.1	27
Information technology service	8.9	3.7	2.7	2.5
Social service	137.8	12.6	9.7	115.5
Sanitation, sporting activities and welfare	3.2	1	0.3	1.9
Education, cultural, broadcast	30.9	1	4.9	25
Science Research and technology service	35.8	21.7	3.4	10.7
Organ, community and Others	36.6	0.5	0.3	35.8

Source: State Assets Supervision and Administrative Yearbook 2004.

<sup>18</sup> Data source: China Statistical Yearbook 2002.

Fifty-one enterprises of 169 group companies had completed or started the split equity structure reform by the end of 2005,<sup>19</sup> and the net profits of SOEs have increased substantially. The 169 group companies achieved estimated sales of 6.6 trillion Yuan (US\$825 billion) in 2005, and the net profits are expected to reach 600 billion Yuan (US\$75 billion), up 20 per cent than 2004. The 169 group companies contribute some 60 per cent of the tax revenues collected from SOEs (see Table 7).<sup>20</sup> And, Sinopec, PetroChina, and China National Offshore Oil Corporation (CNOOC), China Mobile, China telecommunication Group, China COSCO, Baosteel, contributed some 66 per cent of the profit collected from the central SOEs of 169 group companies of in 2004.

The number of state-owned industrial firms dropped to 27,000 in early 2005 from 114,000 in 1996.<sup>21</sup> SOE has the share of Gross Industrial output Value is 34 % (see Table 8) in 2004, there is still 35% is making net losses (see Table 9). Actually, since the early 1990s the performance of the SOE sector has continuously deteriorated, unprofitable SOE cannot operate without government support. Indeed, as shown in Table 2, the magnitude of direct subsidies from the government to SOE is very large. As the government reduced direct subsidies, they were replaced by loans from state banks (see Table 3), which register around 30-50% of non-performing loans, most of them to unprofitable SOE. Even though the SOE received nearly half of the investment in 2001 (Figure 6), growth in the SOE sector was low. The existence of the inefficient SOEs in competitive sectors has greatly increased the opportunity cost for China and the welfare of the China's economy has not been maximized.

**Table 6: Number of Employment with SOE as a Subcategory of Urban Employment**

(million persons)

Year	Total	Urban	SOE	Rural non-farm	Rural farm	SOE as share of urban	SOE as share of non-farm	SOE as share of total
1978	401.5	95.1	74.5	28.3	278.1	78.3	60.4	18.6
1993	668.1	182.6	109.2	145.4	340	59.8	33.3	16.3
1997	698.2	207.8	110.4	171.7	318.7	53.1	29.1	15.8
2001	730.3	239.4	76.4	169.0	321.8	31.9	18.7	10.5

Source: China Statistical Yearbook, various years.

<sup>19</sup> The split share structure refers to the existence of both tradable shares and a large volume of non-tradable shares owned by the state and legal persons. To make all their shares tradable, listed companies participating in the reform have to offer additional shares or funds to public investors as compensation. Resource: According to a just-published book on the survey, which is titled "China's Ownership Transformation: Process, Outcomes, Prospects".

<http://www.sasac.gov.cn/zyqy/qyml/default.htm>

<sup>20</sup> Reforms of SOEs speed up next year, December 26, 2005.

[http://english.people.com.cn/200512/26/eng20051226\\_230813.html](http://english.people.com.cn/200512/26/eng20051226_230813.html)

<sup>21</sup> Outside investors has powerful positive impact on SOEs' performance: survey.

[http://english.people.com.cn/200511/03/eng20051103\\_218609.html](http://english.people.com.cn/200511/03/eng20051103_218609.html)

**Table 7: Total Assets & Total Liabilities of SOEs in 2003(by sector)**

Unit: 100 million Yuan

Item	Total assets	Total liabilities	Net assets	Total owner's equity	Assets-liability ratio (%)
Total	197103.3	113490.1	83613.2	71366.5	57.6
Agriculture, forestry and fishery products	3135	2096.7	1038.3	1010.8	66.9
Industries	98589.7	55830.2	42759.6	35532.5	56.6
Construction	10190.6	8005.3	2185.3	1899.2	78.6
Land and water perambulation	845.9	362.6	483.4	453.7	42.9
Transport, storage	28922.8	18117.3	10805.6	9938.9	62.6
Post and telecommunications	15605.4	6576.6	9028.8	7967.8	42.1
Wholesale and retail trade, restaurants	17110.8	13572.4	3538.4	2762.8	79.3
Real estate activities	240.7	165.9	74.8	69.6	68.9
Information technology service	9764.5	7523.6	2240.9	1820.6	77
Social service	864.9	567.9	297	224	65.7
Sanitation, sporting activities and welfare	15933.7	7819.2	8114.5	7110.9	49.1
Education, cultural, broadcast	111.2	65.9	45.4	41.4	59.2
Science Research and technology service	1371.5	530.9	840.6	827	38.7
Organ, community and Others	1207.5	759	448.5	393.7	62.9
Item	8953.4	7166.4	1787	1383.1	80

Source: State Assets Supervision and Administrative Yearbook 2004.

**Table 8: Gross Industrial Output Value by Ownership (%)**

Year	Share of total (%)			
	SOE Owned	Collective Owned	Share-Holding Enterprises	Private Owned
1978	78	22		
1985	65	32		3
2001	44	11	36	9
2002	41	9	38	12
2003	38	7	40	15
2004	34	6	43	17

Source: China Statistical Yearbook, 2005.

**Table 9: Main Indicators of State-owned and State-controlled Industrial Enterprises**

(Unit: 100 million yuan)

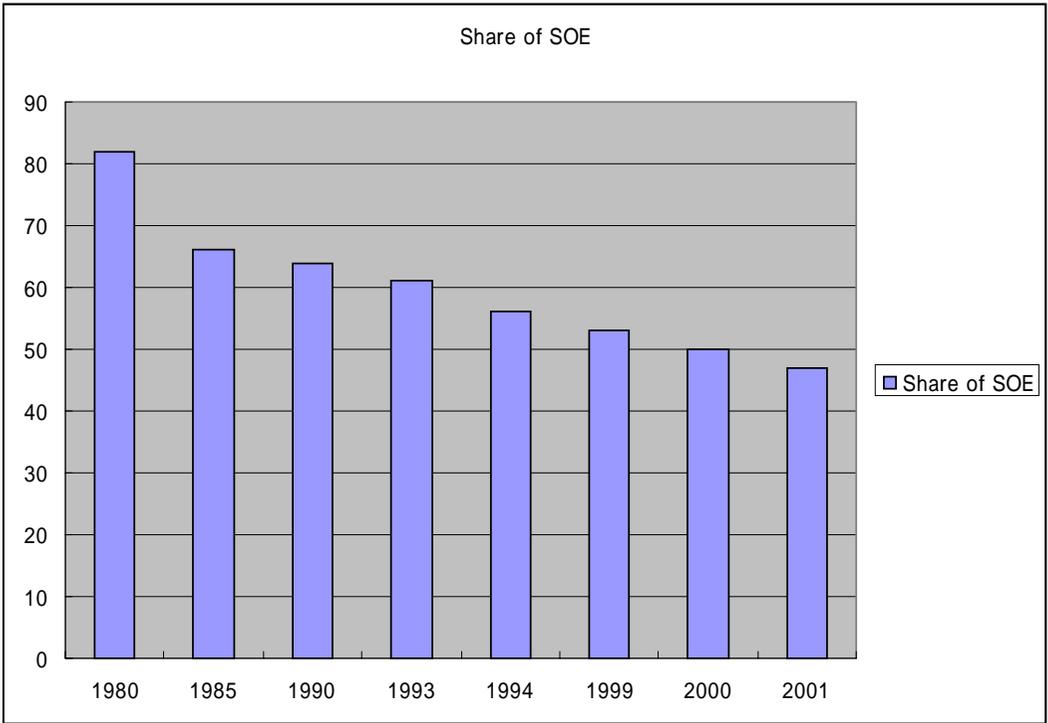
Year	Number of enterprises (unit)	Loss-suffering enterprises(%)	Total Assets	Total Liabilities	Sales revenue of industrial products
2001	46767	36%	87901	52025	44443
2002	41125	36%	89094	52837	47844
2003	34280	35%	94519	55990	58027
2004	31750	35%	101593	60291	71451

Source: China Statistical Yearbook, 2005.

*Further SOEs reforms must be adjusted in the era of globalization.*

The new policy concerns the diversification of ownership structure for those enterprises over which the state still wants to maintain control competitive sectors. Except for a few enterprises in which the state intends to retain 100% ownership, all other enterprises will become joint stock companies with multiple owners. These new owners can be either domestic private investors or foreign investors. Moreover, SOEs can retreat from some so-called public sectors. Many SOEs in so-called public sectors actually should be privatized and the government should retreat from the sectors, such as freeway and etc. The WTO has provided an opportunity to change the function of China government and therefore provided opportunity to improve the efficiency of this type of SOEs as well. If some of the SOEs in public sectors can be privatized, then their efficiency will get much improved. The Second concerns the establishment of corporate governance, including: (i) Directors and top managers are selected and monitored; (ii) Incentive system is designed and enforced. (iii) Major issues of corporate governance concern legal rules limiting agency problems, protecting shareholders and creditors, and providing room for managerial initiatives. Hence, corporate governance reform could be the next step and also most difficult step for SOEs reform.

**Figure 6: Investment Share of SOEs**



## IV. Response of SOEs to EAFTA in China

Since entering WTO, China has been increasingly involved in the world economy and society. Now China is at the last stage of joining the WTO, and it has been active in forming closer economic ties with other East Asian economies. Asia is a latecomer in terms of forming free trade areas, but now, many countries are negotiating with other countries to expand their list of FTA partners. In establishing EAFTA, The accelerated SOEs reform process in China indicates government would attempt to build fair market according to the international practice. Obviously, companies will have to meet challenges from foreign enterprises since trade liberalization will surely generate competition. The author just finished the business survey about the attitude of enterprises to EAFTA in China, including SOEs.<sup>22</sup> Making use of the part of survey result, we can see the response of SOEs to East Asia regional market.

### 1. General findings of Chinese SOEs' attitude to EAFTA and analysis by sectors

In order to know the response of companies to EAFTA, we sent our questionnaire to the companies in China and also did some face to face interviews. The survey results are based on 19 selected large size SOEs. We classified business attitudes to EAFTA by three types: very need, quite need, and no need. The conclusion is, on the whole, Chinese SOEs are divided, with 38% for very need, 48% no need. Chinese SOEs that answered as quite need only accounts for 14%. Their different attitudes are based on the nature of their business (Figure 7). Their operation is mostly focused on Chinese market and has a small share including produces and sales in other countries. For example, some companies have 10 percent of market share in Southeast Asia and 10 percent of raw material supply from European market. The others are in China.

Companies that interviewed, all come from manufacturing industry,<sup>23</sup> which includes five electronic sector enterprises, three general machine equipment (processing or construction) enterprises, three chemical products enterprises, three textile & dress enterprises, three grocery processing enterprises, one transport equipment enterprise, and one steel enterprise. Our survey provided results for sectoral effects that are reflected by differences of the responses of the companies surveyed in different sectors. Due to the different nature of the industries, benefits created by EAFTA are differential.

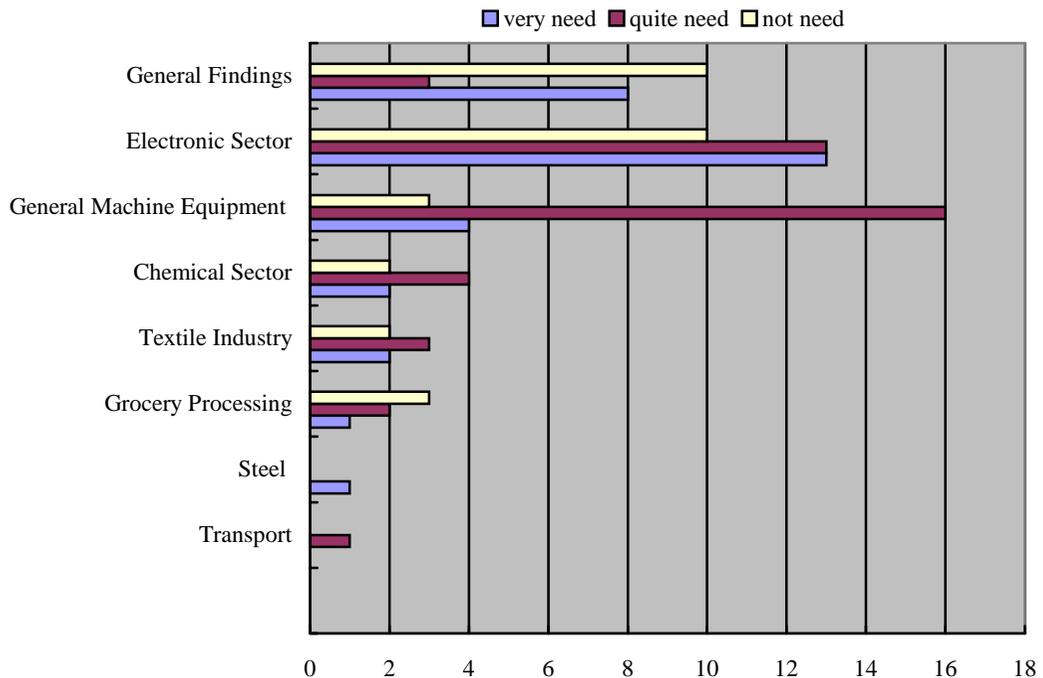
There are five electronic sector enterprises interviewed, four enterprises out of five show no need, only one enterprise has quite need. The reason is that they are different in business

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<sup>22</sup> Liu Xiangfeng, Business survey; Zhang Yunling, *Designing East Asian FTA: Rational and Feasibility*. October 16, 2005.

<sup>23</sup> SOE are mainly in the industrial sector in China.

**Figure 7: Attitude of Chinese Companies to EAFTA**



structure. For those that show no need, their business is more concentrated in China, purchase of raw material and sales of products respectively are either completely in Chinese market or Chinese and Europe market, and seems no regional strategic restructuring in the near future. They think that EAFTA has little effect on them. For the enterprise that show quite need, whose business are more regional based, its raw material supply comes from the China and Hong Kong, and market products sales also go to either China or Hong Kong.

There are three general machine equipment (processing or construction) companies interviewed, two companies out of three show very strong support to EAFTA, as very need. Their raw material and other supply are from China, Japan and sales also in China, Japan, as well as other East Asian economies. Due to their diversified directions of their business, they highly expect an early EAFTA, which can provide with them a much better business environment. For one that answered as no need, because that its raw material supplied completely in China and products sold primarily to Europe.

There are three chemical sector companies interviewed, only one company out of three shows very need, its raw material and other supply are from China, Japan, as well as Europe and market share also in China, Japan, as well as other East Asian economies. The other two companies answered as no need, have their raw material business mostly relating to China.

There are three textile industry companies interviewed, two companies out of three show

very need, the highest rate among all types of industries, and one company as no need. This shows that textile sector has highly regional and international linkage. Those that have high expectation on EAFTA naturally do their business in a regional and even global base. But one company shows no interest on EAFTA, whose raw material supply in China and the products are sold to the Europe. EAFTA will have little impact to it.

In the three grocery processing companies, one company shows very need, one has quite need and one has no need attitude. In this group, those show strong support to EAFTA, raw material are completely from China, but market share also in China, Japan, other East Asian economies, they highly expect an early EAFTA. The One shows no interest, the reason is that its raw material is supplied in China and the products are sold to the Europe. EAFTA will have little impact to it.

Other industries, such as, one steel company and one transport equipment company, similarly, raw material is completely from China and the products are sold to China and the Europe. But steel company shows very need, it hope to expand their market to Southeast Asia after EAFTA. The transport equipment company has no need attitude because EAFTA will have little impact to it.

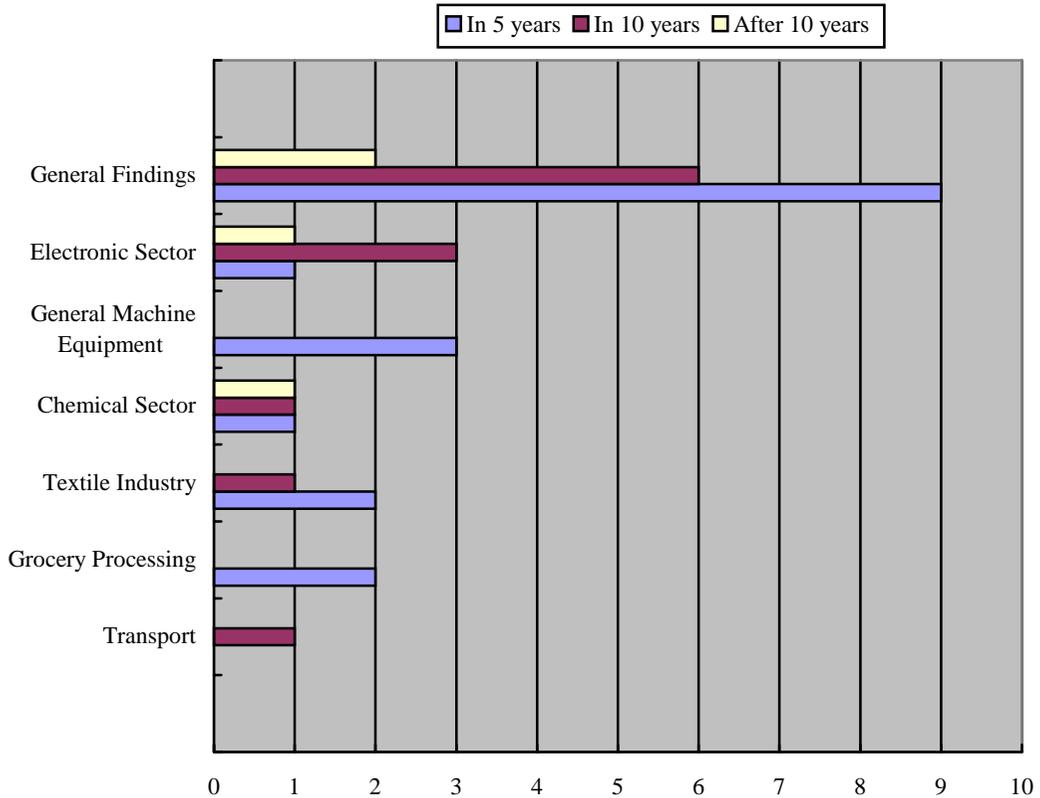
Different attitudes are based on the nature of their business. For those that answered as very need, we may further see the following features:

- (1) Raw materials supply and market share are completely or mostly in China. The reason for them to believe that they will benefit more from EAFTA is that they will have opportunity to sale their products to more East Asian markets.
- (2) Raw material supply is completely in China, and products are sold primarily to Japan. They also strongly believe that they will benefit from EAFTA and look forward to it.
- (3) Raw material supply is primarily in China, but products are sold to Japan, US and Europe. They strongly believe that they will benefit more from an EAFTA and hope to start it in 5 five years.
- (4) Raw material and other supply are from China, Japan and Europe and sales also in China, Japan, other East Asian economies, as well as America & European markets. Due to their diversified directions of their business, they highly expect an early EAFTA, which can provide with them a much better business environment.

For those that answered as no need, they have the following features:

- (1) Raw material supplied completely in China and products sold primarily to Europe.
- (2) Raw material purchase and products sale respectively are completely in Chinese market. They think that EAFTA has little effect on them.
- (3) Raw material supplied completely or primarily in China and products sold primarily to Europe and China, they may consider EAFTA have negative effect on them since liberalization sharpens the competition.

**Figure 8: Schedule of EAFTA**



The conclusion is, on the whole, almost nearly 90 percent enterprises surely welcome EAFTA. Concerning schedule of initiating EAFTA negotiation, 50 percent companies surveyed hope to start as soon as possible, 39 percent expect to begin within ten years, only 11 percent hope to start it after ten years (Figure 8).

## 2. Chinese SOEs view other domestic enterprises as the real competitor

In some degree, EAFTA will have “resource reallocation effect” and “shock effect”, different impacts to their business strategies of the SOEs will be considered. One is “resource allocation effect”, this is, producers respond to a new set of prices in regional market, which guide resources allocation in line with comparative advantages. Another is “shock effect”, with the competitive pressures from foreign competitors pushing domestic producers to achieve the highest potential efficiency. The EAFTA will be reformed once in East Asia

region, it requires that all the countries to remove nearly all the restrictions on trade of goods, it will encourage intra-regional trade while the tariffs on the goods from non-member countries remain unchanged. But, according to the questionnaires result, only four companies replied that they would make some change of their raw material supply or sales from China to other East Asian economies, because EAFTA will help them to reduce the cost and expand markets in East Asian region. Two of them show their interest to transfer supply market to other East Asian economies, and the other two companies expect that their sales will confront more competition in China, so that, they may consider shifting their sales to Southeast Asian markets. But no company considers investment strategy in Southeast Asian markets.

EAFTA will have little “resource reallocation effect” and “shock effect” on Chinese enterprises. The reason is that unprofitable SOE is still the most difficult problem of economic liberalization in China. Chinese economy is primarily divided into two major sectors. The coastal and southeast regions of China have export-import base, but the State Owned Enterprises (SOE) run the rest of the country based on a planned economy. These SOEs are unprofitable, inefficient and incapable entities that really feed on government resources and four primary banks that provide funds to them. In fact, one third of SOEs in China are operating at a loss. Despite some high-profile overseas acquisitions, few Chinese SOEs companies have plans to expand overseas investment. Overwhelmingly inward looking, they view other local enterprises as the real competition at home, rather than foreign rivals. In any event, Chinese companies for the most part are not hunting for new brands and new markets overseas. Their eyes are turned inwards, not outwards. The China market is the main target; the immediate regional market dawdled behind, with Northeast Asia and Southeast Asia.

Moreover, China state owned companies consider their real competition to be the large domestic SOEs, followed by domestic private companies. Foreign competition, while certainly not negligible, does not worry them as much. In regional market, Chinese SOEs will compete with foreign multinational companies (MNCs), but, now the other domestic enterprises are their main rivals, not the MNCs. Preoccupied as they are with the domestic market and their own internal problems, China’s domestic companies are a long way off from going global. The handful of Chinese enterprises going global are either looking to secure a steady supply of energy and other resources, or are buying international brands to strengthen their own, and are mostly in competitive sectors in China, such as household appliances and personal computers (see Table 11). It is a far way for SOEs to enter the international market and regional market.

In the survey, we also find that non-tariff barriers are main trade obstacle for Chinese SOEs. China should continue to make efforts to cut tariff rates and non-tariff barriers. The tariff should not only be reduced, but also should be adjusted towards simplicity. Priority should be given to the elimination of non-tariff barriers. One point is a possible shift from non-tariff barriers to tariff transparency, which is often adopted by developing countries in the early stage of trade liberalization. That is, the replacement of non-tariff barriers by an

equivalent tariff at the first step. If so, trade policy will move towards liberality and transparency.

### 3. Big enterprises and company groups with international competitiveness should be formed

Openness means Chinese firms face heightened competition at home from foreign companies, big and small. Yes, Chinese companies can grow rapidly in the short-term, but this is because of a low-pricing strategy, built around government support, a cheap bank finance and poor standard of internal discipline. Lack the technological innovation and governance systems that are essential to compete effectively in the medium- to long-term. The incomplete reform of China's corporate sector is another key reason that Chinese firms are not likely to go global in a big way in the foreseeable future.

**Table 10: China Looks Outwards, 2005**

Target	Acquirer	Deal value US\$bn
OZGEN (50%), (Australia)	China Huaneng Group	0.20
PetroChina International (Indonesia)	China National Petroleum ; PetroChina	0.50
Ssangyong Motor (48.9%), (South Korea)	Shanghai Automotive Industry Corporation	0.51
Gordon LNG field (oil and gas assets), (Australia)	CNOOC	0.70
PCCW (20%), (Hong Kong)	China Network Communications Group (China Netcom)	1.02
IBM (personal-computer business), (US)	Lenovo Group	1.75
Maytag (US), (bid withdrawn July 2005)	Qingdao Haier	2.25
China National Petroleum Petro	Kazakhstan	4.18
Noranda (Canada), (talks inclusive, no deal yet)	China Minmetals	5.00
Unocal (US), (bid withdrawn Aug 2005)	CNOOC	18.50
MG Rover (UK)	Nanjing Automotive	£ 50m

Sources: Dealogic; *The Economist*; Economist Intelligence Unit.

Although the Lenovo deal attracted a lot of attention, China's big three state-owned oil companies—Sinopec, PetroChina and China National Offshore Oil Corporation (CNOOC)—have already invested in countries ranging from Kazakhstan and Yemen to Sudan and Myanmar (see Table 11). But this trajectory has already been set by the country's energy and resource firms, in a government-supported strategic sector. China's export-led manufacturing boom is largely a creation of foreign direct investment (FDI) that effectively serves as a substitute for domestic entrepreneurship. As a result, China has not strong private companies; especially, very few state-owned companies in China plan to expand abroad because their eyes are turned inwards. So, confronted with foreign companies, China should build better capital markets and a corporate environment more conducive for the growth of Chinese-owned MNCs. SOEs are more likely, in fact, than TVEs to devote a significant portion of their cash flow to research and development activities, upgrading their facilities, improving product quality, developing marketing plans, enhancing management skills and cutting prices (Satya J. Gabriel. 1999). It is much more likely that some fraction of the SOEs will emerge as first-rate, competitive enterprises on the global economic stage.

## V. Concluding Remarks

China has adopted a gradual, evolutionary approach to the transition from the planned economy to a market economy. WTO entry instead of steering economic liberalization on its own pace, the earlier strategy of experimentation in selected areas has to be replaced by well-defined time-tables covering almost every sector of the economy. China's entry into WTO would pose new challenges to the Chinese government. The rule of WTO is the rule of law for global market competition. In order to get strong ability of competition in the global market, China should accelerate its transition to a full-fledged market system. The ability for China to share the prosperity of globalization is mostly dependent on if the China government can finish the transition to a modern government and therefore solve the problems caused by the SOEs. So, the key point of economic liberalization is that if the China government can finish the transition to a modern government and therefore solve the problems caused by the SOEs.

After China's accession to the WTO, direct subsidies by government has been reduced and financial sector reform has already begun, both factors combined will promote the restructuring of the large SOE sector and the closing of unprofitable SOE. Establishment of EAFTA will also bring big changes to China economy; it will probably benefit some sectors, but will probably hurt the welfare of some sectors. Based on the predicament of SOEs in domestic market, it could lose market share because foreign products come to China market more easily. Concerns about possible adverse impacts on SOEs of these events had been rising.

Meanwhile, establishment of EAFTA will also bring big changes to China economy. Concerns about possible adverse impacts on SOEs of these events had been rising. It is obvious that, China need to integrated in global economy and regional economy, and it will likewise need its own multinational companies. Restructuring large size SOEs and having them go public is a major step towards developing China's multinational companies. At the same time, we remain optimistic about China's remaining journey toward a modern market economy. Already, the demand inside China for quickening its transformation of SOEs, development of private enterprises, and establishment of the rule of law has become stronger than it was in the past ever. And China should build better capital markets and a corporate environment more conducive for the growth of Chinese own MNCs.

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