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European Languages	زبانهای اروپائی

OCTOBER 29, 2018

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30.10.2018

America Wants China to Reform Its State-Owned Enterprises to be Market-Oriented: Be Careful What You Wish for!

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Forty years after reforms and opening initiated by Deng Xiaoping, Architect-in-Chief of Modern China, private businesses have vastly transformed the Chinese economy. The numbers 5,6,7,8 and 9 are often used to sum up the contributions made by the private sector to the economy : over 50% of government revenue, more than 60% of GDP, 70% of technological innovation, 80% of total employment and 90% of new jobs created.

Over the same period, the public sector has declined considerably. It has been a laggard on virtually all fronts, becoming woefully uncompetitive and inefficient. In many cases, they survive by virtue of State patronage including monopolistic franchises and easy, unrestricted access to key resources particularly bank loans. Even then, there are quite a number of zombie enterprises.

In the late 1990s, the then Prime Minister Zhu Rongji took a sharp knife to many comatose and walking dead SOEs, resulting in layoffs of almost a million workers, many in the Rust Belt in northeastern China. That was the first time the myth of Iron Rice Bowls was ruthlessly shattered and crushed.

Twenty years on, the problem of SOEs has resurfaced : many are debt-ridden, loss-making and burdened with large production over-capacity. In January 2016, President Xi Jinping unveiled the Supply Side Structural Reforms to push SOEs to step up their game. Xi's supply side reforms and the widely-discredited Reagan-era Supply Side Economics of cutting taxes which were then supposed to trickle down (but little did), are as different as night and day. China's Structural Reforms demand SOEs to de-leverage, get rid of excess capacity, run down over-inventory and improve product quality.

Part of the de-leveraging regimen includes debt-to-equity swap, with the new equity in SOEs issued to lenders to be on-sold to private investors under the mixed (State and private) ownership scheme. Available statistics show that credit growth in SOEs has slowed down to single digits over the last two years.

Reliable sources in China have indicated that reforms of the SOEs will move into higher gear in the years ahead. The government will direct the changes at the "practical level" instead of the hitherto "policy level". That's official-speak for cracking the whip against those who resist government policy or are tardy in implementing the necessary reforms. After the revamp of SOEs, their efficiency will rise by leaps and bounds, giving their private-sector peers a run for their money.

The room for improvement in the public sector is tremendous. SOEs have combined assets worth 150 trillion Yuan or $22 trillion. Private businesses have slightly more assets, aggregating 165 trillion Yuan or $24 trillion. A McKinsey study found that SOEs account for 73% of ALL outstanding loans, and contribute under 40% to GDP. By comparison, only 27% of outstanding loans go to the private sector including foreign enterprises, which together generate more than 60% of GDP. This clearly shows the huge gap in efficiency between the public and private sectors in China.

To be sure, the "inefficiency" of SOEs is partly a result of government policy to keep prices of public services provided by state-owned monopolies such as high speed trains and electricity low and affordable. Another major cause is the State using SOEs as off-budget vehicles for public works and infrastructures. They include the 4 trillion Yuan ($600 billion) stimulus package put together in the aftermath of the global financial crisis in 2008. Of course, there are many SOEs which operate strictly on a commercial basis such as oil and petrochemical companies and airlines. When those SOEs are given the makeover, they will become lean and mean, and contribute more to GDP. For those which are exporters, they are more than likely to capture a bigger share of markets abroad.

Washington might have their wish of reformed Chinese SOEs granted. But it'd be more than they have bargained for!