# Improving Investment Efficiency in China through Privatization and Financial Reform

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## Summary

1. In the quarter of a century since beginning its "open-door" reforms, China has turned in an average annual growth of nearly 10%. This is primarily a result of growth in investment and other inputs, however, while production has not been that efficient, fostering doubts over the sustainability of that growth. The government is striving to move away from the "extensive" type of growth achieved so far toward an "intensive" growth pattern, but doing so will require it to reform its inefficient state-owned enterprises and banks by privatizing them.

2. China's privatization process began in the mid-1990s with small to mid-sized enterprises, and then spread to large state-owned firms after the policy of "strategic realignment of state-owned sectors of the economy" was adopted at the 15th National Congress of the Communist Party in 1997. Many large state-owned firms have become listed companies, but state-owned and corporate shares together still comprise about two-thirds of outstanding shares, and are not allowed to float on the market. This has acted as a bottleneck preventing the securities market from fulfilling its expected role as a vehicle for privatization. Fortunately, full-scale reforms of the non-tradable shares since 2005 has gone a long way toward resolving this problem, and this should accelerate the privatization of large state-owned firms. Meanwhile, the successful listing of China Construction Bank (CCB) overseas has opened the door to privatization of the state-owned commercial banks.

## I. Economic growth driven by the expansion of inputs is not sustainable

In the quarter of a century since starting its open-door policy, China has turned in an average annual growth of nearly 10%. Consequently, China's presence in the global economy has grown rapidly: it now has the world's fourth largest GDP behind the US, Japan, and Germany, and its total trade has surpassed that of Japan to move into the third-ranked position. China's high rate of growth has thus far primarily been the result of growth in investment and other inputs, however, with production remaining not that efficient, and this has fostered doubts over the sustainability of that growth.

The poor efficiency of investments in China can be confirmed through an international comparison of the incremental capital-output ratio or ICOR (Table 1). The incremental capital-output ratio (ICOR) is the ratio of investment to GDP divided by the real economic growth rate; the smaller the number, the more efficient is investment. Investment in China during 2001-04 averaged 40.9% of GDP while economic growth averaged 8.7% per annum over that same period, giving an ICOR of 4.7 (40.9/8.7). This means that the equivalent of 4.7% of GDP must be invested in order to boost growth by 1%. Although Japan's economic growth of 10.2% in the 1960s was higher than China's current growth rate, it only had investments totaling 32.6% of GDP, and thus a low ICOR of 3.2. Korea and Taiwan also had considerably lower ICORs in the 1980s than China has now, 3.2 for Korea and 2.7 for Taiwan.

**Table 1 China's Incremental Capital - Output Ratio (ICOR)**

- Comparison with Japan, Korea and Taiwan during their High - Growth Periods

| | | Investment Ratio (% of GDP) a | GDP Growth (%) b | ICOR a/b |
|---|---|---|---|---|
| China | 91-95 | 39.6 | 12.0 | 3.3 |
| | 96-00 | 37.6 | 8.3 | 4.5 |
| | 01-04 | 40.9 | 8.7 | 4.7 |
| (1991-2004) | | 39.3 | 9.7 | 4.1 |
| Japan (1961-1970) | | 32.6 | 10.2 | 3.2 |
| South Korea (1981-1990) | | 29.6 | 9.2 | 3.2 |
| Taiwan (1981-1990) | | 21.9 | 8.0 | 2.7 |

Sources: Official statistics of countries concerned

Another indicator of the low efficiency of investment is the large number of industries in China, including steel, electrolytic aluminum, coke, and automobiles, with excessive production capacity and low operating rates (Table 2). According to Ma Kai, Minister of the National Development and Reform Commission, production capacity in the steel industry already exceeds demand by 120 million tons. The total production capacity of plants under construction is 70 million tons, and the construction of another 80 million tons of capacity is currently on the drawing board. As for electrolytic aluminum, the current production capacity is 10.3 million tons, but 2.6 million tons of that stands idle. In the automobile sector, production volume was 5.7 million vehicles in 2005, but production capacity was another 2 million units higher. Plants now under construction can reportedly manufacture another 2.2 million units, while plant construction still in the planning stage has a capacity of another 8 million vehicles.

**Table 2 Status of Excess Production Capacity**

| | |
|---|---|
| Steel industry | Production capacity in 2005: 470 million tonnes<br>Counting plants under construction and planned: 600 million tonnes<br>Current market demand: 350 million tonnes |
| Electrolytic aluminum industry | Current production capacity: 10.3 million tonnes<br>Idle production capacity: 2.6 million tonnes<br>Capacity of plants under construction: 1.12 million tonnes |
| Coke industry | Total production capacity of over 1400 companies nationwide: 300 million tonnes<br>Amount exceeding demand: 100 million tonnes<br>Capacity of plants under construction and planned: 60 million tonnes |
| Automotive industry | Surplus capacity: 2 million vehicles<br>Capacity of plants under construction and planned: 2.2 million and 8 million vehicles, respectively |

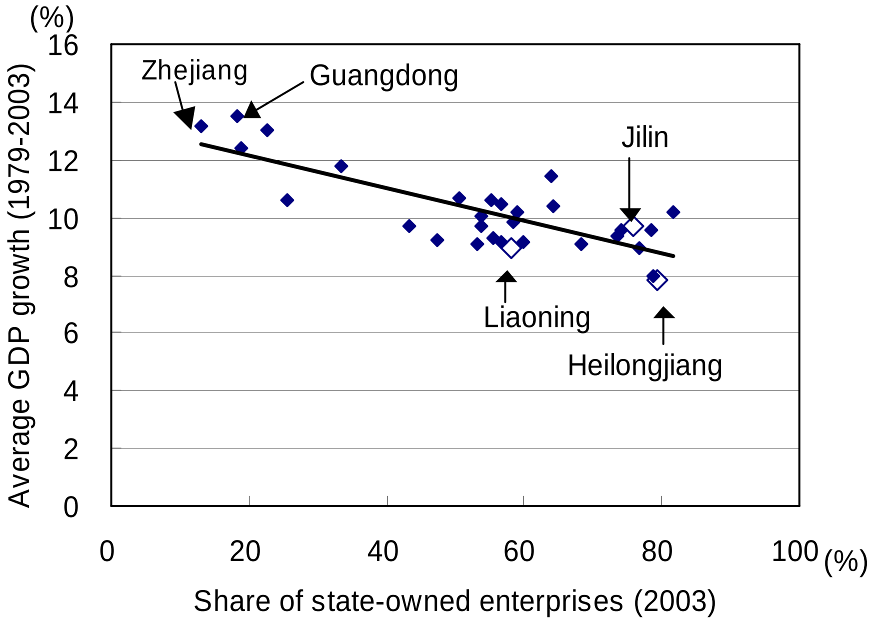
Source: National Development and Reform Commission, as report in *People's Daily*, December 5, 2005.

Professor Paul Krugman of Princeton University astutely pointed out in "The Myth of Asia's Miracle" (*Foreign Affairs*, 1994) some 10 years ago that the robust growth of the Asian economies, which became known as the "East Asian Miracle," was unsustainable, as it was achieved not through a rise in productivity but through an increase in input. His predictions turned out to be correct as the Asian financial crisis swept through such countries as Thailand, Indonesia and South Korea. For China to avert a crisis and achieve sustained economic growth, it must shift its engine of growth from an "extensive" pattern based on increased input to an "intensive" pattern built on improved productivity. In fact, this is one of the major goals in China's 11th five-year plan, which begins with 2006.

## II. Privatization as the key to improving investment efficiency

The fundamental cause of the Chinese economy's low efficiency is the still large presence of state-owned enterprises, particular on the input side. The inefficiency of state-owned companies is a common problem in all countries, and China is no exception. In fact, since China began its open-door reforms, the tendency has been for economic growth to be lower in those regions where state-owned enterprises comprise a higher percentage of industrial production (Figure 1). In China's three northeast provinces of Helongjiang, Jilin, and Liaoning, where state-owned enterprises constitute a larger share than in other regions, economic growth is below the national average. In contrast, the highest growth rates in China can be seen in Guangdong, which has attracted a lot of foreign investment, and in Zhejiang, where private companies are prospering.

**Figure 1 Negative Correlation between Provincial GDP growth and the share of state-owned enterprises**




Note: Results of regression analysis
Average GDP growth=0.1328－0.0569×(state-owned enterprises' share of industrial production)
(27.66)** (-6.92)**

t-values in parentheses
adjusted $R^2$: 0.6098
**: significant at the 1% level

Source: Compiled by the author based on *China Statistical Yearbook*.

In addition, China's financial system, which is still tightly controlled by the government, has failed to efficiently transform people's savings into investments .

In the area of indirect finance, corporate governance remains weak at the four leading state-owned commercial banks that form the core of China's banking sector. Like the state-owned enterprises that receive the bulk of their loans, these banks are not acting to maximize profits for the Chinese people, who are supposed to be their shareholders. Loan interest rates have been set low as a way to subsidize the state-owned enterprises that receive the financing, and the banks have failed to allocate funds to the highest yielding projects. When loans become nonperforming, the people involved are seldom penalized. Government officials, particularly those from local governments, intervene in the business activities of the state-owned commercial banks, including in personnel and lending decisions, resulting in rising nonperforming assets.

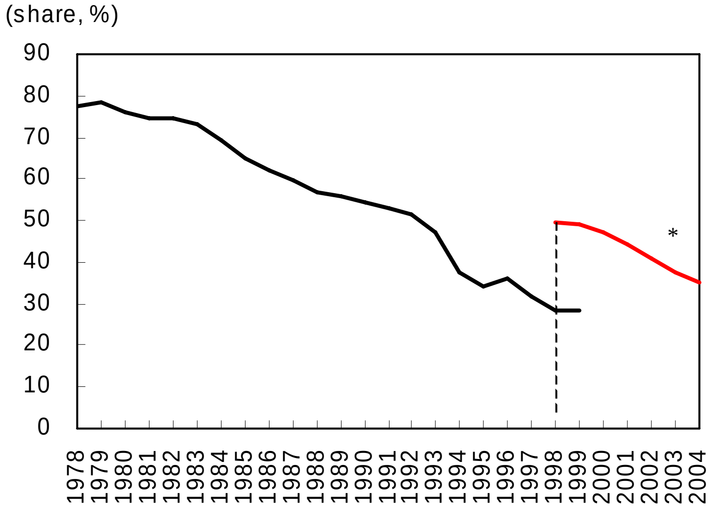
Meanwhile, in the area of direct financing, securities markets have also become dysfunctional, as evidenced by the fact that share prices remained stagnant between 2003 and 2005 despite a booming economy, as investors had lost faith in China’s securities markets amid a series of scandals involving listed companies. The unusual situation that China's securities markets are now in can be attributed to the fact that the majority of listed companies are state-owned enterprises where the government is the shareholder with absolute control. Although the companies are listed, the majority of their shares is still owned by the state and cannot be traded on the market. As the largest shareholder and owner of a majority of the voting rights, the state (more accurately, a bureaucrat entrusted by the state) effectively controls the general shareholder's meeting, the Board of Directors, the auditors, and the selection of the management team. The state widely abuses its shareholder status to trample on the rights of minority shareholders. As a reflection of this, a large number of listed companies in China report a substantial worsening of earnings, or become unprofitable, shortly after their listing.

The inefficiency of state-owned enterprises reflects first of all of a failure of corporate governance. To fix this situation, ownership in state-owned enterprises must be transferred, through a process of privatization, to private-sector investors who take a strong interest in the earnings generated by those enterprises.

In contrast with Eastern Europe and Russia, economic reform in China has avoided the privatization of state-owned enterprises but instead retained a system of public ownership, the core feature of socialism, as it has pursued the transition from a planned economy to a market economy. Nevertheless, behind this government facade of "retaining a system of public ownership," China has made steady progress in privatizing state-owned enterprises in recent years. Combining this with the growth of private companies and foreign firms, state-owned enterprises' share of industrial production has been following a downward trajectory (Figure 2).

Under the planned economy prior to China's open-door reforms, not only did the government own nearly every company, it directly participated in their management, making the firms state-run enterprises in both a nominal and real sense. As a result of decentralization in the 1980s and the separation of administrative from corporate functions, the government's role now stops at ownership, and the companies have expanded considerably their management prerogatives. Because of this, the term "state-run enterprise" was replaced with the term "state-owned enterprise" in the early 1990s. Subsequently, from the mid-1990s the government began privatizing state-owned enterprises under the concept of "seizing the big and freeing the small," and the policy of "strategic realignment of state-owned sectors of the economy." The latter allows state-owned enterprises, including large ones, to exit from sectors where market competition should be the norm, while only keeping industries associated with national security, infrastructure and other important public goods and services, as well as leading companies in key and high-tech industries, as state-owned.

**Figure 2 Declining Share of SOEs in Industrial Production**




Note: Since 1998, only companies with annual sales over 5 million yuan have been included, and the share of state-owned enterprises so calculated has risen.
Source: *China Statistical Yearbook*.

## III. Reform of non-tradable shares opens the way for privatization of major state-owned enterprises

Since then, many small and medium-size state-owned companies have been privatized through such means as management buyouts and mergers with private sector companies, but further reform of the securities market is required before the privatization of large state-owned enterprises can move forward.

In a capitalist country, the most common method of privatizing a state-owned firm is to convert it into a corporation, list its shares, and then gradually reduce the state's shareholdings. Typical examples of this in Japan are the listings of Nippon Telegraph and Telephone Corp. (NTT) and the companies of the Japan Railways (JR) group. In China, however, securities markets have been beset with problems and unable to fulfill their expected role as a vehicle of privatization. In fact, the Chinese authorities attempted to sell off state-owned shares on two occasions, in 1999 and 2001, but this led to a plunge in stock prices on fears that the balance between supply and demand would deteriorate, forcing the authorities to postpone their sales.

Based on lessons learned from this, the blueprint for future reform of China's capital markets announced in February 2004, "The Opinions of the State Council Concerning Promotion of the Reform and Opening and Stable Development of Capital Markets," stresses the importance of reforming non-tradable shares and proposes that holders of such shares should compensate holders of tradable shares. In line with this policy, on April 29, 2005 the government released its "Notice Regarding the Issue of Experimenting with Reforms to the Split-share Structure of Listed Companies" and launched a new pilot project to sell state-owned shares. Unlike the previous two occasions, the experiment simultaneously takes into consideration the interests of both holders of tradable shares and holders of non-tradable shares by including such provisions as "the companies selected to take part in the experiment decide for themselves how they will sell their non-tradable shares" and "the proposed sale method must not only be approved by an extraordinary shareholders' meeting but also be supported by at least two-thirds of the voting rights held by owners of tradable shares that take part in the voting." In addition, out of consideration for the balance between supply and demand, even if state-owned and corporate shares are converted into tradable shares, their actual floating on the market is banned completely for the first year and limited to no more than 5% of all outstanding shares for the second year.

The first round of the experiment began with four companies whose names were publicly announced on May 9, and 42 additional firms were included in the second round on June 19. On Aug. 19, the reform proposals of the last of these firms were approved at its extraordinary shareholders' meeting, and since overall stock prices remained stable, the experiment could be called a success. Based on this, guidelines for reforming non-tradable shares at all listed firms and a series of measures to realize this were successively announced between late August and early September. In line with these moves, another 40 companies unveiled proposals to reform their non-tradable shares on Sept. 12, and since then about 20 firms have been doing so each week. This suggests that the reform of non-tradable shares has moved from the experimental stage to full-scale implementation, and this process is expected to be completed, by spreading to all listed firms, within a relatively short timeframe of one to two years.

The authorities explain that the sole aim of these reforms is to improve corporate governance at listed firms and the intermediary function of the stock market by giving equal rights to non-tradable and tradable shares, and they deny any intention to float state-owned shares on the market. This cautious stance reflects the authorities' desire to dispel concerns about a possible deterioration in the balance between supply and demand. If non-tradable shares remain in the hands of the state even after they are turned into tradable shares, however, there cannot possibly be any improvement in corporate governance or in the intermediary function of the stock market. In order to achieve the desired effects, privatization of state-owned enterprises must be carried out through the floating of state-owned shares. This is also a path that China cannot avoid as it strives to shift to a market economy.

## IV. State-owned commercial banks also becoming targets for privatization

Improving investment efficiency will require reform of not only securities markets but also of the banking sector, the lead provider of indirect financing. To achieve banking sector reform, the Chinese government is moving forward with plans to inject public funds into the banking system, dispose of nonperforming loans, turn the four largest state-owned banks into joint stock banks, and then list their shares on overseas markets. The plan aims to attract strategic investors from overseas in order to improve management efficiency. Meanwhile, foreign financial institutions are looking to enter the Chinese market through capital tie-ups with local banks, with one after another making investments into one of the big four banks (Table 3). Nevertheless, while the weight of public opinion in China recognizes the need to introduce foreign capital, some have criticized the sale of shares in state-owned banks to foreign investors as selling state-owned assets too cheaply.

**Table 3 Foreign investments in the Big Four commercial banks in China (As of May 2006)**

| | | Investors | Investment amount (in $ billion) | % of shares | Timing of agreement |
|---|---|---|---|---|---|
| Big Four state-owned banks | Industrial and Commercial Bank of China | Goldman Sachs (US), Allianz (Germany), American Express (US) | 3.78 | 10% | Jan. 2006 |
| | Bank of China | RBS (UK), Merrill Lynch (US), Li Ka-Shing Foundation (Hong Kong) | 3.1 | 10% | Aug. 2005 |
| | | Temasek (Singapore) | 3.1 | 10% | Aug. 2005 |
| | | UBS (Switzerland) | 0.5 | 1.6% | Sept. 2005 |
| | | Asian Development Bank | 0.075 | 0.24% | Oct. 2005 |
| | | Bank of Tokyo-Mitsubishi UFJ (Japan) | 0.18 | Approx.0.6% | May 2006 |
| | China Construction Bank | Bank of America (US) | 3.0 | Approx.10% | June 2005 |
| | | Temasek (Singapore) | 1.4 | 5.1% | Aug. 2005 |
| | Agricultural Bank of China | - | - | - | - |
| Reference | Bank of Communications | HSBC (UK) | 1.75 | 19.9% | Aug. 2004 |

Source: Compiled from media reports

These critics cite as evidence of such "underselling" the fact that the share prices paid by foreign investors are below valuations based on the earnings of these state-owned banks. Furthermore, when considering the large amount of public funds that have already been spent on injecting capital into, and disposing of the nonperforming loans of, the four big banks, this underselling to foreign investors does appear to be a drain on state-owned assets. It has also been pointed out that the exclusion of Chinese financial institutions from a chance to bid violates the principle of equal footing, a key premise of the market economy.

In response, authorities and economists have made the following counterarguments. First, the purpose of accepting capital from strategic investors is to absorb their managerial expertise so as to improve the banks' global competitiveness, and this makes it inevitable to give priority to foreign financial institutions that are superior to their Chinese counterparts in terms of both technology and experience. Second, from the potential investors' perspective, there are significant risks involved in taking a stake in a Chinese state-owned bank, including the possibility that the bad loan ratios of the Big Four may resurge, and these investors would never have taken an interest in acquiring shares without the expectation of returns commensurate with the risks. Third, strategic investors are required to make firm commitments to provide long-term cooperation, refrain from selling the acquired shares for three years, send executives on loan, and so forth, which effectively eliminate the possibility of speculation by foreign investors.

The decision on whether to introduce foreign capital into state-owned banks should be based on whether the policy eventually results in better management and higher share prices of these banks. Based on this standard, the Bank of Communications (BoCom) - which is the fifth largest state-owned commercial bank, has accepted foreign investors, and has listed its shares overseas ahead of the Big Four - can be cited as a successful case. BoCom accepted an equity investment by HSBC for a 19.9% stake in 2004 and then listed its shares as an "H share" company in Hong Kong in June 2005. Subsequent improvement in BoCom's earnings led to a 100% appreciation in its share price from listing to date (as of May 2006).

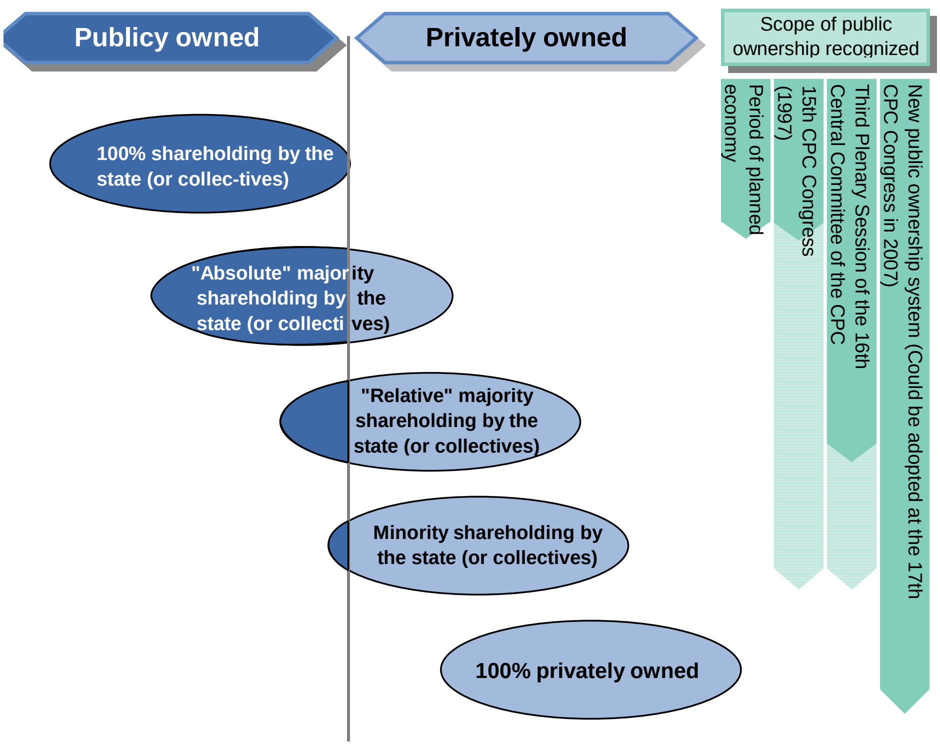
Like BoCom, CCB, another Chinese bank that went public by listing as an H-share company in October 2005, has also seen its stock do well. The greatest beneficiary of this rise in share prices, which can be viewed as a "reform dividend," is the Chinese government, which owns the largest stake – far greater than that held by foreign investors – in these state-owned banks. Such capital tie-ups between state-owned banks and foreign financial institutions are thus win-win strategies for both sides.

The final goal of state-owned bank reform is likely to be privatization, whereby both the government's ownership and its management will be phased out step by step. The ongoing shareholding reform and listing of the Big Four banks is no more than the first step toward that end. Even after shareholding reform, listing the shares, and forming a rules-based system of corporate governance within the bank, it does not mean that an actual incentive system and management oversight mechanism is effectively functioning within the bank. A bank can be transformed into a joint stock bank with a board of directors, a board of auditors, a general shareholders' meeting, and other management structures, but as long as the government remains in control as the largest shareholder, the usual problems are unlikely to be solved. This is why it is important, once the Big Four have listed their shares, to start reducing the government's stake and put privatization within reach. Foreign investment in Chinese banks is currently limited to no more than a 20% stake per investor and less than a 25% stake by all foreign investors combined, but this restriction could easily be loosened in the future. In fact, foreign investors have an aggregate 25.8% stake in CCB, by way of it shares listed in Hong Kong. CCB president Guo Shuqing noted that this did not present a problem, since the 25% limit is meant only for unlisted banks.

## V. The end of the state-owned model

China is thus trying to privatize its state-owned enterprises and banks through shareholding reform. According to conventional ideology, this is nothing more than a restoration of capitalism, and an abandonment of the core tenet of socialism calling for the state to own the means of production. The government's official position on this is that a joint stock company, or a corporation, is merely one form of the modern corporation, a form that can be used by capitalist and socialist countries alike (as stated by Zhang Zemin in his report to the 15th National Congress). Furthermore, the definition of the public ownership system has been evolving over time (Figure 3). At the 15th CPC Congress, it was argued that the state-owned (or collectively-owned) portion of shareholding enterprises ( i.e. the government's stake and collective stake in those enterprises), should be accepted as a part of the publicly owned economy. Furthermore, at the Third Plenary Session of the 16th Central Committee of the CPC, the shareholding system was deemed the main form of public ownership, and an enterprise controlled by the state (or by a collective) was recognized, in its entirety, as part of the publicly owned economy, even when state ownership is less than 50% (absolute majority), as long as the state owns a larger stake than any other investor (relative majority).

**Figure 3 Extended interpretation of the public ownership system: the case of shareholding**




For the period shown by striped bars, only portions described by ■ are recognized as owned by the state (or collectives).

This has sparked a lively debate among economists over exactly what a "public ownership system" is supposed to be. One position that has attracted attention is the "theory of a new public ownership system" put forth by Li Yining, a prominent economist and professor at the Guanghua School of Management at Peking University. Professor Li views the ongoing reform of state-owned enterprises, which is centered on corporatization, as a realignment/development into a new system of public ownership, and argues that even shareholding enterprises that are purely funded by private capital are one form of this new system. Some economists who insist that public ownership should be maintained have criticized this theory of a new public ownership system, arguing that it has distorted the meaning of the term "public ownership system".

The same argument, although to a different extent, could be applied to the government's official line for its deviation from the conventional ideology of socialism. With the Chinese economy's center of gravity steadily shifting from public ownership to private ownership and the contradictions between the "economic base" and its ideological "superstructure" deepening, however, it is becoming difficult for the government to maintain the facade of "public ownership of the means of production." China is now under pressure to further expand the scope of public ownership in accordance with Professor Li's proposal, and eventually will probably have to formally abandon that principle altogether. Since the official replacement of the planned economy with the market economy at the 14th CPC Congress in 1992, adherence to public ownership has been the biggest obstacle hindering productivity growth, and its abandonment will certainly trigger further dramatic advances in the Chinese economy.