Social and Political Challenges of the Chinese SOEs reform

国有企业改革对中国社会和政治的挑战

Master Thesis of The Lauder Institute

Director: Professor Jennifer Amyx

Student: François Desné

April 25th, 2003

I would like to extend sincere thanks to my Thesis advisor, Professor Jennifer Amyx, who guided my efforts with valuable insights, constructive criticisms and precious support.

Table of Content

Social and political challenges of the Chinese SOEs reforms

Foreword

Today, China is making a transition of a magnitude some have likened to that made by the former Soviet Union. The government is engaged in gradually shifting away from central planning to adopt a more market-based economic system, in which the rule of supply and demand regulates the transaction of goods. As a result, the state-owned financial and industrial sectors have experienced drastic changes in their economic environment and fallen into decline. Their financial duress, in turn, raises concern about possible surges in unemployment or amounts of non-performing loans. The State-Owned Enterprises -SOEs- accounted for 80% of the industrial output in the late 70s; but by 1999, the figure had dropped to less than 60%. SOEs' collapse seems unavoidable as their excessive employment, highly leveraged capital structure or production inefficiency wipe out current profits and compromise future expansion.

Several questions thus arise. Why should the Chinese government actively manage SOEs' reforms and not let the domestic market self-adjust? Why is there a challenge in reforming the Chinese SOEs? After all, several East-European countries reformed their public sector without generating domestic turmoil or recession? First, it is necessary to point out that the Chinese government faces macroeconomic issues with the decline of the state-owned sector. SOEs represent a large part of the Chinese industrial output, provide welfare and income to the majority of the workforce and play an important role in foreign relations, as China remains the "factory of the back room". Therefore, given the preponderance and the omnipresence of the SOEs in the Chinese economy, it is necessary to deal with the decline of the state-owned sector and to implement reforms. Second, several microeconomic issues render the reforms scheme complex and therefore create numerous challenges for the Chinese government. Among them, the ownership structure separated from the management that controls SOEs, the highly leveraged capital structure, the scarcity of professional management or the so-called soft-budget issue. But more importantly, the social and political challenges that hide behind SOEs' reforms.

Many scholars have looked at the reforms of Chinese state owned enterprises from a liberal perspective, contending that *shock therapy* is the only way to successfully implement reforms in transition economies. *Shock therapy* advocates drastic implementation of economic reforms, regardless of any societal or historical factors. It argues that the only way to reform transition economies is to set a free market environment and let it self adjusts. Such theory has proven successful in countries like Korea or Thailand. At the time of the financial crisis, Korea, Indonesia or Thailand had political pressures from financial institutions such as the IMF and took advantage of these external political pressures to implement drastic reforms and budgetary austerity leading sometimes to social discontent. The restructuring of the financial sector in Korea and Thailand demonstrated that the IMF precepts, combined with coordinated government action, are sound and efficient. But the social cost of those reforms was high and, in some case, led to workers unrest, social uncertainty and political turmoil. To that respect, it is worthwhile to note that other countries, such as Malaysia, did not follow the recommendations of the IMF to survive the Asian financial crisis. Malaysia has had recurring social and religious tension among its ethnic and religious groups. In 1969, tensions between the Chinese community and the Alliance Malays sparked riots in which more than 2,000 people died. Many contended that the 1969 riots forced a reappraisal of Malaysian society; and when the Malay government launched the *New Economic Policy*, which aimed to curb inequalities between Malays and Chinese, it combined market policies with social justice programs. The goal of the Malaysian government was to prevent potential social unrest that could result from the then-existing religious and ethnic tensions between the different groups setting up the Malay society. To some extent, we argue that the Chinese government is implementing reforms in a very similar way. The objective of the central government is to preserve social contentment while fostering economic development in order for the Chinese Communist Party (CCP) to stay in power. Chinese officials must therefore address the social component of the reform, at the same time they try to deal with its financial and economic aspects.

This paper gives an overview of the social and political challenges contingent on the reforms of the Chinese SOEs and tries to demonstrate that Chinese SOEs reforms cannot take place under a strict market mechanism between financial institutions and corporations. This analysis focuses first on the historical, socio-political and economic context, with the aim to provide a clear picture of China, as a country, and explain how SOEs' reforms are linked to Chinese history, political institutions, social system or traditions. In this first chapter, we will try to reconcile the apparent paradox between the communist regime, the market economy and the reforms of the state-owned sector.

The second section focuses on the political challenges of the reforms. The Chinese government's main concern is to stay in power and therefore avoid criticism from its people. As a result, the government institutions are willing to address reforms of the state-owned sector in a way that prioritizes creation and distribution of wealth in order to avoid social unrest and political instability. This implies reorganization of the political system. This part of the paper will try to draw the link between the reforms, the decentralization and the change in the central and local government related institutions as well as reforms in the property rights or the banking system. Last but not least, we look also at external factors, such as dependence on the World trade, with the aim to pinpoint the additional challenges the entry of China into WTO will bring to the reform of the Chinese SOEs.

The third section presents the social aspect of the reforms. The reform process of Chinese SOEs unveils the complexity of the Chinese social security system. SOEs, around which the life of ordinary Chinese people used to be organized, have historically provided employees with significant benefits. Despite swift reforms in the coastal areas, social problems contingent on SOEs reforms exist. Reforms of the educational system, pensions, healthcare and social benefit are therefore linked to SOEs reforms, as the government provided most of those services to the people through SOEs. This section tries also to analyze the labor surplus issue in China. The decline of the agriculture sector will provide cheap labor. With 800 million people living in rural areas, we argue that the labor surplus issue will slow down the restructuring of SOE as the Chinese government cannot foster massive lay-off in the state-owned sector while at the same time facing migration of unemployed people from the rural to the urban areas; a migration contingent on the modernization of the agrarian sector.

There is a widely shared view that the Chinese government lacks aggressiveness when addressing the problem of SOE reforms. In that respect, scholars and economist would like to see China adopting more drastic reforms on various macroeconomic related areas such as the banking system, property rights or the capital structure, to name a few of them. On the other hand, any turmoil in China is of global concern given the trade relationship between China and the world, the inflow of FDI or the foreign managed assets in the country. This analysis will also try to reconcile the paradoxical requirements surrounding the SOEs reforms. The international community, predominantly under western influence, is asking at the same time for drastic liberal reform and political stability. The former favors the growth of the Chinese economy, and hence creates potentially lucrative market for multinational corporations. The latter favors inflow of FDI and preserves foreign interests in China. We will try to demonstrate that the gradual reform process of the Chinese SOEs is an attempt to meet the two above-mentioned requirements with the concurrent goal of achieving some of the efficiencies of a market economy while retaining political stability.

1 China's transition economy

Those who remember their physics classes recall that the movement of a solid on a road depends on several internal and external parameters. Internal parameters of the solid are its shape, its mass or its consistency. External parameters of the solid are its initial speed, the force we apply to initiate and maintain the movement or the roughness of the road. Intuitively, it is easy to foresee how each of these parameters conditions the movement of the solid. In other words, internal and external characteristics related to the solid determine its ability to move. We argue that in light of the different economic, socio-political and geographic context, the same concept applies to China and the Chinese economy. In other words, internal parameters of China, such as its political system, its social network or tradition and external parameters, such as the trade dependence with the US and Europe or the entry into WTO should condition the economic transition, its scope and the speed at which it can be implemented.

In the case of China, we strongly oppose the widely shared view of scholars such as Jeffrey Sachs, who advocate that social and historical contexts are irrelevant in the reform process of transition economies (emerging markets). Sachs argues that successful economic reforms can be applied regardless of the socio-historical context. The underlying assumption here is that once the economic reforms are applied, the country might experience a "social" cost, but that eventually the domestic economy self-adjusts, leading to a free market economy providing wealth. In the case of China, we believe that a different scenario should be considered. The ultimate goal of the Chinese Government is to stay in power, probably in a model similar to that of Singapore i.e. a drastic government control in the social and political spheres, but ultimately favoring free market economy. The common myth is that China evolves gradually towards a western system and will, soon or later, become democratic. This might be the case, but at the expense of the Chinese Government. On the contrary, we argue that the Chinese government will never implement reforms that could potentially lead to high social costs, worker unrest and eventually regime collapse. The social cost of shock therapy would be too high and would eventually lead to nation-wide social unrest. To begin with, recommending *shock therapy* for China implies that we first get rid of the Chinese government. And at the time being, this is not an option.

However, some could argue that even the gradual transition scheme taken today has a social cost. Certain economic adjustments, such as the trade concessions to the WTO or the tightening of the State banks credit policies, can trigger social discontent. The former will progressively wipe out inefficient SOEs competing with foreign firms, potentially leading to massive lay-offs. The latter will increase the financial burden on SOEs and therefore undermine their ability to pay wages, pensions and social benefits to their employees. But we argue that the Chinese government -CCP- is willing to face a certain degree of social unrest for two reasons. First, those social costs are gradual, in contrast to those incurred with the *shock therapy*, and the government has therefore the ability to address them progressively. Second, they are the consequence of an economic program designed to sustain growth, which is another prerequisite to the CCP staying in power.

***

In order to demonstrate why *shock therapy* cannot work, we will look at the historical and social factors and demonstrate why we should take them into account when implementing SOE reforms. First, we will give an overview of the historical context in order to buttress the path-dependence of the reforms. We will see how history, tradition and foreign influence have shaped a nested economy, distinctively Chinese. Second, we will then look at the environment dependence of the reform and explain why the division of labor within the Chinese SOEs further renders the reforms scheme complex and difficult to implement. In addition, we will include an examination of the regional growth exacerbating the difficulty to implement nation-wide SOE reforms.

1.1 Historical Context

1.1.1 Questioning "shock therapy": why societal and historical factors matter

In the shift from a socialist economy to market economy, China faces path-dependence factors in the transition. We contend that the economic structure and institutional history will lead to a third way, distinctively Chinese i.e. a system that is not a replication of the western or the Japanese model. Following the "revolution" of 1949, the Chinese government implemented a command economy and a centralized structure, both influenced by the Soviet Union model and the remains of XIXth century bureaucratic China. The Chinese government has maintained its power, control and influence at the local level through a widely implement nested economy, materialized with work units and government controlled neighborhoods. Those units had a social, political and economic role. The local units had first a social role, organizing and regulating the daily life of the inhabitants. Second, local units also had a political function as the government's arm controlling and channeling possible discontent while making sure that the Government's precept was embraced by China's most remote areas. Third, local units followed and implemented economic directives in line with the command economy. Those structures, which lasted over the years, have shaped the existing local economic structure and its socio-political context.

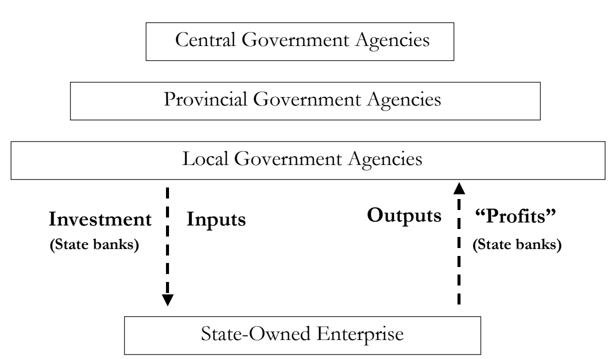
One of China greatest challenges is to link the change in its institutions, such as its administration, its policy or even its political regime, to the development of its market economy. The legitimate question is thus to what extent institutions must change when a country moves to a market economy? What are the required changes and can China implement those changes? Furthermore, are there any specific requirements for institutional change related to the privatization of SOEs in China? What is the impact of SOEs' reform on the health insurance system, the housing and educational system, the workers retirement plan or the banking system? Is ownership of property rights an issue at all? There is an obvious conflict of interest for the Chinese government in dealing with SOEs' reform. The CCP has few incentives to adopt a drastic approach with SOEs' problems, as the social cost of SOE restructuring could be high, especially in light of the excessive employment in the state-owned sector.

The following sections will present the historical, geographic and socio-political context of the Chinese economy with the aim to set the stage for the analysis of the social and political challenges of SOEs' reforms.

1.1.2 Nested economy

The Chinese central and planned economy was devising production strategy and setting quotas for State-Owned Enterprises. The first vague desire to favor a transition towards a free market economy appeared in 1979. At that time, the government granted Chinese SOEs the authorization to produce above a defined quota and to sell the surplus on the free market (Steinfeld, 1998 p.52). Progressively, the government split the different entities with the aim to separate the SOEs, regulating inputs and outputs of goods, from the banks (providing funds) () to the

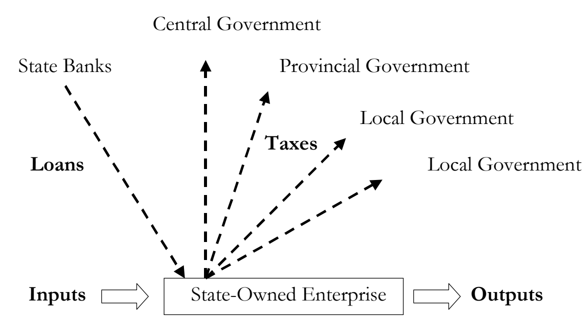
Figure 1: Pre-reform structure of the Chinese economy



Source: Forging reforms in China – E. Steinfeld government (regulating the economy). *Figure 1* provides the former relationship between the different actors of the economy. Under the latter economic system, state planners decided resource allocation. The government controlled, among other things, inputs and outputs of goods, as well as their price. Demand, supply and price were set according to bureaucratic decision and not market-response driven criteria.

With the onset of reforms in the 80s, the central government changed the pattern of autonomy and constraints. The Chinese government sought to replace the bureaucratic control over resources with a market-based allocation where producers control the output and the price according to consumer demand. In this dynamic, and as presented in *Figure 2*, the former vertical relationship between the government and SOEs has been gradually replaced by horizontal transactions between the market actors.

Figure 2: Post-reform structure of the Chinese economy



Source: Forging reforms in China – E. Steinfeld

On the production side, SOEs are supposed to make decision regarding their output and prices. State banks become on their part semi-autonomous actors and have the responsibility to grant loans to financially viable SOEs. The local government can no longer rely on funds granted by the central government but rather on tax revenues from local producers. Following reforms, government agencies have to focus on overall regulation and provision of social goods. More specifically, they define how to use the tax revenue to invest in physical infrastructure, education, public security or similar government functions. In 1983, the government further extended local responsibilities while maintaining a high level of taxation. The state-owned enterprises were allowed to keep 15% of their profit while the government took the remaining 85%. SOEs' management had discretion about how to use the incremental profit by either reinvesting it in the company or using it for its employee welfare and benefits[1].

However, despite the reforms, two problems persist: First is the state intervention and second is the barrier to effective corporate governance.

First, the Chinese economy suffers from a state intervention that is hard to remove, as property rights are virtually non-existent. It is important to understand why, despite the reforms and the transfer of decision-making process to SOEs, unsecured property rights and excessive state intervention creates challenging environment for SOEs reforms. The later tends to favor gross inefficiencies and low productivity as the people controlling the SOEs -*management*- differ from those owning the SOEs -*state*-. It is easy to understand that incentives of entities controlling and owning SOEs are not aligned. The question is then how to transfer property rights to the SOEs -or the people controlling it- in order to create a healthy incentive scheme where the people controlling the SOEs are the one reaping profits. The problem lies in the definition, the transfer and the protection of property rights. In the late 80s, there are no property rights *per se* in China, to begin with. Furthermore, should the property rights exist, there is no legal system allowing the owners to defend themselves if their rights were challenged[2]. It is therefore difficult to remove the state control, and thus intervention, without the existence and the protection of property rights. Furthermore, State

[1] Steinfeld, Forging Reforms in China 1998 p.45-75
[2] *Ibid.* p.57

intervention still exists and in 1998, China had a State Planning Commission. Most of the planning commissions, such as industrial ministries, investments boards or economic commissions still exist at the municipal or local level. The Great Leap Forward (1956-1964) and the Cultural Revolution (1965-1971) have unveiled the risks linked to the reform of political institutions. *Mao Zedong* proved that the state apparatus could be challenged, but that failure to provide alternative agencies resulted in political chaos and social turmoil[3]. In other words, when looking at the reforms of the SOEs and the required decrease of state intervention, the challenge is to offer suitable alternative allowing gradual transfer of the control from the government to the people owning the SOEs. Given the complexity of the nested economy, the number of actors, the numerous government "layers" and the necessity to have a progressive transfer of ownership, we argue that the *Shock Therapy* cannot succeed.

Second, the state-owned sector has a problem with how to identify effective corporate governance. Once state banks are separated from the government and the SOEs, the problem is then how to allocate loans and investment to the most efficient SOEs. Selection and incentive aspects of SOEs governance go hand-in-hand. If managers of the SOEs face the threats of bankruptcy or liquidation, they will have an incentive to foster the performance of their firm. Conversely, profit-making SOEs would have the ability to channel credit and investments. Growth attracts investment and ineffective behavior is punished with the withdrawal of credit. In practice, however, information about the firm performance is distorted so that it is still difficult to distinguish a profit-making SOE from a loss-making one. In addition, dysfunctions of China's banking system further undermine the ability of state banks to allocate credit to the efficient SOEs. The *Shock Therapy* thus cannot rely on tougher credit policies to create economic incentives fostering the efficiency of SOEs. The nested economy creates an additional challenge as the credit policies reforms suggests that the government has to deal at the same time with inefficiencies in the banking sector and distortion of information about the financial performance of SOEs.

At the macroeconomic level, responsibilities have been pushed down the ladder. SOEs at the local level have been empowered to take decisions regarding production, development or investment. Budget allocation does not function as it did under a planned economy but rather according to the firms' requirements, investment capacity and performance. In other words, production, capital allocation, investment policies are no longer carried out in Beijing (Steinfeld, 1998). These decisions are done at the local level, under the sole responsibility of the SOEs and the local administration. At this local level, administrative offices have begun to pay more attention to efficiency issues but have no claim on cash flows or the firm's profit. In other words, local government institutions act as a regulatory body and have influence over the investment decision. One could question the efficiency of this model. The logic of this top-down transfer of administrative decision towards the lower level of the administrative ladder keeps the Chinese Central Government away from the local decision making process in SOEs. It forces the local administration to address local problems. At the firm level, the government imposed independent budget and self-responsibility policies. This is a way for the Chinese central government to distance itself from local problems. In other words, the central government declines any responsibility in the decision process and therefore avoids any criticism in case of social discontent. If any problems arise in a given work unit, SOE or TVE[4] employees will question the competence and the efficiency of the local government -*the decision maker*- but not that of the central government, which is supposed to deal with country level issues. And in each case the government will have the possibility to take the example of successful, "well-managed" local entities to demonstrate that the success of a given SOE or TVE is contingent on the presence of a skilled administration at the local level.

[3] Lawrence, Alan. China under Communism p.82

[4] Township and Village Enterprises (TVE): Township and Village Enterprises are rural non-agriculture enterprises. The goal of TVEs is to employ workers coming from agriculture (OECD 2002).

But one can see that this top-down transfer of economic responsibilities from the government to the local administration favors mid and small size SOEs. It has however a strong impact on large sized firms, which do not benefit from a high level support from local government. In addition, larger SOEs are more likely to compete with foreign entrants and therefore face the double challenge of diminished support and heightened competitive environment.

As a counter-argument, some will suggest that the Chinese government is still organizing the bail out of loss-making SOEs, as they cannot simply send home the entire workforce of loss-making SOEs. We will alleviate those concerns arguing that there is now a sense of responsibility for profit and loss among SOEs as well as a legitimate feeling that successful companies will survive while loss making ones will eventually collapse. The necessity for SOEs to take bank-loans to finance their operation or cover their losses is contingent on hardening of the budget constraints (OECD 2002 p.134). Central and local governments no longer take the responsibility for bailing out loss-making firms.

The section of this report dealing with the political challenge of the reforms will try to provide answer to the necessary decrease of state intervention as well as to the expected implementation of effective corporate governance.

1.1.3 "Grasp the large, release the small"

In contrast to the Korean *chaebol* or the Japanese *keiretsu*, the Chinese SOEs fall into two categories that divide corporations into large and small & medium enterprises. The Chinese government has set the path for reform in 1997 with the motto 抓大放小, literally "grasp large corporations, release medium and small enterprises" (Guthrie, 1999). This implied a wave of restructuration triggering a focus of SOEs on their core business as well as privatizations of small and medium sized corporations. First, the government favored the spin-off of social and health service providers in order to get rid of financial burdens that constrained most of SOE profit. In certain regions of China, schools and hospitals were part of the "SOEs core business" (Naughton, 1998). But despite concrete measures to spin-off those social services, the pace is slow, as the government does not always have alternative to finance and provide those services. Second, the highest ranks of the CCP have promoted the spin off of some of SOE's most performing entities, in order to create economic growth engines free from heavy financial burden and bureaucratic management.

But the effect is that the debt, the bad-performing assets or the less skilled workforce remain with the parent SOEs and therefore postpone the problem reforms try to deal with (Lardy, 1998 p.39). One could argue that the CCP fosters economic growth by easing the administrative and financial burden on performing entities from large SOEs while giving time to the parent company to implement restructuring and reforms. It is however unlikely that the growth of these performing privatized entities will balance, in the short term, the loss incurred by the parents SOEs. Furthermore, one could question the efficiency of this model at a macroeconomic level, as it will remove a significant part of the cash flow from the parent company thus preventing further payment of welfare, severance package, capital expenditure, or loan interests.

***

We have demonstrated that the nested structure of the Chinese economy creates a challenging environment for the SOE reforms. Several characteristics of the nested economy, such as of the separation between SOE's control and ownership, the relationship between banks and the state-owned sector, the state intervention or the administrative complexity suggest that SOEs reforms go beyond economic reforms only. We will now point out geographic factors and see how they also render difficult the implementation of a nation wide reform's scheme.

1.2 Environment dependence of the reforms

1.2.1 Division of labor[5] within China: role and impact

Another problem inherent to the Chinese economy has been its size and the difference in the speed at which each of the provinces have been growing over the past two decades. In addition to the complexity of the nested economy, another geographic factor adds difficulty to the implementation of reforms.

In the late 90s, most multinationals wrongly perceived China as one big market. A common misperception led to flawed strategy and unproductive investment, even for the most successful international corporations. In a very similar approach, we argue that China cannot be considered as one country but rather the juxtaposition of several different regions for which reform of SOEs each requires a tailored political and social approach.

Table 1: Per Capita GDP - China main Provinces

	Per-Capita GDP (RMB per Capita) 1980	1999	Compound Annual Growth rate (%) 80-99
Eastern			
Beijing	1,582	19,803	14.2%
Tianjin	1,392	15,932	13.7%
Liaoning	768	9,958	14.4%
Shanghai	2,738	30,805	13.6%
Jiangsu	544	10,699	17.0%
Fujian	343	10,969	20.0%
Guandong	473	11,739	18.4%
Hainan	278	6,227	17.8%
Average	1,015	14,517	16%
Central			
Inner Mongolia	345	5,400	15.6%
Heilongjiang	685	7,660	13.5%
Anhui	285	4,710	15.9%
Jiangxi	342	4,673	14.8%
Henan	317	4,899	15.5%
Hunan	365	5,227	15.0%
Average	479	6,727	15%
Western			
Sichuan	315	4,356	14.8%
Guizhou	219	2,463	13.6%
Gansu	388	3,595	12.4%
Ningxia	409	4,477	13.4%
Xinjiang	405	6,653	15.9%
Average	369	4,785	14%

Source: OECD 2002 - China Statistical Yearbook, 2000.

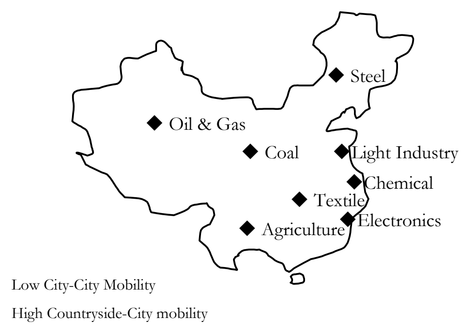
First, the growth pattern differs sharply from one region to the other. *Table 1* presents the level and the corresponding compound annual growth rate of GDP for China most important provinces. On average, the coastal areas of China had the highest level of GDP per capita with 14,517 RMB[6] in 1999 growing at a 16% compound annual growth rate since 1980 (OECD 2002 p.683). *Fujian*, and *Guangdong* benefited respectively from the proximity of dynamic economies and the respective inflow of Taiwanese and Hongkongese investments. On the other hand, central provinces, more subject to structural problem or to less dynamic economic environment, have on average a GDP per capita of 6,727 RMB, less than half of that of coastal provinces. Western provinces have on average the lowest level of GDP per capita with the slowest growth rate. Here, we can further argue that the gap between coastal, central and western provinces is undermined by probable flawed economic figures. In reality, wealth is concentrated in big coastal cities such as *Shanghai*, *Tianjin*, *Beijing* or *Qindao* -all benefiting from the inflow of foreign direct investment- while central and western provinces for the most part struggle with obsolete state owned enterprises and gloomy economic environment.

[5] The concept of division of labor derives from author's discussions with Chinese scholars or researchers.

[6] Note on Chinese statistics: The reliability of the Chinese Government Statistics is subject to controversy. Two schools of thoughts have arisen in the 90s. One advocates that the official statistics are false and "designed" to serve the government interest i.e. to let people believe that the Chinese economy is successful. The other, less critical, contends that both the administrative complexity of China and the willingness of the Chinese government to present the most favorable picture led to numbers somehow incorrect but giving a good sense of the Chinese economy performance. We favor the latter interpretation.

Second, the success of the SOEs reforms is environment dependent. Geographic and historical factors have influenced the way labor has been divided among the Chinese provinces. Historical factors have conditioned the emergence of certain industries in defined areas. For instance, the Japanese influence in the 30s, followed by the influence of the Soviet union have channeled massive investment dedicated to the Steel industry in the North east Chinese province of *Heilongjiang* -close to Japan and to the former soviet union. Geographical factors have also played a role in the division of labor. Natural resources, located in the west of the country, have favored the emergence of energy related SOEs in the western provinces of *Xinjiang* or *Qinghai*.

Figure 3: Division of labor within the Chinese provinces



Reforms in each sector will therefore impact the economic growth of each region differently. For example, reforms of capital intensive SOEs, such as the steel producing SOEs of *Heilongjiang*, could pose potential social problem in the North East of China, where this industry represents a large stake of the local economy. Drastic reforms could lead to a sharp increase in unemployment thereby creating social tensions. The same type of reforms of capital intensive SOEs close to Shanghai are less likely to create social tensions as most of the laid-off workers have opportunities to work for alternative industries implemented in the Shanghai zone. The potential social problems, or the lack thereof, posed by the reforms depends highly on the environment of SOEs. SOEs in wealthy, diversified areas are easier to reform than SOEs in more remote areas, where they contribute to a large portion of the local economy[7]. The industry concentration across provinces thus plays a role in the ability of the government to implement SOEs reforms. The disparities in GDP level and growth rate are not only contingent on geographic location but also on the division of labor across the Chinese provinces.

1.2.2 Interaction of SOEs with domestic economy: analogy with Korea

In addition to the problem of division of labor and difference in regional growth, SOEs pose a structural dilemma to the domestic economy with the interdependence between state-owned sector and the government. To that extent, it is interesting to compare the role of SOEs to that of Korean *chaebol* before the financial crisis of 1997[8]. During the economic growth, *chaebol* were responsible of the success of the Korean economy. Therefore, the role of *chaebol* in the Korean economy, as one of the key GDP contributor, is to many respects similar to that played by the SOEs in the Chinese economy. C*haebol's* reform is a good example of how to limit the interdependence between business and government decision, while attempting to drastically change the financial sector, taking into account possible social costs. At the height of their power and economic influence, *chaebol* placed the financial institutions under their control and exercised their power to obtain favorable credit condition and lenient government regulation. Following the entry of Korea into the WTO in 1995, *chaebol* experienced foreign competition, but were still under the shield of the government protectionist policy (Lee, 2000). Two years later, *chaebol* were harshly hit by the financial and currency crisis. After an era of unrestrained market power and economic expansion, the *chaebol* economy collapsed with the outcome of the financial crisis in 1997. The freefall of the economy was contingent on the *chaebol* excessive debt financing, their excess capacity, the collusion or the

[7] Jean Oi. Stanford University, "The Politics of Corporate Restructuring in China" Conference at the University of Pennsylvania. Tuesday, March 25th 2003.

[8] Class notes. Elective SAS 514. Prof. J. AMYX [October 10th]

speculation in the real estate market. Their asset price fell by 60%, decreasing the value of collateral, reducing the possibility to renew revolving loans, and eventually leading to market failure and a chain of bankruptcies. In 1997, Korea was almost insolvent and the foreign debt exceeded 150 $bn, of which 60 $bn were short-term loans. The social instability increased as the unemployment rose to 8.6% of the workforce, or 2 million workers. *Chaebol's* dilemma is that their interests are embedded in the Korean economy. The government cannot deal with structural reform without fearing gloomy social and political outcomes.

The problem is similar in China. SOEs also have excessive debt financing, idle capacity and increasing pressure from foreign firm following the entry into WTO. And like the *chaebol*, SOEs use their relationship with governments and banks to inject fund in their operation and limit social costs. As suggested in *Table 2*, Chinese SOEs employed up to 114 million of workers, or 65% of the urban labor force in 1996 (OECD 2002). Even if the figure has decreased since, the percentage of urban workers currently employed by SOEs is high. Chinese politicians have learned the lessons from the other Asian economies' industrial reforms. More specifically, we argue that the government preserve a creating dependence between urban SOEs, government and banks in order to avoid the dynamic that led to social unrest following the *chaebol's* collapse. The risk in urban areas is that the laid-off workers are likely to get organized in one protest movement. In other words, when groups of laid-off workers are in remote areas they have no possibility to coordinate their actions and therefore voice their discontentment or criticism against the reforms. In larger cities, group of workers laid-off from different SOEs will have the opportunity to coordinate a "class" action. According to recent studies, protest of unemployed workers happen daily in some of Chinese largest provincial cities[9]. The necessity to maintain a certain degree of interdependence between SOEs, banks and government in urban areas in order to avoid social unrest also creates an additional challenge for the speed and the scope of the SOE reforms.

Table 2: State Sector Employment 1990 - 1995

Year	Workers (million)	Percentage of urban labor force (%)
1990	103.46	70
1991	106.64	70
1992	108.89	70
1993	109.20	68
1994	112.14	67
1995	112.61	65
1996	114.44	…

Source: China's unfinished economic revolution (N. Lardy - 1998)

In addition to the historical and geographical characteristics of China, we will now examine socio-political contexts that render the swift implementation of SOE reforms almost impossible. First, we will look at the type of regime and its latitude to implement economic changes. Second, we will further analyze the interdependence between the business and the financial sphere. Third, we will conclude the section with a discussion on the government's lack of sense of emergency compared to the situation other East-Asian countries faced following the 1997 financial crisis. Last, we will discuss the requirement for improved prudential regulation and see how the latter creates an additional "administrative" challenge. All of the above factors create inertia and confirm that the government has to deal with a gradual approach when looking at the reform of the Chinese state-owned sector. The socio-political section should therefore reinforce our argument against the validity of the *Shock Therapy* in the case of China, and prove that the gradual approach to SOE reforms is the only feasible one.

[9] Jean Oi, *Ibid.*

1.3 Socio-Political Context

1.3.1 Influence of the regime type

One of East-Asian economies recurring problems is the discrepancy between the claim of reform and the actual change implemented. Statistical studies tend to show that little is implemented to limit the cross unit interdependence in China. Korea's reforms benefited from the government interventionism in the economy, sometimes implementing necessary measures disregarding political or lobby interest. It is important to note that Korea benefited from a presidential system, with a strong executive able to make decisions and to implement them. The Korean government took measures against the interest of the country's largest *chaebol*. For instance, in March 2000, the Korean Hyundai Group's honorary chairman appointed a new group chairman, in a move against legal procedures (Kwak, 2000). As a result, the Minister of Finance and Economy called on *chaebol* to dismantle their in-house task forces in charge of restructuring. The Korean government further asked that the *chaebol's* restructuring coordination bodies should be dissolved if they govern group subsidiaries. In practice, government decided to implement a set of measures aimed at improving *chaebol's* governance structures. In Japan, the implementation of the reform was less successful as the executive was weak and tempered by the relative omnipresence of the decades long ruling LDP, preserving its groups of interest[10].

China resembles the later system, where group of interests and government intervention still dominate most of the decision-making process surrounding the SOEs reforms. Among the characteristic of the Chinese system rank the relationship network within the financial sphere as well as the interdependence between businesses.

1.3.2 Financial sphere and business interdependence

One of the Chinese government's measures has been to group former independent SOEs to form a Business Group. Generally, one of the SOEs has a financial arm and provides financial services or short-term loan to other members of the enterprise group. In the late 90s, China had more than 7,000 known business groups (Nakagne, 2000). The industrial rationale behind the creation of those groups is the cross exchange of managerial and technological resources. To some extent, these Chinese business groups function on the principle of the *chaebol* or the former *keiretsu* as they are organized under a strong, performing SOE that guides the corporate governance. They offer an alternative form of control to the administrative bureau since the early 80s. But one of the underlying problems is that those groups are formed according to relationship, administrative incentive or political pressure rather than sound business strategy such as core business focus or industrial synergies[11]. In addition, the government has the ability to appoint the top management in most of the Chinese largest SOEs. The remaining bulk of the Chinese SOEs is made of small and medium sized firms at the provincial, regional and county level. The tax revenue, bad-performing loans and unemployment problems fall into the responsibility of the local government. For those smaller firms, the central government does not provide bailouts and the local government does not have the mean to ensure local bailouts.

Just as was the case for the Japanese economy, the fiscal stimulus provided by the Chinese government could provide employment but could not stimulate the revitalization of the economy. In Japan, there was a gap between the announced measures and what the government implemented,

[10] Class notes. Elective SAS 514. Prof. J. AMYX [October 10th]
[11] *Ibid.*

coinciding with a recurring gap between the estimated and the actual growth rate. Between 92-97, only one third of the stimulus packages announced were undertaken and the government prolonged a loose monetary policy[12]. This undermined the ability of Japan to implement a sound financial system. The financial institutions also refused to acknowledge the magnitude of the non-performing loans in 1991 and manipulate accounts in order to avoid public disclosure of problem[13]. To some extent, we can observe the last two symptoms in China as most of the Chinese official tend to downplay the importance of non-performing loans while announcing reform of property rights that are not fully implemented. Relational networks could build inertia in the decision making process and constrain the government, eventually limiting the options to reform the financial sector. The Chinese centralized bank system introduces a structural dependence between banks and fails to prevent the domino effect that could follow an economic recession.

1.3.3 External versus internal pressure: IMF and financial crisis

There is currently no sense of crisis in China. In other words, the economy is not bankrupt and China does not face external pressure from international institution such as the IMF or the World Bank to reform its industrial and financial sectors. It is however interesting to look at the measures implemented by the IMF following the East-Asian crisis, and to see what are the underlying challenges for China, in light of its current economic situation. Following the financial crisis, most of East Asian countries had the goal of favoring economic liberalization while maintaining market discipline. Counties like Korea aligned their macroeconomic policy with restructuring measures.

In 1997, the IMF implemented drastic measures and forced Korea to lower the country's growth rate with budget austerity while adopting a high interest rate and a reduction of the current account deficit. This involved comprehensive financial and corporate restructuring, and called for tightened accounting standards and disclosure rules. It also required the removal of government subsidies, market opening and the promotion of labor flexibility. As a result, the Korean government imposed four rules on the *chaebol*: first, business consolidation into core competence areas; second, improvement of their capital structures and reduced reliance on short-term loans; third, the elimination of cross-debt guarantees and cross-ownership; and fourth, improvement in management transparency. These measures were efficient but triggered massive lay-offs and significant social cost.

1.3.4 Prudential regulation

China needs to implement tougher accounting standards and to dismantle personal interest-based corporate governance. Priority should be given to transparency and reliability in accounting numbers together with sound credit worthiness evaluation. The Chinese government needs now to implement measures similar to those that marked the beginning of the second phase of *chaebol* reform on July 2000. On the financial side, the government should expand regulatory powers to assess responsibility for financial failure and punish illegal financial deals (Heung, 2000). At the outcome of the crises, Korean policy makers agreed to strengthen the supervisory powers of the Financial Supervisory Commission and the Fair Trade Commission. As a result, most of the Korean banks cleaned up their balance sheets and were recapitalized to obtain a sound capital base. Later on, the government and the financial institutions focused on the restructuring of non-bank financial institutions (Lee, 1999). To support financial sector restructuring, the Korean government also injected US$ 41 billion of public funds (Lee, 1999). In tandem with restructuring efforts, Korea has liberalized financial markets, and completed the deregulation of foreign exchange transactions, with its full liberalization at the end of 2000. China's current challenge in the domain of prudential

---

[12] Class notes Elective SAS 514. Prof. J. AMYX [October 31st]
[13] *Ibid.*

regulation is its ability to create financial regulatory bodies focusing on accounting practices and enforcing sound credit worthiness evaluation.

1.4 Economic environment

In the preceding sections, we have demonstrated the importance of the historical and social context. We will now look at the economic environment of the state-owned sector, arguing that the latter also conditions the speed and the scope of the reforms. Certain parameters of SOEs, such as the composition of their debt, the regulatory environment or the competitive environment in which they operate, bring economic challenges. The aim here is to understand those challenges and see how they render impossible the swift implementation of SOE reforms as they create political and social complication. The first part of this section will show that China does not face a "foreign" debt problem. The debt problem is more at the SOE level, where the highly leveraged capital structure of loss-making SOEs casts doubt on the ability of the government to implement rapidly the reform of the state owned banking and industrial sectors. We will also look at other factors, such as the closed capital account, the foreign competition or the dependence on the world trade to emphasize the ability of and the necessity for the Chinese government to implement gradual SOE reforms.

1.4.1 Foreign debt and the reform of the financial sector

In contrast to Thailand in the mid-90s, China does not face the risk of excessive foreign short-term loans. Excessive amounts of short-term loans contracted in foreign currency were among the factors that triggered the 97 Asian financial crisis. At the year-end 1997 China had 131 $bn of foreign debt, of which 14% were short-term loans (Thornill, 2002).

Table 3: Ratio of Foreign Direct Investment inflows to China's GDP

	Total Foreign Direct Investment inflows (US$ Billion)	China's GDP (US$ Billion)	FDI as a percentage of China's GDP (%)
1983	0.916	300.375	0.30%
1985	1.661	305.254	0.54%
1990	3.487	387.723	0.90%
1995	37.521	700.278	5.36%
1996	41.725	816.490	5.11%
1997	45.257	898.244	5.04%
1998	45.463	958.990	4.74%
1999	40.319	989.621	4.07%

Source: OECD 2002 - China Statistical Yearbook, 2000.

The remainder was granted by government and by other international institutions. By 1997, China had accumulated 140 $bn in foreign exchange reserve and current estimates forecast 260 $bn and 285 $bn in foreign exchange reserve for respectively 2002 and 2003 (Naughton, 1998). Most of that reserve derives from recurring surplus in the payment balance since 1994. The latter is largely due to a drastic increase in the inflow of Foreign Direct Investment after 1995. As presented in *Table 3*, reforms initiated by *Deng Xiaoping* in 1992 led to a drastic increase in the FDI inflows, which grew from 0.9% of Chinese GDP in 1990 up to 4.5% in 1995. In addition, between 1993 and 1997, China welcomed 250 $bn of foreign capital, of which 78% were FDI and 22% were loans. Today, the forecasts for 2002 and 2003 suggest that the level of foreign debt will remain stable at around 150 $bn while the FDI inflow will stay at around 53.4 $bn. The foreign exchange accumulation is the result of a cautious policy from the Chinese government who remains reluctant to abrupt change in the domestic economy.

The continuous inflow of foreign investments allowed the Chinese government to sustain growth, while limiting the amount of foreign debt. In addition, the low level of foreign debt reduces the exposure of the Chinese SOE to potential currency devaluation. In other words, if most of the debts are contracted domestically, there are in local currency, not in dollars. Therefore the borrowing SOE does not have a "currency" risk i.e. if the dollar appreciates against the *Ren Min Bi*, this has no impact on the SOE interest payment. However, if we agree that the foreign debt level is not a concern, we consider that capital structure of SOEs places them in a fragile financial equilibrium highly dependent on sustained economic growth.

1.4.2 Highly leveraged SOEs

A growing concern about the Chinese SOEs is their highly leveraged structure and the associated risk of liquidity problems for Chinese banks. SOEs problems have a high liability-to-asset ratio. They experienced a drastic reduction in their fixed investment, contingent on a decrease in their profitability. Concordantly, SOEs relied increasingly on bank loans rather than on their own retained earnings to finance fixed investment or working capital and thus continuously increase their liability. By 1996, only 10% of the investments in fixed assets, carried out by SOEs, were financed with after-tax profit (Lardy, 1998 p.33). Three other factors contributed to reveal the SOEs high liability-to-asset ratio. First, the fact that SOEs debt does not take into account inter-enterprise debt i.e. debt to other SOEs, also called the triangular debt. Second, low depreciation rates that overvalue the SOE's assets and hence its solvency. Third, the excess inventory carried forward, which contributes also to the overvaluing of the firm's asset.

In addition, the *Table 4* suggests that SOEs had an 85% asset-to-liability ratio by the end of 1995. This implies that SOEs are insolvent as the value of their liabilities exceeds the value of their asset. It also implies that SOEs use revolving loans to pay wages, pensions or suppliers rather than to invest in fixed asset and therefore develop their business as they use most of their profit to pay interest expenses.

Table 4: Libailities of State-Owned Enterprises 1980-1995

(as a percentage of total asset, in %)

Year	All SOEs	Industrial SOES
1980	n.a.	19
1990	58	n.a.
1991	61	n.a.
1992	62	n.a.
1993	72	68
1994	75	79
1995	85	n.a.

Source: China's unfinished economic revolution (N. LARDY)

It is worthwhile to note that this level of debt is similar to that of the Korean *chaebol* before 1997. An asset-to-liability ratio of 85% is equivalent to a debt-to-equity ratio of more than 500%, above the ratio of the Korean *chaebol* at the time of the financial crisis. Indeed, at the end of 1997, *chaebol* had up to 400% debt to equity ratio with non-performing loans ratio amounted to 21% and with interest expenses accounting for 6% of sales, compared to 2-3% for similar firms in other countries at the same time (Lee, 2000). Leveraged *chaebol* were too big to fail when hurt by the crisis. At the time of the crisis, the 5 largest *chaebol* employed several 100 thousands of Koreans[14] and the necessary restructuring of the industrial and banking sector raised huge social concerns as it could trigger workers' unrest. Since 1998, the Korean government has implemented institutional reforms to apply

[14] Class notes. Elective SAS 514. Prof. J. AMYX [November 19th]

new global standards in the areas of accounting, information disclosure, external auditing and best business practices. In 1999, the top five conglomerates have paced up their efforts to meet debt-restructuring targets as agreed to with their creditor banks in the capital structure improvement plan (Lee, 1999). Creditor banks enforced plans by monitoring progress on a monthly basis, while the financial supervisory authority oversees the creditor banks' enforcement. The Korean financial institutions have also favored business restructuring with mergers and business swaps among *chaebol*. SOEs figures are therefore concerning as the state-owned sector, just like the *chaebol* before the 1997 crisis, could face a similar liquidity problem at the first sign of economic recession. For China, this implies that efficient economic and financial reforms can be implemented, but with a slow pace and at the condition that they sustain the economic growth.

Some could argue that historically, Chinese SOEs had no other way to raise funds but to increase their debt level, as there was no equity capital market. Therefore, it is normal that most of Chinese SOEs' capital structure consists of debt, as SOEs did not have access to equity or private ownership to raise funds. The all-time high level of debt of the Chinese SOEs should be placed in the context of the Chinese financial market where the debt, contracted to the central banks, was the only source of funds. But we would counter-argue that financial constraints are about the same if SOEs have only debt (interest payment) or a combination of debt and equity (interest payment and dividend payment). The financial burden in each case would be about the same. Therefore, we believe that the composition of the SOE capital structure together with their financial performance casts doubt on their financial viability and their possibility to provide wages and social benefit to their employees.

1.4.3 Closed capital account and currency exchange

In the beginning of this section, we have seen that the low level of foreign debt gives greater flexibility to the Chinese government, as it reduces its exposure to the devaluation of the *Renminbi*. The second factor giving the government latitude when dealing with the reforms is the closed capital account. The Chinese closed capital account provides the Chinese government with protection against currency speculation while offering greater flexibility for the SOEs reforms. A closed capital account limits speculative attacks against the *Renminbi* as it prevents the currency from leveraged bets against its value. The *Renminbi* is only convertible to the current account. In other words, a detailed documentation is required to legitimize the currency trading. This means that China does not have the "hot money risk". In addition, a closed capital account gives room to the Chinese government to maneuver for SOEs reform without facing external pressure and with a greater flexibility in terms of interest rate or bank loans. Unlike its South East Asian counter parts, China is able to set an autonomous domestic policy lowering interest rate and stimulating credit and investment without facing the risk of capital outflow (Naughton, 1998).

1.4.4 Foreign competition and reforms

In addition to their highly leveraged capital structure, SOE's low level of profitability raises concerns about their ability to deal with competition with foreign firms. Will the entry of foreign actors accelerates the shrinkage of the SOEs sector? We could draw a distinction between the domestic market (low requirement) and the export market (US, Japan and EU standards)[15]. Whether we look at the automotive or the chemical industry, the requirements for those markets differ

[15] Author's observation following trips to China and surveys conducted independently between 1990 and 1998: We argue here that the domestic and international market have different requirements. In other words, the quality requirements of Chinese manufactured goods (electronics, apparel) differ if the product is for the export (drastic requirements) or for the domestic market. We thus argue that there are "two" markets: one domestic market and one international market. And if the Chinese SOE cannot compete for export, they still have a huge reservoir of domestic customers they can target.

substantially when we consider the domestic or the international market (OECD, 2002). We argue that the Chinese SOEs facing the pressure of the WTO are those who will compete with foreign firms. The rest of the SOEs could continue to supply the in-land market, where both the product quality requirements and price levels are lower. In other words, the disparity in the end-market provides SOEs with the opportunity to chose between a drastic restructuring in order to compete with incoming foreign players or a slower reform pace in order to continue to supply a low requirements in-land market.

But lessons drawn from the 1997 financial crisis tell us that the threat of foreign competition exists, as this was the case for Thailand in the retail sector. Following the crisis, the Thai government welcomed foreign retailers. The foreign actors captured 40% of the retail market. Within a couple of years 200,000 of the 250,000 local supermarkets were wiped out of the competitive landscape[16]. To certain extent, a similar situation could take place in China with the emergence of supermarket actors like Carrefour (second largest retailer in China after a domestic player). More broadly speaking, the incoming of foreign actors could change the environment in several industrial sectors and generate drastic changes in the competitive landscape. This emphasizes the necessity of the Chinese government to deal with the reforms with a gradual approach in order to adjust the scope of reforms according to the effect of foreign competition in a given sector.

1.4.5 Dependence on World Trade

In order to complete the picture of SOE's economic environment we will finally look at the dependence of China on World Trade. Indeed, SOE reforms face a vicious circle where restructuring of the state-owned sector is necessary to sustain outstanding economic growth rate in order to channel FDI inflow, but at the same time the restructuration of the state-owned sector creates social uncertainty that could potentially lead to social unrest and hence directed FDI outside China to other successful transition economies, such as India.

In addition, Chinese economic growth relies on western and Japanese economies. We argue here that the 2001-2003 recession in developed economies creates an additional risk for SOEs. Chinese GDP growth figures remain respectively at 7.8% and 7.4% for 2002 and 2003 (Thornill, 2002). Despite no clear deflation risk in China, there is an economic risk linked to the trade interdependence between China and the world three largest economic zones: the United States, Europe and Japan. More specifically, the United States absorbs a significant part of the Chinese exports while Europe is, behind Japan, the third largest trading partner of China. When looking at the economic environment, recession in western economies and Japan is a risk for China. If the recession continues in western and Japanese economies (Leser, 2002), the excess capacity of manufactured goods planned for exports could flood the domestic market and drive the price down, thus limiting revenue and profit growth for Chinese SOEs.

Last, we also argue that the competitive landscape among regional players has changed. Following the post-war period, Asia adopted a division of labor between countries. This division of labor encouraged each Asian country to focus on the production of goods for which it had a clear competitive advantage. For instance, until the end of the 90s, China produced labor-intensive goods such as toys and telephone handset sold in the United States, while the rest of the ASEAN countries produced mainly hard drives. But with the globalization, China and ASEAN countries have faced similar challenges of saturated market and excess capacity in certain export sectors and today, a trend in generalized export competition exists (Naughton, 1998). The division of labor is diminishing and Asian countries tend to compete in the same sector. China takes advantage of this in the electronics or the chemical sector. But in the long run, it could face the increasing competition of India or other

[16] Class notes Elective SAS 514. Prof. J. AMYX [November 19th]

South East Asian countries in the sector of textile or the apparel industry. This could further increase the competitive pressure on Chinese SOEs (Naughton, 1998).

2 Political aspects of the reforms

In the first section of this paper, we have presented the social, political and economic context of China. We demonstrated how the nested economy creates a challenging environment for the SOE reforms. This section deals with the challenges of SOE reforms related to the political sphere. We will examine the political strategy of the Chinese government and explain why the gradual approach for the reforms is the only feasible one, given the socio-political context.

In the first part of this section, we will look at the problems contingent on the SOE governance. First, we argue that the success of the reform will be contingent on effective SOEs corporate governance. Currently, the split between the ownership and the controlling entities creates conflicting interests altering the functioning of Chinese SOEs. This creates challenges as the Chinese government is obliged to deal with property rights reforms, phased privatization or change in the shareholding structure of SOEs. Second, Chinese SOEs still operate under the supervision of lenient creditors. We will elaborate on their relationship with the banking system and the lack of immediate liquidation threats for loss-making SOEs. This will raise questions about the ability of the government to dispose of state's assets or to place loss-making SOEs into bankruptcy. We will also explain how systematic government intervention can lead to a dangerous moral hazard dynamic, which could slow down the pace of the reforms.

In the second part, we will examine the effect of China's entry into the World Trade Organization onto Chinese SOEs. The change in the competitive landscape following China's entry into the WTO will create additional challenges for specific sectors. While we acknowledge that China will greatly benefit from the WTO, we will analyze how the concession granted by the Chinese government in certain sectors might hamper the successful implementation of SOE reforms.

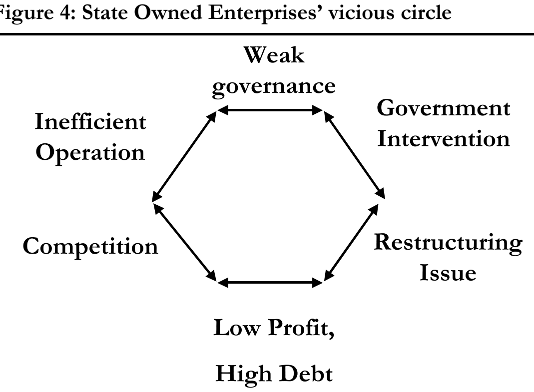
2.1 Governance of State Owned Enterprises

In September 1997, the 15th Party congress removed barriers to local restructuring, thus triggering a wave of disposals, privatizations and bankruptcies of local enterprises. We will demonstrate that despite a drastic political shift toward reforms, the implementation was less drastic than expected and the resulting new ownership structure remains under the authority and the control of the Chinese government.

2.1.1 Control and ownership

China's SOEs face the problem of the split between ownership and control. There is a conflict of interest between the manager and the shareholder-state that most of the times lack the information and the skills to take sound business decisions. The majority of the SOEs shareholder's are state ministries at the provincial or the municipal level. They do not have access to the firm's information and lack sufficient business experience to effectively assess the profitability level of the SOEs as well as the appropriate business strategy. In addition, lenient accounting standards and poor auditing

Figure 4: State Owned Enterprises' vicious circle



Source: OECD 2002

practices maintained low level of corporate transparency. The resulting challenge of SOE reforms is therefore to reconcile the control and the ownership of SOEs in order to align incentives and favor profit-oriented strategy (OECD 2002 p.16).

2.1.2 Privatization and property rights

The different theories regarding SOEs reform agree that the privatization and the property right play a preponderant role in the transition process. It is interesting to look at these theories in order to understand how the establishment of property rights or the transfer of public assets to private investors creates political challenge for the government. The three theories are the market school, the property rights school and the institution reforms. First, the market school's view advocates the removal of SOEs' social role. It suggests a development of a market economy within China, and advocates the convergence toward a North-American system with efficient management, sound corporate governance and market rules (Nakagne, 2000). In that case, property rights and privatization follow the establishment of market economy and are considered as tools favoring the implementation of sound corporate governance and efficient management. The second view is that of the property rights school, which advocates the necessity to privatize SOEs and financial institutions at the same time. This prevents the banks, i.e. Chinese government, to maintain control onto the SOEs and implies an increasing financial pressure on the state-owned sector. Third, the institutions school which underlines the need to strengthen the institutions protecting and enforcing property rights laws and to have independent regulatory bodies.

However, one can see the complexity of SOE reforms. In each case, there is a causal relationship between financial and institution reforms, privatization, property rights and restructuring of the state-owned sector. The development of the private sector will foster the creation of institution regulating and protecting the ownership. Conversely, the establishment of mechanism protecting property rights will bolster the development of private ownership and therefore foster economic growth.

Some will argue that privatization increases efficiency and productivity (Nakagne, 2000). The idea is that managers who have also the ownership of their firm will have greater incentives to improve efficiency and increase profit, as the latter will have a direct impact on their wealth. But privatization is confined to small and medium size SOEs, with almost no change in the political structure or the administration. The government gradually allows the transfer of public assets into private hands, but the banks and regulating agencies remain under the control of the State.

Therefore, we argue that the Chinese government still faces a double challenge in the area of privatization and property rights. First, the scope of the privatization has to be broadened to large SOEs and not strictly limited to the small and medium enterprises. Second, the transfer of public asset to private investors has to take place without the control of the banking system. In other words, private investors have to be independent and not related financial institutions controlled by the government. The following section further elaborates on the shareholding structure of SOEs, in order to present the different type of ownership created with the SOE reforms.

2.1.3 Shareholding structure

While the number of state-owned enterprises converted into private owned companies increases, the type of ownership structure varies with certain privatizations. Gradually, the Chinese state has moved from limited private ownership, where the Chinese government controlled the majority of the ownership, to an ownership structure opened to the private sector. But the privatization process is generally accompanied by strict government-controlled measures to help workers laid-off in the process. The CCP has favored the establishment of two types of ownership: the *shareholding structure* and the *stock company*.

In the case of shareholding cooperatives, the Chinese government takes the majority of the equity, and offers the remaining part to workers and managers, generally a small percentage of shares. If employees leave, the firm buys back the shares that cannot be traded outside the corporation. This facilitates corporate governance and preserves a shared control of the corporation between the Chinese government and the company's management. The shareholding cooperative is the most common form of restructuring and provides an alternative fund raising scheme, filling the gap left by declining bank loans. It is also a cheap way for the Chinese government to preserve employment and therefore limit social tension. The second form of ownership is the Stock company, but in contrast to the Shareholding cooperative, the stock company can have shareholders outside the corporation i.e. individual investors of other corporations. As in the Shareholding cooperative, the local state has the majority of the shareholding in the stock company (Lardy, 1998 p.54).

In both forms, the Chinese state has ownership through equity, and the profit returns to the state through dividend payment. So, despite the obvious diversification of the Shareholding structures in China, the Shareholding structure and the stock company tend to demonstrate that the Chinese government has still preserved a significant influence over the recently "privatized" SOEs.

2.1.4 Over investment policy

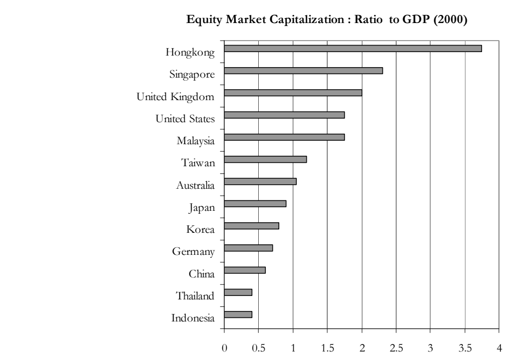
The next area of concern is the excess of investment in fixed assets. This creates idle capacity and decreases the return on investment of industrial assets. The case of the Korean *chaebol* well illustrates our argument. In the 90s, *chaebol* over invested in under-performing asset facing excessive competition, speculative activities, or providing poor return on investment. The average annual return on investment on manufacturing asset was below 1% during the 90s (Lee, 2000). The over investment, combined with insufficient level of savings, was a major issue for Korea as the marginal productivity gained with additional investment could not balance the foreign debt incurred to fill in the saving-investment gap. In other words, savings were below the investment demand and Korea borrowed money abroad to fill in the difference between the country saving and the investment demand. But the return on the additional investment was not high enough to balance the foreign debt interest rate. To that extent, China, which experiences an annual 20% increase in fixed asset investment, faces a similar challenge (Thornill, 2002).

In the case of China, the obvious over investment policy led also to excess capacity in a wide range of industrial sector. In 1995, a census among the major 900 Chinese manufacturers revealed that the utilization rate of industrial equipment was on average below 60%, against about 80% for western manufacturers (Lardy, 1998 p.36). This figure is particularly surprising given the rather fastuous period of economic growth that China experienced in the mid-90s. This over investment policy and its resulting excess capacity raise the cost of goods sold as the depreciation expense of the fixed asset is spread among fewer manufactured goods. In addition, healthy SOEs were compelled to take over loss-making entities, sometimes to have access to the land or the regional market of the non-performing entities, sometimes because they were ordered to do so by the government (Naughton, 1998).

2.1.5 Capital restructuring

China remains an economy with little access to equity capital market. Most of the Chinese SOEs capital is in the form of debt, for the main part contracted to state-owned banks. As presented in the *Figure 5*, the ratio of equity to GDP remains low compared to other East Asian and Western economies. In order to favor the emergence of an equity market, the Chinese government has gradually allowed the development of Asset management companies to favor SOEs debt-equity swap. As a result, part of the existing debt of large SOEs has been converted into equity and is now hold by asset management companies (Lardy, 1998). This removes the interest expense and therefore eases the financial burden on large SOEs that can use their cash to develop their activities. It also reduces SOEs' liquidity risk and therefore improves their credit rating and hence their ability to raise additional credit lines. However, there is a concern with the reduction of government income. The decrease of state banks' revenue (SOEs contract less debt from state banks) could generate government deficit. This is a concern in a context of growing government spending; especially with the government policy to undertake construction of large public infrastructure to boost economic growth in western provinces ("develop the West" policy)[17]. Indeed, Chinese government expenditure should increase from 20.8% in 2002 to 21.5% in 2003 GDP (Thornill, 2002).

Figure 5: Equity Market



Source: OECD 2002

One of the other challenges the Chinese government will face is to set financial targets in-line with the economic environment and to make sure that reduction in the leverage correspond to effective decrease in the debt amount rather than to a creation of off-balance sheet items. For instance, at the end of 1999, the Korean government set a 200% target for the *chaebol*' debt-to-equity ratio. Some Korean economists argued that most of the companies were unable to repay their debt and issued shares at cheap price, with the aim to decrease their debt-to-equity ratio (Lee, 2000). The argument is that those arbitrary financial targets derived from bureaucratic decisions rather than sound business rationale thus weakening the *chaebol*. A corollary to these arbitrary financial targets is that most of the *chaebol* used off-balance sheet structure to remove some of their liabilities. For instance, at the end of 1999, Samsung had a 197% debt-to-equity ratio, but 496% with off-balance sheet items. Similar figures can be drawn for LG or SK which both transferred part of their liabilities into off balance sheet financial units, therefore diminishing their debt-to-equity ratio.

2.1.6 Disposal of State's assets and bankruptcy

In regions like *Hong Kong* or *Guangdong*, the Chinese state has organized buy-outs through outright sales of assets. Foreigners have bought state's stake in SOEs and gained the full ownership of the firm. The logic beyond the buy-out process is that the private investor will help the firm to return to profit, therefore providing revenue for the government (local tax) and jobs for the community, the latter being contingent on production expansion. But as it is the case in the privatization process, these buy-outs are subject to political and social constraints and the disposal process takes time and must obtain the central government approval. At the local level, it represents a way to get rid of non-performing assets and to remove debt, but with a potential social cost (lay-off) that is under high central government scrutiny.

The Chinese government considers bankruptcy when the SOE has recurring losses or lacks the investment capacity to grow. But corporations have no authority to file for bankruptcy and the bankruptcy law that the Chinese government adopted in 1986 is rarely applied (Oi, 2002). In general, local government initiates the bankruptcy process. Then, the state asset management bureau assesses

[17] Class notes Elective SAS 514. Prof. J. AMYX [December 5th]

on the one hand the value of the asset and on the other hand the social impact, when the company has to pay creditors (debt holders) before the workers (severance package, retirement). The bankruptcy process is eventually approved when the local government can pay-off the workers with the proceeds from the asset disposal following the bankruptcy. In some extreme cases, local government can pay-in-kind the workers, most of the time with the SOEs manufactured goods.

SOEs, the *chaebol* and the *keiretsu* each played respectively significant roles in their domestic economies. At the time the government initiated reforms, they represented a significant part of their country output and provided employment and social benefits to a large portion of the population[18]. However, when dealing with reforms of SOEs and possible lessons that could be drawn from the Korean and the Japanese examples, we should point out that the structure of the economy differs with respect to the nature of the conglomerates and the market potential for SOEs. Chinese SOEs still account for about 60% of China industrial output and therefore the largest portion of the workforce (Lardy, 1998); SOEs are responsible for the safety & insurance system organized around the firm with not much of government support; and last, the Chinese government acts as guarantor, regulator and creditor of the State-owned sector (Stiglitz, 2001).

2.1.7 Independence of the banks

Another major challenge of SOE reforms is the speed at which the government favors the independence of the financial institutions. The Chinese government faces the same recurring conflict of interest with one the one hand the necessity to sustain economic growth and on the other to avoid political turmoil.

In 1993 *Zhu Rongji*, created a banking system able to say "no" to the loan demands stemming from the state enterprise system (Naughton, 1999). The SOEs are now less inclined to increase the size of their credit line, facing mounting pressure from the Banks and increasing real interest rate (Kynges, 2002). However, independence was far from being achieved. In 1995, the government further implemented banking laws re-centralizing the banking system (Naughton, 1998). Most of the banks had to reorganize their branch network under the authority and the control of their Beijing headquarters. As a result, they became less incline to pressure from local governments willing to have access to cheap and recurring loans. In addition, the central bank independence remained subordinated to the Chinese government leadership. The banks gradually imposed tougher requirements on the Chinese SOEs and their local government leadership. As a result of the change in the bargaining power of the banks, the Chinese "soft-budget constraint" under which SOEs could always incur short-term losses was no more guaranteed. Even though the Chinese government succeeded in preserving banks from regional lobbying, the financial institution lacks of independence and remains under the sole control of the CCP.

The latter interdependence is a concern as one of the origins of the 97 financial crisis was the collusion between the *chaebol* and the Korean government, with shared interest between political funding and government regulatory decision. Political officials were granting *chaebol* major public projects or huge business concessions and in turn received funding to further establish their political power. To that extent, one could argue that the problem is different in China, as there is no democratic election system, and therefore no need to campaign or find political parties. This argument is however flawed as the corruption at the individual level in China has replaced corruption at the political party level in Korea. Chinese bribes generally target decision makers within central or regional government entities and up to a recent period, corruption within the Government was a major issue in China. Under this system, the Korean economy experienced growth, but the entire

[18] Class notes Elective SAS 514. Prof. J. AMYX [October 8th] [October 10th]

system was subordinated to the *chaebol* interest and most of the investment (loan) decisions were granted according to sound credit risk analysis (Lee, 2000).

2.1.8 Government dynamic and moral hazard

Government intervention creates a moral hazard dynamic, with the current strong and shared sentiment that the Chinese banking system cannot fail (Lardy, 1998). Chinese government reforms give the impression that there is a systematic bail out of loss-making SOEs, associated with the protection of the financial institutions. In other words, in order to ensure its power, the Chinese government would prevent any major bankruptcy that would let the country falter. One could counter argue that government interventionism, such as that of the developmental state, favored the economic growth. But the developmental state role was different as it coordinated the industrial sector and prioritized investment decisions but did not systematically bail out industrial or financial groups.

Table 5: Annual Growth in Tax Revenue - 1994 to 1999

	Share of total revenue	Compound annual growth rate
VAT	36.3%	11.0%
Business Taxes	15.6%	20.0%
Consumption taxes	7.7%	11.0%
Tariff revenue	5.3%	15.5%
SOEs	6.0%	0.9%
Collective Enterprise	1.6%	11.7%
Foreign-funded enterprise	2.0%	35.3%
Personal income taxes	3.9%	41.5%
Others	21.6%	-
Total	100.0%	

Source: OECD 2002 - China Statistical Yearbook, 2000.

2.1.9 Financing reforms - impact on government revenue

We will conclude this section by looking at the funding of the reform process. The last two political concerns we have about SOEs reforms are the impact of the reforms on the government revenue and its ability to finance a gradual economic transition over the long run. First, we argue that there is a risk that SOEs reforms reduce government revenue. But as per presented in the *Table 5*, only 6% of government's revenue is derived from SOEs taxation, and since 1994 this number has grown at an annual compound rate of 0.9%. Most of the Chinese tax revenue comes from VAT, business and consumption taxes and tariffs, which altogether account for 64.9% of the total tax revenue. This confirms not only that reforming the SOEs should not dramatically impact the ability of the Chinese government to fund the reform but also that the economic growth, and hence the business development, will increase the source of government revenue. Furthermore, *Table 6* suggests that the Chinese government still has room left to increase taxes, as the government budget revenue is one of the lowest among OECD and transition economies (OECD 2002).

Table 6: Government budget revenue

	Percentage share of GDP (%)
China	20.4
OECD average	37.8
United States	31.0
European Union	45.0
Japan	37.6
Brazil	31.7
India	18.8
Indonesia	17.3
Russia	29.3

Source: OECD 2002

2.1.10 Privatization and political stability

The privatization of SOEs is a "*state-sponsored process*" in the sense that the government has to control the restructuring plan in order to ensure political and social stability. In other words, when social costs of the reform are too high, the government takes the decision to keep open or to keep operating loss-making SOEs therefore preserving jobs, social benefit and welfare for a significant portion of the population. This maintains social stability and, in turn, prevents from social unrest that could result from high unemployment rate or poor working conditions. The political factor is thus a key component of SOE reforms.

The Chinese government is divided into regional assemblies and administrations according to an administrative and bureaucratic structure with still several layers and numerous ramifications (22 provinces, 4 special municipalities and 5 autonomous regions). If willing to stay in place, the regime has to preserve wealth for the majority of the Chinese people. A drastic increase of unemployment in China could trigger demonstrations and social unrest challenging the way the party deals with reforms and eventually claiming for a political change in China. The Chinese government has even put in place a system of sanctions against local officials if they face workers' unrest in their region/district (Naughton, 1998). Therefore, government officials or local bureaucrats take into account the social impact of SOE reforms when making decision.

A corollary of the social components of the reforms is the Chinese pension fund system and the challenge of having an aging population. China evolves under a Pay-as-you-go system, where the government revenue on income tax finances the pension of the retired people. But the retirement age was not adjusted since 1951 and the percentage of the retired people as part of the population is growing (Lardy, 1998). China's population also has a longer life expectancy. In 1996, the life expectancy was 71 years, instead of 50 years in 1951. This poses a simple problem of liquidity, as the volume of workers will not be enough to pay the entire pension and retirement plan by 2020.

***

In this first part, we argued that the success of the reform is contingent on effective SOEs corporate governance. But we pointed out the political challenges as the Chinese government is obliged to deal concurrently with property rights reforms, phased privatization or change in the shareholding structure of SOEs. Furthermore, we have demonstrated that the lack of immediate liquidation threats for loss-making SOEs raise questions about the ability of the government to dispose of or restructure state's assets. Last, we have argued that the systematic government intervention can lead to a dangerous moral hazard dynamic, which could slow down the pace of reforms. In the second part, we will examine the effect of China's entry into the World Trade Organization onto Chinese SOEs.

2.2 Effect of the WTO onto Chinese SOEs

2.2.1 Growing inflow of FDI: opportunities and threats

The entry into the World Trade Organization has already fostered the development of the Chinese economy. Following China's entry into the WTO, the multinational corporations' wave of acquisition favored the strategic reorganization of SOEs.

It is now common to read in Chinese newspaper articles about the increasing competition in the Chinese market between domestic players and international actors. In the postal service, Federal Express and the Chinese Postal Service are competing against each other for the leadership in the express delivery service. In *Nanjing*, SOEs turned to a Sino-foreign joint-venture bank to renew their credit line, thereby leaving their local bank. These are among numerous examples of the changes brought by the entry of China into WTO.

However, these events are the premises of the changes SOEs will face with the WTO. They are not an epiphenomenon resulting from sector competitive pressure. After the entry into WTO, SOEs will face a stern transformation, where opportunity and risk coexist. In the manufacturing sector, SOEs will benefit from the so-called spillover effect. In other words, foreign actors will raise the skill of the work force, transfer knowledge and technology while educating the network of suppliers and the distribution channels; and this will render the SOEs more efficient and more profitable. On the other hand, in the sector where advanced expertise in required, such as financial services, insurance, commercial retail or public infrastructure, state-owned enterprises have little if any competitive advantage and will certainly face a paramount pressure from the multinational firms coming into the Chinese market.

In the first 9 months of 2002, 24,771 Chinese foreign enterprises were established (+33.4% compared to 2001). In the first 10 months of 2002, FDI amounted to 46.4 billion dollars (+19.65% compared to 2001). The actual recession in Europe and the United States have reduced the total amount of foreign capital available at the world level. However, it did not prevent the increase in the inflow of FDI into China. In addition, exports amounted altogether to 262 billion dollars, growing by 20.6% while imports amounted to 237 billion dollars, growing by 18.7%; the resulting trade surplus was 24.7 billion dollars (Shen, 2002).

WTO rules also favors the process of fiscal decentralization. Local governments compete now with Foreign Direct Investment. In other words, local governments, and their related financial institutions, offer new loan conditions to SOEs looking for capital injections and inclined to allow multinational to fund their operations.

2.2.2 Consolidation of industrial sectors

Another component of the WTO that will influence the pace and the scope of reforms is the merger and acquisition activity. Ever since the end of the 90s, the Chinese government encourages mergers with and acquisitions of Chinese SOEs. In the late 80s, the only way to get into the Chinese market was to from a joint venture. Later on, the government allowed foreign actors to set-up wholly owned subsidiaries. Now, you can buy SOEs or controlling stake thereof.

Multinational corporations fostered the consolidation of the Chinese industrial sector through acquisitions of domestic companies. The two main sectors that will be subject to a consolidation contingent on a wave of foreign acquisitions are the automotive and the banking industries. *First Automobile, Dong Feng* and *Shanghai Automobile*, the three main domestic automotive manufacturers and the Japanese Toyota, Japanese Nissan, the American Buick companies should undertake mergers and acquisitions in the domestic market (Shen, 2002). In addition, other sectors such as finance, commercial retail or telecommunication are becoming the hot domain in the merger and acquisition field.

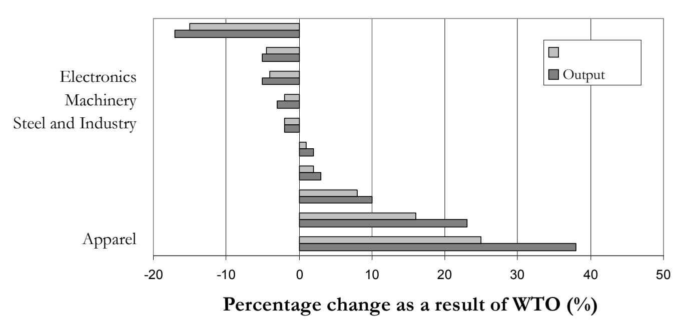
Table 7: State ownership of banks

	State-owned or State controlled Banks (% of the banking system capital) 1998	1994
China	99%	100%
Hongkong (China)	0%	0%
Singapore	0%	0%
India	82%	87%
Indonesia	85%	48%
Malaysia	7%	9%
Thailand	29%	7%
Japan	15%	0%
Russia	36%	n.a.
Argentine	30%	36%
Brazil	47%	48%
Peru	0%	3%
Germany	47%	50%
United-States	17%	0%
United Kingdom	0%	n.a.

Source: OECD 2002

In the banking sector, several major international players will enter the Chinese market through mergers or acquisitions. The American investment bank Goldman Sachs will merge with the Chinese *Xin Da* asset management company while Morgan Stanley will merge with the Chinese asset management company *Hua Rong*. The state ownership of Chinese banks suggests that those acquisitions have just started (Shen, 2002). In 1999, Chinese banks were controlled 99% by the state. As a study of the OCED points out, *Table 7*, standard ownership of government in developing countries range from 0% from the most liberal (UK) to 47% for the government controlled European economies (Germany).

In other sectors such as the retail industry, the energy, or public transportation, large SOEs are now selling equity trough international tender offers (the *Shenzhen* energy group, the water service group, the fuel gas group, the mass transit group). In the short term, large SOEs from different sectors plan to open their share ownership to foreign investors. According to the government programs, the following percentage of shares hold by foreign investors should be as follow: 25% in the energy, 45% in the water service, 24% in the fuel, 45% in the public transportation, 70% in the food business (Shen, 2002).



In the above-mentioned cases, the WTO concession in the Automotive, the Insurance or the Banking sectors will increase the pressure on Chinese SOEs. According to *Table 6*, the state-owned sectors that will suffer a decrease in both output and employment are the automotive, petroleum, machinery and steel. However, we can point out that sectors such as the automotive were not historically dominant within the state-owned activities, even though they represent a significant part of the industrial SOEs in terms of output and employment (Shen, 2002).

However, it is interesting to note that in other sectors, such as the chemical, the Textile or the Apparel industry the entry into WTO will provide growth opportunities in output and employment. *Figure 6* shows that the Chinese Chemical, Textile and Apparel sector should grow respectively by about 8%, 16% and 25% in employment and 10%, 23% and 38% in output.

China entry into the WTO will bring thus opportunities and risks for the state-owned sector. But once again, we argue that while it will create merging opportunities for the successful SOEs, the loss-making one will incurred additional economic pressure.

2.2.3 Questioning the priority to foreign investment

Several Chinese scholars and journalists now argue that there is a wrong tendency to give priority to the financial performance of the SOEs and grant the foreign actors preferential treatment to enter the Chinese market. The wave of FDI inflows and foreign acquisition of domestic firms have given rise to questions among Chinese scholar about the government emphasis on welcoming foreign actors. In the reform process of the SOEs, the government follows the so-called 重外轻内 process, literally "external important, internal light". This can be interpreted in two ways. First, the external parameters of SOEs, such as profit, revenue are the most important, while the internal parameters, such as the employee and the related social benefits linked to them, are less important. The second interpretation is that the external capital markets are more important -and get preferential treatment-, compared to the domestic capital provider (Shen, 2002).

***

In this second part, we examined the effect of the World Trade Organization onto Chinese SOEs. The change in the competitive landscape following China's entry into the WTO creates additional challenges for specific sectors while providing growth opportunities for others. While we acknowledge that China will greatly benefit from the WTO, we examined how the impact of WTO in certain sectors might hamper the successful implementation of SOE reforms, as it will wipe out most of the state-owned companies not able to cope with the efficiency and the competitiveness of foreign firms.

Another important point to note is that the gradual approach of SOE reforms also favors foreign interests in China. We argue that, in contrast to the shock therapy, the gradual reform process of the state-owned sector preserves political stability by avoiding or limiting social unrest. This stability serves the Chinese economy as it favors foreign investments and economic growth in China. But at the same time, it allows the international community to benefit from low-cost labor force and to access new and fast growing markets. It is therefore paradoxical to see scholars arguing for the *shock therapy*, as the potential social unrest resulting could not only hurt China but also hurt the international community.

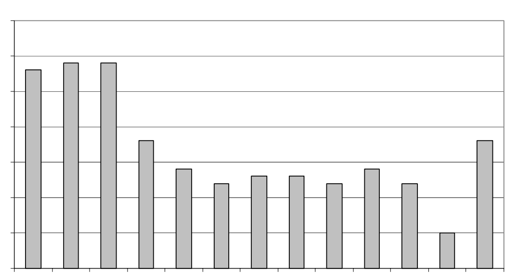
3 Social aspects of reforms

In the preceding sections, we have looked at the political challenge of the reform and have tried to demonstrate the complexity of political changes accompanying SOEs reforms. In this section, we will examine social aspects of the reforms in order to point out what we foresee as the biggest challenges for the Chinese government. We have identified three upcoming social challenges related to the reform of the Chinese SOEs. First the establishment of welfare and pensions system, second the rising unemployment and third the labor surplus contingent on the modernization of the agrarian sector.

3.1.1 Funding welfare and pensions

In the first part of the paper we have examined how the reforms of the financial institutions create a challenge for SOEs that provide wages and pensions to their employees. In addition to this problem, SOEs also face the inefficiency in the collection and reallocation of social security funds. The current system involves collection of resources at the municipal level. The regions with the greatest needs tend also to have the greatest inefficiency in the management of social security funds. In other words, the economically dynamic cities can efficiently finance unemployment, health insurance or pensions. On the other hand, western or central provinces have no organizations enabling them to fund the social securities program (OECD, 2002). The government tried to solve this issue by implementing inter-cities compensation funds, but the resource allocation resulting from those fund was not enough to offset the massive needs for social security funds required to cover severance package, health insurance or pension program. But great inefficiencies remain and cast doubt on the ability of the government to fund the welfare and pensions in China's least dynamic areas.

3.1.2 Unemployment



In addition to the pension issue, we also looked at the unemployment problem and observed that the aggregate employment growth has decreased over the past decade (OECD, 2002 p.22). Even though the most recent figures might have slightly changed, the overall trend of the aggregate employment is towards a decrease, as shown in *Figure 7*. This implies that the economy, as a whole and including foreign invested firms, is not creating enough jobs to compensate the potential unemployed people coming into the jobs market following SOEs restructuration. This creates an additional social challenge for the SOEs reforms as it prevents several inefficient SOEs from exiting as there is no alternative to the social security program provided by the government. In many cases, we face a vicious circle where state bank, under the pressure of the municipality, injects funds into the SOEs through revolving credit line in order to pay employees salary and benefits. A second important point to notice from *Figure 7* is the dependence of external factor. The decrease in 1989 and 1998 prove respectively the importance of political stability and the dependence world trade as factors influencing the aggregate employment growth. In 1989, *Tian An Men* square events raised uncertainty on the political future of China and drastically reduced inflow of foreign investments. In 1998, the financial crisis exacerbated the dependence of China onto world trade and the slow-down pace of capital inflow into China therefore hampering the economic growth and hence the aggregate employment.

In the case where SOEs are operated in order to avoid an increase in the local employment figures, the Chinese government should study the possibility of direct subsidies to unemployed people. In other words, the government should analyze the cost of operating loss-making SOEs and compare it to the funding of unemployment.

3.1.3 Labor surplus

Basic macroeconomic theory teaches that labor surplus prevents transition economy from over-heating. The increase in the number of laid-off people has had a positive effect on the economy. The rise in unemployment and suppression of the lifetime employment increased the pressure on the workforce and contributed to improve its performance (OECD, 2002 p.765). It also

Table 8: TVEs in the Chinese economy

Year	Number (million)	Employment (million)	Share of national employment (%)	Share of national GDP (%)	Share of national exports (%)
1990	18.5	93	14%	14%	16%
1995	22	129	19%	25%	43%
1996	23.4	135	20%	26%	48%
1997	20.2	131	19%	28%	46%
1998	20	125	18%	28%	45%
1999	20.7	127	18%	30%	48%
2000	20.8	128	18%	31%	42%

Source: OECD 2002

helps avoiding inflation in wages. Similarly, the prospect of working for a multinational corporation or a privately managed Chinese firm, where incomes are higher, has also been a factor stimulating worker's efficiency. However, excessive labor surplus is a concern as it increases unemployment and moderates the growth in disposable income favoring consumption and hence economic growth. To that extent, we argue that the modernization of the agrarian sector might further exacerbate, in addition to the SOE restructuring, the problem of labor surplus in China.

The role of agriculture has changed within China with modernization. Large-scale increase in agriculture productivity provides the industrial sector with a massive amount of workers, all coming from the agriculture sector. In order to employ those workers, the Chinese

Table 9: Rural poverty in China

Year	Rural population (million)	Absolute poverty (million)	Incidence (%)
1980	790.47	218	27.6%
1985	807.57	96	11.9%
1990	841.42	85	10.1%
1995	859.47	65	7.6%
1996	864.39	58	6.7%
1997	866.37	50	5.8%
1998	868.68	42	4.8%
1999	870.17	34	3.9%

Source: OECD 2002

government has developed TVEs -*Township & Villages Enterprises*-. By 1996, these TVEs employed 135 millions workers, or 28% of the rural workforce (OECD, 2002). Two important conclusions are worthwhile to note from the *Table 8*. First, while the share of the national employment working in TVEs has decreased over the past decade, the number of TVEs as well as number of people employed in TVEs has roughly remained constant from 1998 to 2000. Second, about half of the Chinese exports is produced in TVEs i.e. TVEs focused on labor-intensive sectors such as the toy industry or the textile (assembling).

But with the accession into WTO and the still backward state of the Chinese agriculture, more workers should exit this sector and flood the job market. In addition, a large portion of those "rural" workers are a floating population as they come from the in-land of China and need to move to the coastal areas where most of the TVEs are located.

Both the increase in the number of rural workers, as well as the geographical location of TVEs providing jobs raise concern about the ability of the Chinese economy to absorb the massive unemployed population contingent on the increase in the agriculture productivity (OECD, 2002 p.13). This floating population from the agrarian sector should inexorably add up to the laid-off SOEs workers. We argue that the Chinese government will have to deal with massive, floating, unskilled population leaving the countryside to join any industry in the central or coastal area.

Table 10: Rural household net income by sources

	1985	1990	1995	1998	1999
Total annual net income in rural areas (RMB)	1,311	1,370	1,718	2,132	2,210
% of rural income coming from farming related activities	75%	74%	63%	57%	53%
Income coming from farming related activities (RMB)	983	1,014	1,082	1,215	1,171
Annual growth rate (%)		0.9%	4.6%	7.5%	3.7%

Source: OECD 2002

Table 9 shows that in 1999, more than 870 million people where in rural areas and about 4%, or 34 million, were at the level of absolute poverty (OECD, 2002). Some have argued that this constant stream of low educated population will provide a continuous flow of "cheap labor" into the industrialized areas therefore limiting the inflation of income in basic industry of China most dynamic province. Furthermore, the growing gap between industrialized and rural areas could provide additional incentives to rural population to migrate to more economically dynamic zones. According to *Table 10*, the average annual income for a rural household was 2,210 RMB (~$300) in 1999. This confirms that in addition to the decline of the agrarian sector, the growing disparity in income level between urban and rural areas could further foster the migration of rural population towards urban areas.

***

In this section, we pointed out the difficulties the government is facing regarding the welfare and pensions system in China, the unemployment as well as the labor surplus contingent on the modernization of the agrarian sector.

Conclusion

This paper opposed the widely shared view among western scholars that China should implement *Shock Therapy* to reform its state-owned sector. The premise of *Shock therapy* is that the Chinese government lacks aggressiveness when addressing the problem of SOE reforms. In that respect, scholars and economists recommend that China adopt more drastic reforms on various macroeconomic related areas such as the financial institutions or property rights. On the other hand, any turmoil in China triggers worries among the international community given the importance of the mainland economy in the world trade. Thus, we face this paradoxical situation where the international community, predominantly under western influence, is asking on the one hand for drastic liberal reforms favoring economic growth but potentially creating social unrest and on the other hand political stability preserving foreign investments in China but threatened by the first sign of social unrest.

We have tried to reconcile the apparently paradoxical requirements surrounding the SOEs reforms by arguing that the gradual approach to the reform is the only feasible one. We have demonstrated that, in contrast to the *Shock Therapy*, the gradual reform process of Chinese SOEs is an attempt to meet the two above-mentioned requirements with the concurrent goal of achieving a market economy and political stability. We argued that the implementation of the market economy aims at creating and providing wealth for the largest possible population of Chinese. On the other hand, the political stability helps the government maintains its control over the political and financial bodies. In doing so, it also serves the foreign interests as they guaranty an economic environment favorable to long-term investment. But beyond market economy and political stability, we contend that the objective of the central government to stay in power is the main driver to the reform process. In order to keep the control of the political institutions, the Chinese government has to preserve social contentment while fostering the economic development. Chinese officials must therefore address the social component of the reform, at the same time they try to deal with its financial and economic aspects. In this context, the nature of the SOE has changed. Reforms that used to deal with economic problems are now dealing with economic, political and social problems. Despite the fact that China needs political stability to attract foreign investment we believe that the government is still willing to face a certain degree of social discontent, as the reforms represent the only possibility to sustain long-term economic growth.

For this reason, we considered the SOE as a socio-politico-economic entity, and not as economic-only entity. The second part of this paper analyzed the SOE reforms from a political and social perspective (most of the economists have previously looked at the SOE problem from a purely economic point of view). We argued that the specificities of China, such as its historical legacy, its geographical particularities or its political system -defined as the nested economy- make the reform scheme complex. Several characteristics of the nested economy, such as the separation between SOE's control and ownership, the relationship between banks and the state-owned sector, the state intervention or the administrative complexity suggest that the SOEs reforms go beyond a strict economic scope.

In addition, we demonstrated that the success of the reforms is also environment and industry dependent. Geographic factors render the implementation of a successful reform's scheme difficult across the country and across industries. First, the size of the country, as well as the growth dynamic differences between regions creates disparities in the way reforms can be implemented. We have suggested that there is a virtuous circle in the coastal provinces while the central and western provinces suffer from a vicious circle. Drastic reorganization is difficulty to complete in remote provinces as it could potentially lead to social unrest, as laid-off workforce is unlikely to find a job alternative in those backward areas. On the other hand, it is easy to accomplish SOE reforms in economic dynamic areas as the "process can take care of itself". In other words, it is less of a social risk to reform SOEs in region where laid-off people are likely to find job rapidly, because of the surrounding booming business environment. In addition, SOE from different industries will not experience the same difficulty when facing the entry of China into WTO or the consolidation of the sector. Reforms of the financial institutions will hit capital intensive SOE that rely on revolving loans and highly leveraged capital structure to finance wages and social benefits of their employees. To that extent, we noticed that as China is progressively phasing out egalitarianism; the gap between successful SOEs and loss-making SOEs is widening.

As we unfold the complexity of the reforms scheme, several legitimate questions arise and lead us to speculate about the future of China. We identified three issues that will be the future challenges of China: economic differences among provinces, the entry of China into WTO and the growing concern of labor surplus contingent on the restructuring of SOE and modernization of the agrarian sector. These challenges raise questions about the efficiency of the reform scheme over the long run and hence the future of China.

The SOE reforms require rules of the game taking into account regional differences. The government and relevant institutions need to implement clear guidance in area such as corporate governance, legal system or capital management so that all the SOEs accept and cope with the reform process. The general principle and guidelines have to be set and adopted. But we buttress the problem of the fairness of the reforms at the local level. Sometimes the level of constraints, or the social cost is too high at local level leaving no choice or alternative but the *status quo*. Hence, the rules of the game need to take into account the regional and industrial difference. In other words, the tightening of the credit policy for Steel industry in the North East has to differ from that designed to Shanghai based chemical industry.

China's entry into the WTO will also change the competitive landscape of SOEs. It will provide certain sectors, such as the Chemical, the Textile or the apparel industries with tremendous growth opportunities both in output and employment. But it will also bring risks to existing SOEs in the steel, automotive or energy sector. WTO entry might thus hamper thus the successful implementation of SOE reforms, as it will lead to possible massive lay-off in the steel or the energy sector, historically concentrated in provinces with slow economic growth.

Last, but not least is the issue of labor surplus in China and the modernization of the rural areas. Rural areas harbor more than 800 million people. The modernization of the agrarian sector will create massive unemployment in the countryside and, as a result, will foster the migration flow from rural to urban areas. This could create another social -or unemployment- challenge and further slow down the restructuring process of Chinese SOE in order to avoid excessive labor surplus. To that respect, we foresee a growing importance of TVEs in the Chinese economy and possibly the development of a "local" economy, self-sufficient and with little exposure to the dynamic and competitive coastal areas.

The Chinese gradual approach also will help the government dealing with the effect of the SOE reforms and adjusting the speed and the scope of the process as the reforms unfold. We remain convinced that the current SOE reform, although not following the western economic principles, is the only one suitable to the Chinese environment. Success of the SOE reforms relies on a fragile equilibrium made of foreign investments, economic growth and political stability. We argue that the way the Chinese government addresses the social and political challenges of the reforms is the only one suitable to favor long term growth of the Chinese economy, under the current political system.

4 Bibliography

Amyx, Jennifer. "Informality and Institutional inertia: the case of Japanese financial regulation" Japanese Journal of Political Science, 2001.

Amyx, Jennifer. "Moving beyond bilateralism in Regional financial crisis management? Japan and the Asian Monetary fund" University of Pennsylvania, April 2002

Binamira, Joel A. and Haworth, William C. "Debt Restructuring in East Asia: Government and the corporate sector" Managing Financial and Corporate distress - Lessons from Asia The Brookings Institution press, Washington D.C., April 2000.

Goldman, Merle and Macfarquhar, Roderick. The Paradox of China's Post-Mao Reforms. Harvard University Press, Cambridge: MA, 1999.

Guthrie, Doug. Dragon in a Three-Piece suit - The emergence of capitalism in China Harvard University Press, Cambridge: MA, 1999.

Heung, Robert. "The challenge of Chaebols reform in Korea" Korea Herald, 2000.

Ingves, Stefan and He, Dong "Facilitation bank and corporate restructuring: The role of Government" Managing Financial and Corporate distress - Lessons from Asia The Brookings Institution press, Washington D.C. (April 2000)

Katzenstein, Peter J.Introduction: Asian Regionalism in Comparative Perspective Ithaca, Cornell University Press, 1997.

Kim, Jin-Young. "The IMF-Induced Economic Reform and Limits to the Korean Democracy" College of Social Sciences, Pusan National University: Korea, 2002.

Kwak, Young-sup "Top financial regulators urge Chaebols to dismantle restructuring bodies" web page, March 31st, 2000.

Kynge, James. "Banking: a Strategy towards profitability" Financial Time December 12th, 2002

Kynge, James. "The middle kingdom's class revolution". Financial Time. December 12th, 2002.

Lardy, Nicholas R. China's unfinished Economic revolution. The Brooking Institution Press, Washington D.C., 1998.

Lawrence, Alan. China under Communism. Routledge Press: New York, 1998.

Lee, Keun, Ryu, Keunkwan and Yoon, Jung Mo. "Productivity efficiency of Chaebols and non-Chaebols firms in Korea" School of economics: Seoul University: Korea., July, 2000.

Lee, Kyu-Sung "Economic Reform and International Cooperation: Meeting the New Challenges of the 21st Century" Public Conference. Republic of Korea. May 18, 1999.

Lee, Phil-Sang "Economic crisis and Chaebols reform in Korea" School of Business Administration, Korea University APEC Study center, October 2000.

Liu Yi Shun " National capital law " China.com.cn March, 2002《国资法》起草组长刘仪舜透露：国资经营将获特殊授权

Mo, Jongryn. "The politics of economic reform: South Korea" Web page, 1999.

Nakagne, Katsuji. "SOEs reforms and privatization in China - A note on several theoretical and empirical issues" University of Tokyo - web page, November 2000.

Naughton, Barry. "China: Domestic restructuring and a new role in Asia" by; The Politics of the Asian Economic Crisis Cornell University press, 1998

Naughton, Barry. "China's transition in economic perspective" The Paradox of China's post Mao reforms. Cambridge: MA, 1999

Noble, Gregory W. and Ravenhill, John. The Asian Financial Crisis and the Architecture of Global Finance Cambridge University Press: UK, 2000.

OECD "China and the global economy: Agricultural policies in China after WTO accession" 2002

OECD «China in the world economy: the domestic policy challenge », 2002.

Oi Jean C. "The role of the local state in China's transitional economy" The China Quarterly, 1995.

Oi, Jean C. "After State Socialism: Welfare constraints on Privatization in China" Stanford University March 29, 2002.

Ridding John "More powerful, still cautious" Financial Time December 12th, 2002

Sachs, Jeffrey and Wing, Thye Woo "Structural Factors in the Economic Reforms of China, Eastern Europe and the Former Soviet Union", paper presented at the Economic Policy Panel meeting in Brussels, Belgium 1993.

Sachs, Jeffrey. Poland's Jump into to the Market Economy. Cambridge, MA: MIT Press, 1993.

Scott, David. "Government as managers of systemic financial crisis: controlling cost by integrating bank and corporate restructuring" Managing Financial and Corporate distress - Lessons from Asia The Brookings Institution press, Washington D.C. (April 2000)

Shen Jie "China post WTO challenges" China.com.cn March, 2002 "入世"之后的中国青年-

Smith, Heather. Structural reform and macroeconomic policy in Korea Asia Pacific Press, 1999.

Steinfeld, Edward D. Forging Reform in China: The Fate of State-Owned Industry Cambridge University Press: UK,1998

Stiglitz, Joseph E. and Yusuf, Shahid "The state and the reform of the Corporate Sector in Korea". Rethinking the East Asian miracle Oxford University press, 2001 pp. 343-377

Thornill, John. "Capital markets: Real trading depends on big agenda for change" Financial Time December 12th, 2002.

Thornill, John. "Private enterprise seen as a way forward". Financial Time. December 12th, 2002

Wang Jun Chao "The Chinese state-owned enterprise reforms present situation and prospect" China.com.cn March 2002 王君超：中国国有企业改革的现状与前景-

The Lauder Institute - May 2003