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The Chinese Economy

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THE IMPORTANCE OF SOE REFORMS, PRIVATE SECTOR AND MARKET-ORIENTED ECONOMY IN CHINA'S GDP GROWTH

Contents

1. Introduction

China has managed to growth substantially in the last decades through reforms and authoritarian capitalism. After economic reform in 1978, private sector have been had more important role in sustainable growth and allocation efficiency. SOE reform did not include rapid and widespread privatisation. Market-oriented and more liberal development is progressed with reduction in the weight of SOE in the economy. Even though SOE reform in China built the new path to a new economic model that is enhanced by intensive inclusion of the state, the authority opened the door to more liberal economy. SOEs created the necessary conditions for the emergence of private enterprises and enterprises with different types of owhership structures. Year by year stakes of state reduced in SOEs after significant level of internationalism, thus there's small number of enterprises that purely owned by state. Privatisation and private sector itself enhanced the efficiency of the enterprises through better management and better allocation of capital.

2. Process of SOE reforms and the path to more market-oriented economy

For over 40 years, reform of SOEs has been the main core of the China's economical expansion. SOEs formed the main line of China's economy during central planning years, the transformation is the most striking one among changes in China's enterprise and economical system that have been taking place in the policy reforms that led more market-oriented economy. China followed a different path to privatisation with its 'state capitalism' or 'corporate Leninism' system (McGregor 2012: 31). China's authority understood the significant political, social and economic consequenses of breaking SOEs in a short time without providing the appropriate and sustainable conditions for change (McMillan and Naughton 1992). The long term goal for Chinese had been building a socialist market economy with the hand of state -also the biggest stakeholder-.

SOE reforms stimulated the China's economy with different contributions. By direct intervention of the state, those enterprises created the sustainable environment for privatisation with more efficiency that the state sector was being the concrete model for the entrepreneurs. Such intense development enhanced the efficiency and competitiveness of SOEs, leading to substantial increase in their output and maintain their share in the economy, thus attracting foreign investors and the world's attention to the China's market and China's different approach to stimulate the overall economy by the state's hand for decades.

SOEs were the main economic units in nonagricultural sector. The enterprises had low independence to decide the policy related to production and distribution of goods. The government used to decide every step in the governance of the agricultural sector. The lack of market-base incentives and multiple functions of SOEs led to low effict-ient financial performance, causing the inveterate problems of low outputs and shortages during the planned economy periods. Because of these problems, the idea of SOE transformation that leads to adopting the market mechanism with resource allocation and promoting the efficiency with output expansion became more crucial.

In the period of central planning, SOEs relied on government help through various types of instruments that have inhibited high class competition among SOEs, it was "material balance planning (Naughton 2007: 61). In addition to that, SOEs had few concerns about efficiency when deciding on investment and production, other than specific government output targets.Soft credits from state owned banks, subsidies by government and tax exemptions helped firms soften their budget constraint. Thus, they were less sensitive to market-based dynamics and inclined to losses that often aided by government (Kornai et al. 2003: 1095).

Given that SOE dominance in the economy, the main policy of SOE reforms became the idea of reducing state's share in SOEs. This had two effect. On one side it reduced the burden on government by inefficient SOEs, on the other side it created opportunities for private firms for expansion (Garnaut et al. 2006). Government officially recognized and encouraged multi-ownership economic system and enhanced private property rights (Chow 2002). Briefly, the main objective was to reduce government intervention in business operations and provide more market oriented autonomy.

An enterprise responsibility system was started to being implemented which takes household responsibility system as a benchmark, because the household responsibility system was quite successful. Through this application, the main goal was to increase SOEs' output, profitability and productivity level. Only after fulfilling state plans and output quotas, enterprises were allowed to use the extra profit on strategic decisions, on production plans or other operations related strategies. In 1984, enterprise rights were widened to production planning, purchase of inputs, worker payment and recruitment and the use of retained profits(which meant that extended autonomy were given in that time). Under the contract system, each SOE was allowed to adopt a compulsory plan that needed to met the output quota by the government that is sold at state-set prices but under the market-oriented scheme the enterprise were allowed to sell the product at market prices with much more autonomy in business operations (Chow 2002). In 1985, more stable and formalised relationship intended to have between SOEs and government agencies through the new contact responsibility system. Thus, SOEs became more responsible in terms of generating profits or losses. Almost %93 of SOEs at the end of 1988 were subject to the contract system (Huang 1999: 102). The dual price system and the cotract system were the main constructial point os the government's plan, that is representing planning-based and market-based coordination plan (Naughton 2007). No need to say that the system is automatically disappeared with the increasing market competition. By the increasing competition among SOEs, government managed to remove the entry barriers and supported the rise of non-state companies. While there's no change that the main stakeholder had been the state, this reform measure led to diversified ownership types in the whole industrial sector, that induced higher level competition in many industries (Jefferson and Su 2006). In terms of state's active role in managerial side, we can mention about the decentralising process in mid 1980s that gave more autonomy to local governments. This led to more incentives from local authorities to local enterprises for more revenue sources and tax base.

In the period of 1978 and 1994, the number of state owned enterprises increased slightly to 102,200 (from 83,700), the number of collective enterprises (multi-ownership typed) increased agressively to 1.86 million (from 264,700). Industrial enterprises surged to 10.02 million (from 300,000) by number. SOEs' share in China's total gross industrial output changed from %78 to %37.4. On other side, collective enterprises share in th gross industrial output increased to %37.7, having more of the output than SOEs (Jefferson 2016: 9). The output ratio is also consistent with the number of enterprises. In 1980–91, output growth (annualy) of SOEs were %7.8, of collectives were %18.6 and of private enterprises %140.6 (Rawski 1994: 272). In spite of slower growth, state owned enterprises were the necessary source for the private and collective owned enterprises' access to technical information, equipment, management skills, government-backed guarantee and subcontracting opportunities (Rawski 1994). So the path to the market oriented industrial sector was almost complete despite in need of larger private property rights.

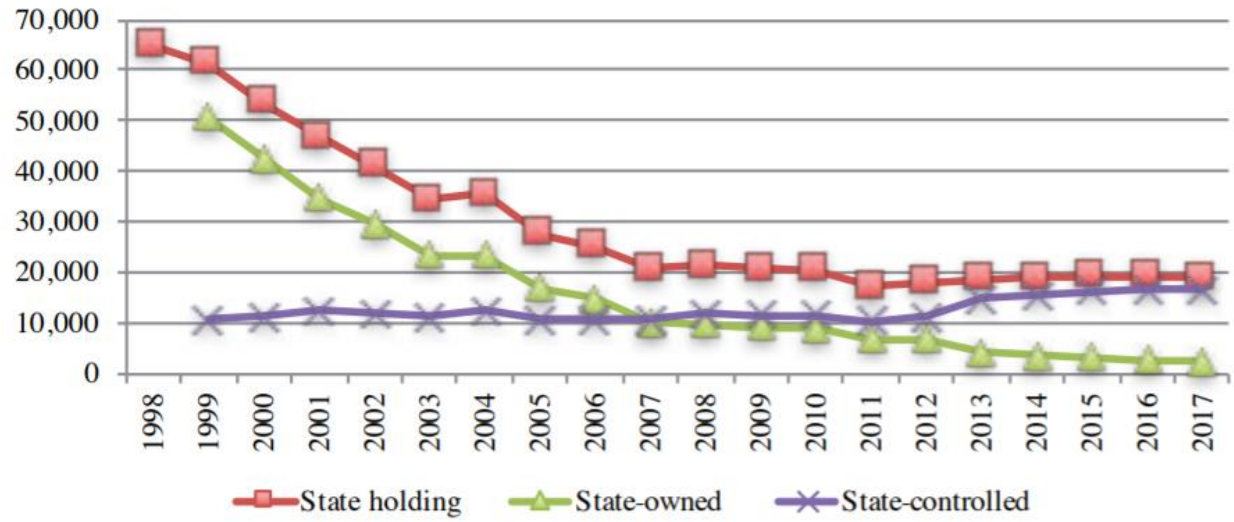
Through all progress mentioned above, SOEs reached more healthy productivity, efficiency and financial performance. Some researches concluded that the SOEs had succeeded to improve their labour and total factor productivity which is vital in terms of Cobb-Douglas production equation. However, SOEs recorded worsening profitability rate (based on the returns on fixed assets) declined from %18 to %6 in the early 1990s (Song 2015: 184). As a result, that meant SOEs contribution to government declined. There also was a problem with soft budget constraints on SOEs, despite the efforts by the government for handling with this problem for years. Government' subsidies to those SOEs grew from 6.3 billion RMB(% 1.4 of GNP in 1980) to 268 billion RMB (% 10 of GNP in 1992), literally a huge increase (Huang 1999: 113).

While rise market competition can be seen a valid reason for the worsening financial performances, other potential reasons might be the lack of social security system that burdens the SOEs (McMillan and Naughton 1992; Song 2015). In addition to that, enterprises claimed that there were still significant government interference to the business operations even under the contract responsibility system (in the former system that was output-input contract control, there were direct interference of government). The seperation of ownership and control gave rise to the corruption that some managers took advantage of their positions by warping real profits and use it for their own benefits. So, that raised the questions about the monitoring problem (Chow 2002).

The huge losses of SOEs led to further reforms by then government. Ruling Communist Pary also saw the need for further development by the institutional-sructural base for more expanding economy (Naughton 2007). The 2nd part of reforms are largely characterised by transportation *(gaizhi)* with a focus of SOE privatisation. Deng Xiaoping's tour to south China in 1992 triggered the new movement by the policymakers. So that tour became a keystone in reform history. *Gaizhi* became the essential element for the government towards 'socialist market economy' that is set forth by the fourteenth National Congress of CPC (Song 2015). Western corporate model became the role model for the government. Jiang Zemin managed to make legal transition which are put into process by Company Law (1993) and Competition Law (1994). Furthermore, the *xiagang* ''laid-off'' policy, which made possible of firing large number of workers in the process of the change in ownership structure, was implemented (Song 2015). In 1997, the 15th National Congress announced the new social security system under new establishments (Chow 2002). In 1990s, some more complementary policies were put in action. Fiscal reforms included a more broad tax base and more stable local-central government relations. Moreover, stock markets were established in 1999 to enhance the privatisation rapidly and provide enterprises to raise capital through internationally open market. The development supported the ownership transformation (Naughton 2007). This development attracted global investors and made China's economy less opaque. The potential joining process of China in WTO (World Trade Organisation) led some trade reforms in 1990s that were one of the another siginificant impact on SOE privatisation process (Jefferson 2016).

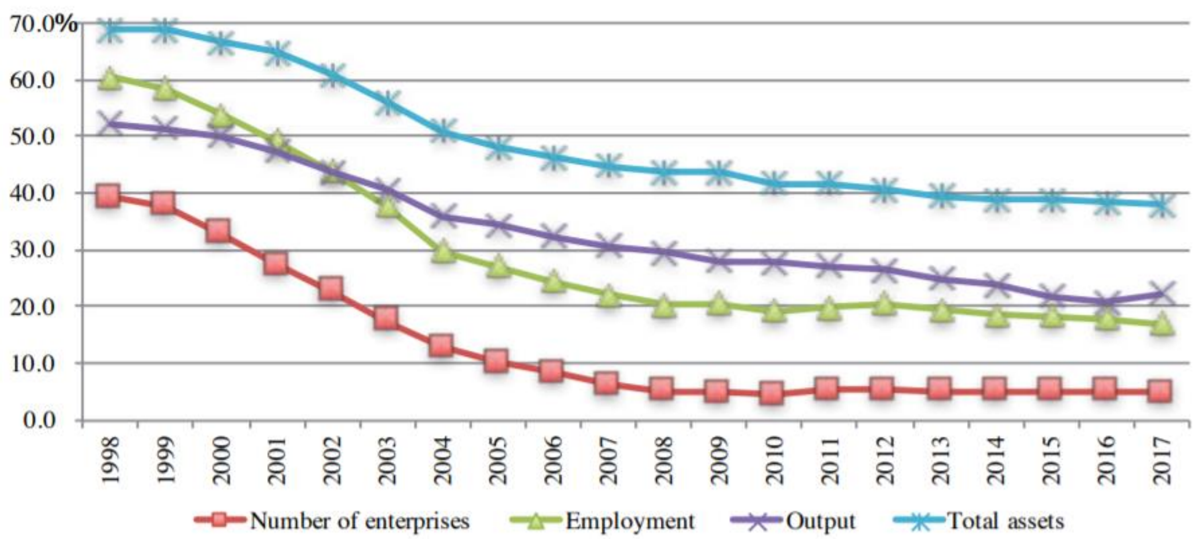
The government was still holding more than 50 percent of the shares of keystone enterprises for the economy, meaning that anyone who invests in those enterprises becomes partner with the state. This policy is largely adopted in 1995 that is named as "grasping the large, letting go of the small" *(zhuada fangxiao).* It was formally approved at the fifteenth National Congress in 1997 (Song 2015). About 500-1000 large enterprises were retained, whereas other enterprises had been structured through sale or lease. There was a simple logic behind the policy which was that the larger ones performed much better than the smaller ones and had greater importance to economy. *Gaizhi* was carried out in different forms, including through employee shareholding, open sales, leasing and joint ventures with foreign enterprises, public offerings, bankruptcy (Garnaut et al. 2006). Between 1995–2003, the number of SOEs declined from 118,000 to about 34,000, and the labor force state-owned enterprises fell by 44 million people (Song 2015: 191). Between 1995–2003, the number of SOEs decreased by about 23,600, and their labour force dropped by 13 million people. More efficient asset allocation to non-state enterprises led to more productive use of the assets. So, it turned out to be win-win situation as it decreased the burden of poor-performing SOE enterprises (Garnaut et al. 2006). As a result, in 90s and 00s, the share of the total gross output of SOEs declined from about %55-60 to about %44. Overall, as stated before, better resource allocation in the enterprise sector is one of the substantial outcome of the ownership reform in these periods.

Number of state holding enterprises, 1998-2017



Source: CEIC China Database; China's 40 Years of Reform and Development 1978-2018

Change of relative position of state-holding enterprises 1998-2017



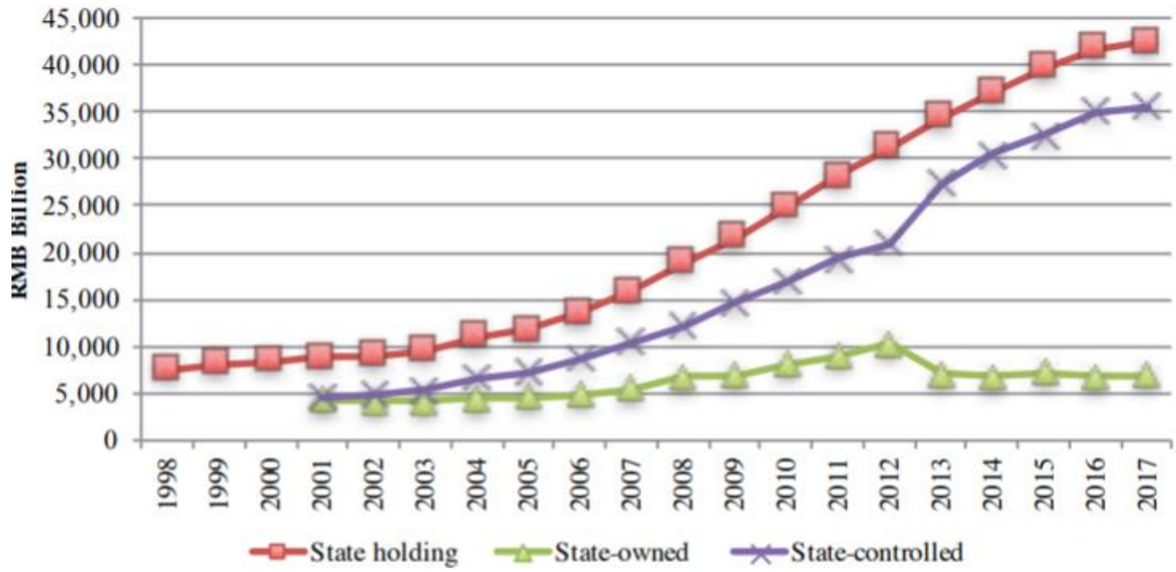
Source: CEIC China Database; China's 40 Years of Reform and Development 1978-2018

As can be realized on the graphs, the privatisation has been successful by the terms of productiviy. In Garnaut (2006) and Sun and Tong (2003) studies, it's clearly concluded that ownership reform has improved the productivity, SOEs' earning ability and worker productivity (as cited in China's 40 Years of Reform and Development: 1978-2018). But they lagged behind of those private enterprises. During 1008-2003 the share of the SOEs that generated loss was still very high, at %35-39. So, the banking reform was initiated by the government at the end of 1990s to solve non-performing loans (NPL) in the lossmaking state firms. In 1995, by the Law on the People's Bank of China and the Commercial Bank Law, the government set out the main banking reform program that is increasing the budget constraints on SOEs. Therefore, four asset management companies were established to deal with NPLs through the processes transferring the loans and clearing the balance sheet of SOEs (Chow 2002).

Large SOEs are kept under control through *gaizhi* operations which was the initial process to the modern market oriented enterprise system. Organisational development was the another process in SOE reforms while SOE reconstruction under *gaizhi* went on. In March 2003, the State-owned Assets Supervision and Administration Comission (SASAC) was established through the guiding principles on the consolidation and development of publicly owned ecenomy which had put emphasis on the importance of private economy (Yang 2015). SASAC was under the control of State Counsil. The comission supervises large-central SOEs *(yang qi)* while indirectly oversees local SOEs *(di fang guo qi)* which are under the direct control of local authorities. SASAC have an important effect on SOE reform.

SASAC's main goal was to increase state-owned assets in SOEs, while continuing ownership reform to consolidate SOEs. It enabled government to maintain disproportionate control over profits, investment and national economy. As a result, the number of central SOEs under SASAC was reduced from 196 to 159 after consolidating and restruction, from 2003 to 2006 (Mattlin 2007). Afterwards, the number further fell to 106 during the period 2015-2016. (Jefferson 2016:3). With SASAC, the government emphasised the importance of large SOEs through the policy of "grasping the large, letting go of the small". In 1999, 15th National Congress highlighted the four industrial groups that were retain the dominance of SOEs: nonrenewable energy sources, national security, public utilites and infrastructure services and high technology (Broadman 2002).

Total assets of state-owned of state-controlled enterprises, 1998-2017 (RMB billion, current price)



Source: CEIC China Database; China's 40 Years of Reform and Development 1978-2018

During 2006, the State Council proposed more specific industry sectors and ownership goals. Officials set different goals for different industry types. Such examples are: maintaining 100 percent state ownership and increasing state-owned assets in defence, power generation and distribution, oil and petrochemicals, telecommunication, coal, civil aviation, shipping; absolute or conditional relative controlling stake even though the ownership share is reduced in the sectors like machinery, automobiles, IT, construction, steel, base metals, cehmicas, land surveying, research and land development; maintaining the necessary influence by controlling stakes in key enterprises but with the reduced state ownership in industries like trading, investment, medicine, construction metals, geological exploration (Mattlin 2007: Table 1, p.16).

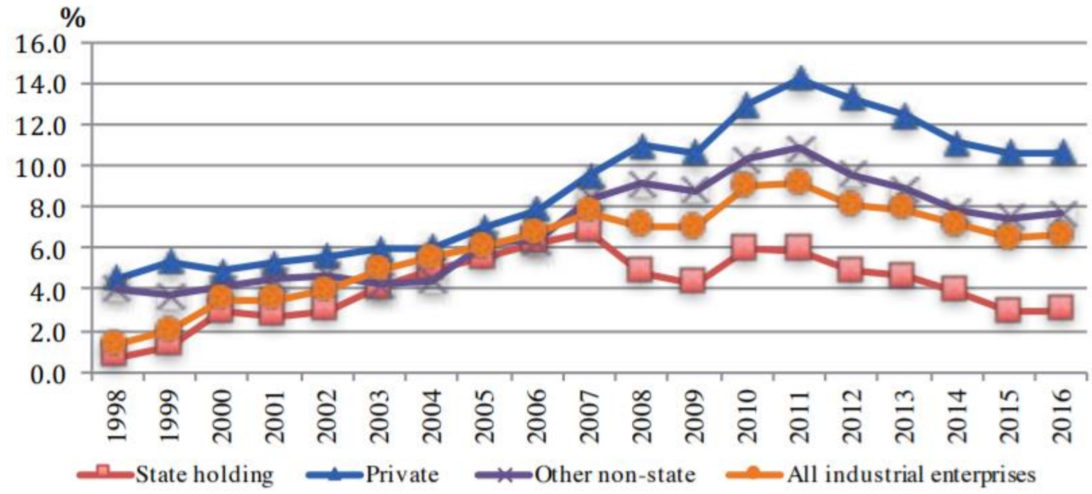
Another very significant development was the support of SASAC and the other government agencies to the expansion of SOEs through public listings on domestic and international stock exchanges and international mergers and acquitions (M&As). M&As became the vital strategy to expand through foreign investors towards being 'more global' and widespread (Song et al. 2011). Also, it induced the listed SOEs to be more open by their financial statements and background and attracted foreigners directly through these public informations which are announced often. Then, many SOEs started to took place in Fortune Global 500 list, with their sales focused in energy, finance, telecommunication, engineering, construction, motor vehicle and parts industries (Jefferson 2016:5).

Restructuring process through SOE reforms and SASAC supervision increased the average size of SOEs by substantial amount. Although the number of SOEs decreased significantly, from 34,280 to 17,851 during the period 2003-2012. The reduction in the number of purely state owned enterprises contributed to this. So by this fact, it can be concluded that even though the number of purely state owned SOEs decreased, the assets of the SOEs substantially increased. As a result, much larger sales output had been observed. The average amount of total assets grew to 1.75 billion RMB from 276 million RMB, between 2003-2012. Their average output value grew from 170 million RMB to 1.37 billion RMB in 2012[1]. The state sector's share in the total number of firms substantially declined in the period of 2003-2007, to %5. In addition to this, SOEs' shares in total industrial employment were still large, at about %20 and %25 significally. In contrast, SOEs still held up to %40 of total industrial assets, although it declined from %56 to %40 in 2003. The declining trend of SOEs' shares in the number of firms and total employment, sales and assets indicates that decisive SOE restructuring took place in the period 2003-2007 but then slowed until 2013. In contrast to that, total value of assets, sales output and average firms size of the state sector grew (China's 40 Years Reform and Development: 1978-2018, p.357-358).

Statistics and several studies show that SOE restructuring were being implemented in an efficient way and had positive impact on economical growth and enterprise productivity between 2003-2007 following SOE reforms in 1998-2003. In the period of 1998-2007 the total factor productivity had been higher than the period 1988-1998 (Brandt and Zhu, 2010). In terms of financial performance and financial growth, SOEs came close to fully private and other nonstate enterprises during the period 2003-2007. The return on assets (ROA) of SOEs rose to %7 from %4, while ROA of private enterprises increased to %9.5 from %6. Return on equity of SOEs grew to %16 from %11.5, while the ROE of private companies increased to %21 from %15 (indicating a gap of almost %5)(China's 40 Years Reform and Development: 1978-2018, p.358).

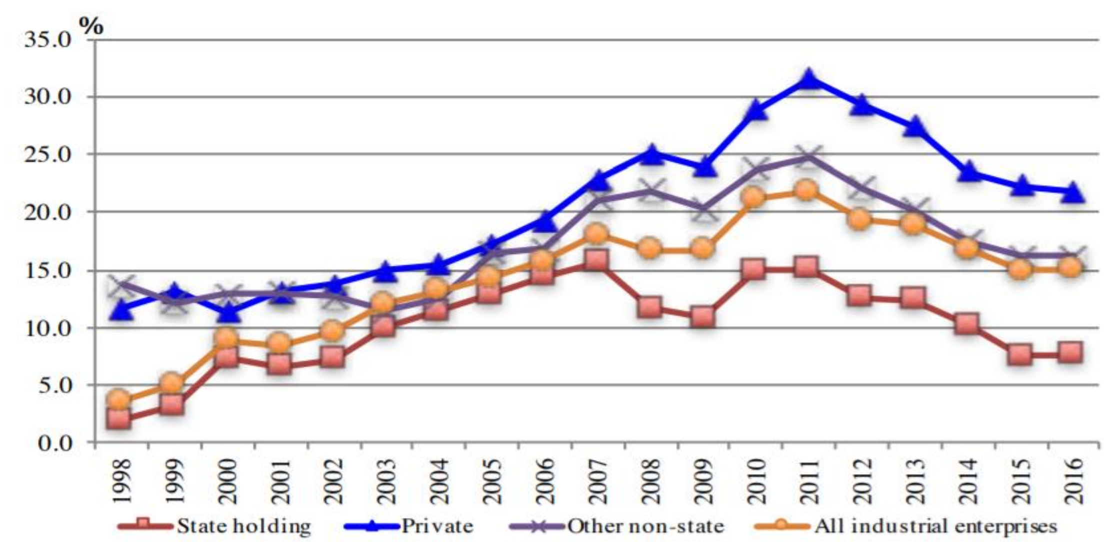
[1] CEIC China Database; China's 40 Years Reform and Development 1978-2018

Returns on assets of industrial enterprises by ownership type, 1998-2017



Source: CEIC China Database; China's 40 Years of Reform and Development 1978-2018

Returns on equity of industrial enterprises by ownership type, 1998-2017 (percent)



Source: CEIC China Database; China's 40 Years of Reform and Development: 1978-2018

SOEs' financial performance worsened noticeably between 2007-2013, during the rapid growth of the average size of assets and output. As shown in graphs above, both ROA and ROE of SOEs dropped during 2008-2009 and increased again during 2010-2011, before falling in 2012-2013.

This trend largely reflects the government's stimulus program during the financial crisis in 2008 and the aftershock effects of GFC. But again, the gap in ROA and ROE increased substantially, showing off the efficiency of private enterprises. The portion of lossmaking SOEs was in the range of %20-38 which is very much, while of private enterprises was between %6 and %15.

The worsening financial performance of SOEs seems to be correlated with specific factors of SOEs' governance and operations. The main function of SOEs could be still attributed to specific government objectives such as macroeconomic stabilisation, maintaining social stability and crisis response, but they performed poorly in terms of generating profits. Such activities are mostly not profitable. One of the problems of SOEs was the overstaffing, mostly due to consolidation, as social security protection is a political and functional feature of the state-owned enterprises (Jefferson 2016:5). Also government started to collect few dividends (%5-15) after 2007, in contrast to the former period (Mattlin 2007). The SOEs were being funded by the four large commercial banks which are also owned by the state. The NPL that generated by SOEs in banking sector grew significantly (Jefferson 2016: 6).

The another booster of the weak performance is SOE managers and lack of oversight in management. Principal-agent problem had rose because of the large autonomy given to SOE managers under the contract responsibility system. The authority was simple given to managers, delegated from the government itself. But there was the monitoring problem. The accountability of enterprise managers' business decisions are couldn't well monitored and audited due to delegated authority and insider control of the managers, party and administrative roles and social networks of the managers and dominance of relevant government agency or SOE representatives over the board of directors of the state-controlled shareholding enterprises (they were largely influenced by them). The personal power of managers and economic importance of large SOEs, especially central SOEs, have made them powerful interest groups that have large influence even on the government (Zhang and Freestone 2013). The corruption charges increased largely against some of SOE managers. Some 124 top officials in SOEs were facing corruption charges according to *South China Morning Post* (Meng 2015).

Another issue is overinvestment because of the considerable corporate savings from retained profits due to small dividend payments. Many local authorities encouraged local SOEs to undertake large investment projects in the aim for local economic growth (Naughton 2016). "Zombie firms", large debts, and overcapacity problems surged substantially. Increasing competitive pressures from private enterprises caused SOEs' output share to decrease in the proportion (Zhang and Freestone 2013). The imbalance between SOEs' output shares and their asset holdings suggests removal of entry barriers, if any, and SOE ownership transformation would enhance the efficiency and output growth of these industries. In conclusion, the issues related to SOE reforms that discussed above are considered as unfinished tasks of the most recent reform period.

18th National Congress in November 2013 took some policy decisions about reforms. The decisions drew important directions for reform to adress the key issues of SOE governance and operation: Firstly, defining the functions of SOEs to determine levels of state ownership and control; Secondly, promoting mixed ownership; Thirdly, shifting from asset management to capital management and increasing dividend payments to social security funds (Yang 2015: 59). For competitive sectors it had been implemented as described above, but in the sectors that have strategic importance to government stayed largely state-controlled but share-holdings of non state parties were encouraged (State Counsil 2015). Some SOEs took place in Shanghai exchange market like China Unicom. So, the process of partial privatisation had been carried out through stock exchange market reducing the concerns about selling the assets at low prices.

SOEs were to be still served political role for the government supporting social stability and projects such as the Belt and Road Initiative (BRI). Top SOE managers began to be appointed by SASAC and approved by the personnel bureau of the CPC. Nevertheless, the participation of private power on the boards of directors, at least partially, which brings the management experience and resources from private sector which may have the potential benefits for the efficiency and financial performance of SOEs.

In 2015 guideline, there was a call about government-directed mergers to make SOEs larger and stronger, which has long been a goal. But it does end the price wars and leads to monopoly situation. The 2015 guideline also induced new personnel management reforms in SOEs. The recent reforms aimed at dual-track system for SOE personnel management. In the dual track system of manager appointment, managers that are apointed by SASAC enjoyed the high bureaucratic position and but low salaries which often leads to bureaucratism and inefficiency. On other side, managers outside the bureaucrtic system enjoyed the competitive salaries that are market-based, but their jobs are contract based and subject to evaluation annually, which is good for corporate efficiency and better financial performance.

In April 2017, State Council revealed some targets about the recent reforms in SOEs. This included building a modern enterprise system with strenghtening Party control, which showed us the love of the state for holding the control over economy and the market, again. But in addition to this, the council emphasied on the market factor again by concluding that the SOEs should operate independently following the laws of a market economy and enterprise development. Also, they mentioned about the anticorruption campain once more. The trend continued that the purely state owned enterprises contined to decline in contrast to state-controlled shareholding enterprises, which increased through privazitations. Again, the size of purely SOEs increased sharply during the period 2015-2017. ROA and ROE of the SOEs did not show any significant improvement despite the efforts of the government. The gap stayed same between the SOEs and private enterprises as can be concluded from the graphs that take place above. Maybe the nowly performed measures and reforms need more time to show its effects in financial statements, especially in income statement and profitability (because total assets continued to rise partly due to leverage)[2]. Moody's Investors Service (2016) estimates the debt of SOEs at 115% of GDP in 2015. Due to lack of the data it's difficult to be shown. We largely depend on the estimates of internationa agencies like Moody's, IMF etc.

In conclusion, as the SOE sector still remains significant to the economy, China managed to transform the main structure of SOEs through reforms to more market-oriented economy and privatisation. The SOE sector has been transformed into a modern corporate sector with many large and globally operated corporations, diversified ownership and complex organsiational and operational structures. The use of SOEs and the help of the privatisation, China managed to handle the hard infrastructure investments through mobilising resources, thus led them to have high growth rates. In spite of strong reforms, SOE sector is still lagging behind of the private sector in terms of financial performance. And there is still lossmaking SOE that are at higher proportion than the non-state sector. The government tries to handle the situation by supply side reforms to reduce excess capacity, deleveraging and support industrial restructuring. State capital has also been invested in

[2] State-Owned Enterprses Leverage as a Contingency in Public Debt Sustainability Analysis by, Asian Development Bank publish in January 2018

private firms in new industries. This demonstrates the growing role of private sector in SOE-dominated and monopolistic industries. SOEs continue to play significant roles in key industries like energy, telecommunications and information technology, transport equipment, new materials, space technologies, construction materials and infrastructure development. The government also revealed the "Made in China 2025" policy, which aims to build high-end manufacturing industries across all key industrial sectors.

3. Some events and facts that accelerated private sector and money flow into China

State capitalism worked with both economic planning and laissez-faire capitalism, and advocates a kind of socialism marked by strong government intervention, which is China's reality. Does it really play a big role in rapid growth in China in the last 40 years? In the past 20 years, the private sector has been the key accelerator of the economy. The collective and private sectors grew much more rapidly than the state sector. In 1978, state enterprises produced %77.6 of total gross industrial output value. In 1996 the amount reduced to %28 as the %39 contributor was the collective enterprises. The data shows that even if state enterprises are not increasing their productivity, China's economy could continue to grow rapidly if the nonstate sectors remain vibrant, because the state enterprises accounts for only a smaller share of total output (China' 40 Years of Reform and Development: 1978-2018, p. 99).

China's gross industrial output value by ownership (RMB billion in current prices)

	State-owned	Collective-owned	Individually owned	Other types	Total
1978	328.9	94.8			423.7
1985	630.2	311.7	18.0	11.7	971.6
1996	2,836.1	3,923.2	1,542.0	1,658.2	9,959.5

Source: NBS (1997: 413).

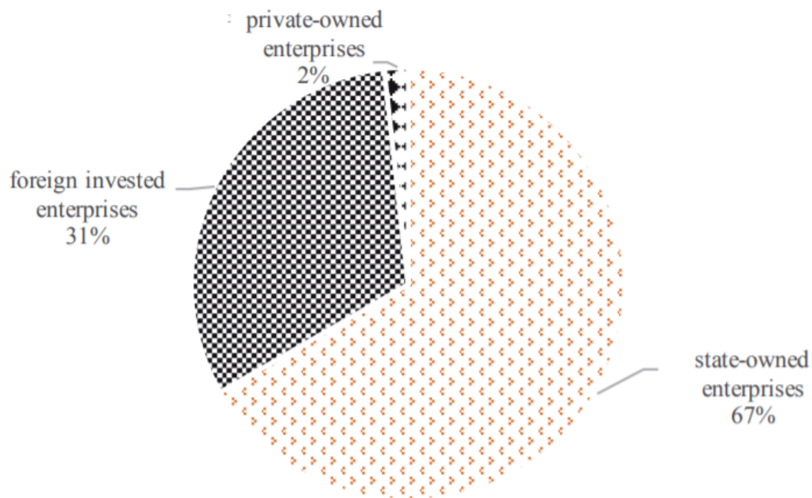
Source: China's 40 Years of Reform and Development: 1978-2018

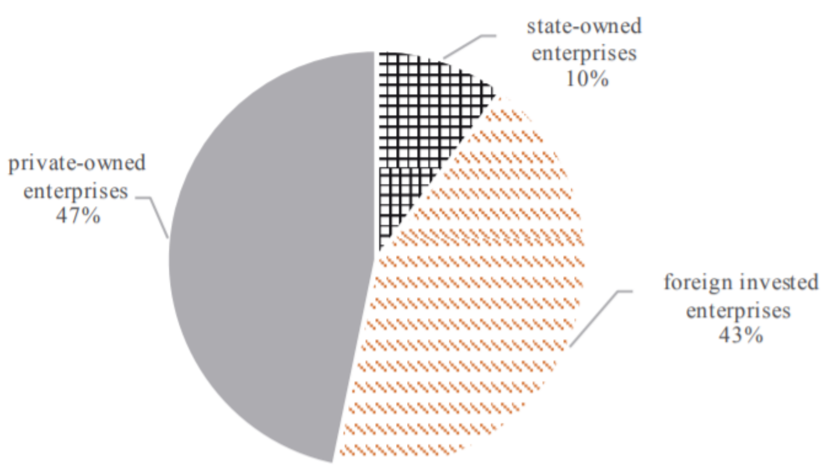
The inefficiency of state enterprises has been thought as a major problem in the Chinese economy. The productivity of state sector has been increasing in the past 20 years, but at a slower rate than that of the collective and private sectors. Also, the relative importance of state sector has been declining and the outcome of the state enterprises' performance on the growth is less important than before. State sector became more burden to the government and economy, especaially through such lossmaking enterprises. They require subsidies by government. Wages, social system, health care and retirement benefits for the workers are very costly, but on the other hand, reducing the employment level increases unemployment level (China' 40 Years of Reform and Development: 1978-2018, p. 99).

Deng Xiaoping's open-trade policy triggered tha fast-paced environment for more liberal economy. He encouraged the opening of China to foreign imports and exports. In 1978, the exports and imports only amounted to %7 of China's national income. Until 1987, the volume of foreign trade had increased to %25 of GDP. By 1998, it reached to a level of %37 of GDP (China' 40 Years of Reform and Development: 1978-2018 p.104). As a father of China's modern state-socialism dynamics, he had very much influence on China's opennes to the global trade, thus promoting privatisation and attracting foreign investors.

During the East Asian Financial Crisis, exports weakened as a result of currency devaluation in East Asia, especially in Japan. But those times, private enterprises performed very well in terms of the promotion of Chinese goods by exports, whereas state enterprises were doing poorly. The growth rate of GDP only moderately affected by the crisis that suppressed the demand outside China because the exports were amount to %20 percent of GDP, not yet the main driver of the economy. Nevertheless, the role of private enterprises cannot be neglected in that era. In the meantime, the government tried to stimulate exports by lowering the export duties and refunding taxes on raw materials used to produce exports. Trade and export-oriented processing industries flourished China' 40 Years of Reform and Development: 1978-2018 p.105). In 2007, before the global financial crisis, the share of import and export value in GDP reached %62, 20 percentage points higher than in 2002. After it decreased to %45 in 2012 (China' 40 Years of Reform and Development: 1978-2018 p.180).

Ownership structure of China’s export, 1995 and 2017 respectively

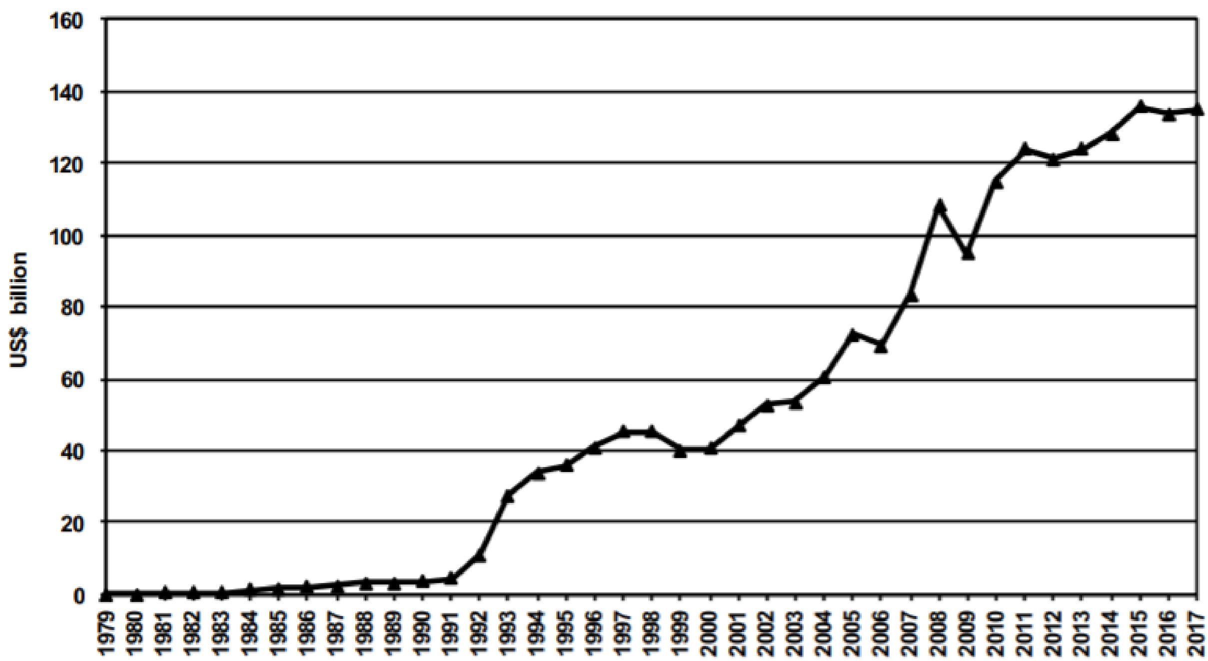




Source: NBS; China Database and China’s 40 Years of Reform and Development 1978-2018

Beside exports-imports, foreign direct investments (FDI) were the main source of the money that flows into the country, to be used in private sector. From 1984 to 1992, FDI in China grew rapidly from $2.9 billion to $165.5 billion. The ratio of total import-export to GDP rose from %17 to %34. A trade deficit of $1.3 billion was replaced with a surplus of $4.4 billion. Through 1990s, China absorbed about half of the FDI flows to emerging economies. In 5 years after the initial membership of WTO, China’s FDI growth rate increased at an annual average of %22 (compared to %4 in the prior)[3]. The large volume of FDI inflows to China have contributed greatly to the economy in terms of capital formation and privatisation. Employment creation, export expansion, technology transfer are some of the benefits of it (p 595). FDI inflows grew to $45.9 billion in 2001 to $108.3 billion in 2008. However the Global Financial Crisis caused a decrease in FDI to $95 billion in 2009, before recovering to $114.7 billion in 2010 and $136 billion in 2017 (China' 40 Years of Reform and Development: 1978-2018 p.29, 173, 595, 600)

The liberalisation of China's FDI policies and FDI inflows into China



Source: UNCTAD(various issues); China's 40 Years of Reform and Development: 1978-2018)

When China joined the World Trade Organisation (WTO) in 2001. China agreed to allow its domestic markets to open to international goods at international market prices (although some tariffs were being implemented). China's transition to market economy in this era was largely increased (China' 40 Years of Reform and Development: 1978-2018 p.137).

The development of property rights have induced foreigners to be less skeptical about the security problems about privatisation. The research paper of Lund University School of Economics and Management, indicate that increasing protection of private property rights is correlated with

[3] World Bank (2018)'s authors calculations; China's 40 Years of Reform and Development:1978-2018

the size of the private sector in China. The conclusion includes the necessity of property rights protection within more innovative economies and also includes empirical statistical data and evidence[4].

The Shanghai and Shenzhen stock exchanges were formally started in 1990. In 1990s, they were the main vehices of selling state-owned shares to private interests. Over time the stock exchanges have listed more and more firms, including private ones. The China Securities Regulatory Comission (CSRC) regulates the stock market (China' 40 Years of Reform and Development: 1978-2018 p.146). The stock exchange markets are one of the main sources for private foreign-private capital to get into the Chinese market.

The government has made a serious effort to modernise the legal system. The Ministry of Education in the early 1980s started to set up new programs for legal literacy and education, training many lawyers. On paper, today's Chinese laws are comprehensive and modern in content, but their enactment has not largely changed the behaviour of Chinese people. Also, the WTO membership enhanced the modernisation of China's legal system as it is forced to deal with much more foreing firms (China' 40 Years of Reform and Development: 1978-2018 p.105, 110). Even though it still falls short of West's legal system, there's increasing trust in legal procedures in China. The recent news indicate some good news for foreigners who are in seek for their right in Chinese courts, such like Jaguar's victory in the landmark case against Chinese copy of Evoque model.[5]

The privatisation of housing began slowly in the early 1990s, but became wider policy in late 1990s. The enterprises that in the housing sector made possible the discounted sales to their own employees and a private market for new housing was created. After the initial privatisation, all urban housing is either leased or rented to households at market prices. But under the *hukou* system that divides the population into rural and urban residents and makes it very hard to switch registration from rural to urban, leading to less efficient and less liberal housing system (China' 40 Years of Reform and Development: 1978-2018 p.150). Also, the houses cannot be sold for a period

[4] Do Property Rights matter for China's Private Sector?, A panel Data Analysis 1997-2007

[5] https://www.theguardian.com/business/2019/mar/22/jaguar-land-rover-wins-landmark-case-against-chinese-evoque-copycat

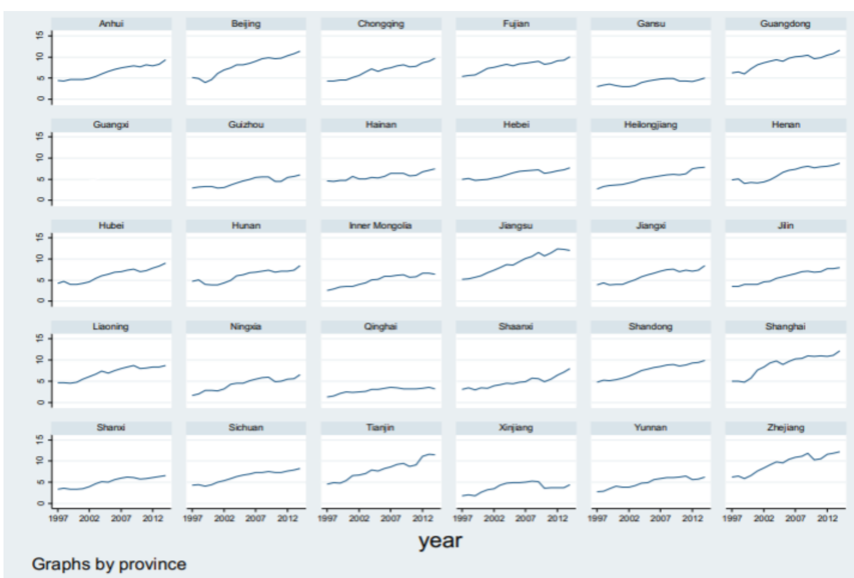
of infinite time. The property owning rights were restricted to specific period of time that set by government, but an opaque system that there's no clear identification of the time length.

The term *gaige kaifang* is very important for introducing elements of a market economy into what had previously been a rigidly planned system. It addressed China's reform and opening. It consists of private foreign investment and trade, domestic private-sector growth alongside with traditional state-sector, large political decentralization by giving more autonomy to local authorities. It led to higher competition among cities to attract foreign investors and it encouraged locals to look for innovative approaches to providing public goods (China' 40 Years of Reform and Development: 1978-2018 p.155).

4. Some statistical data about the state sector and private sector, and market capitalisation

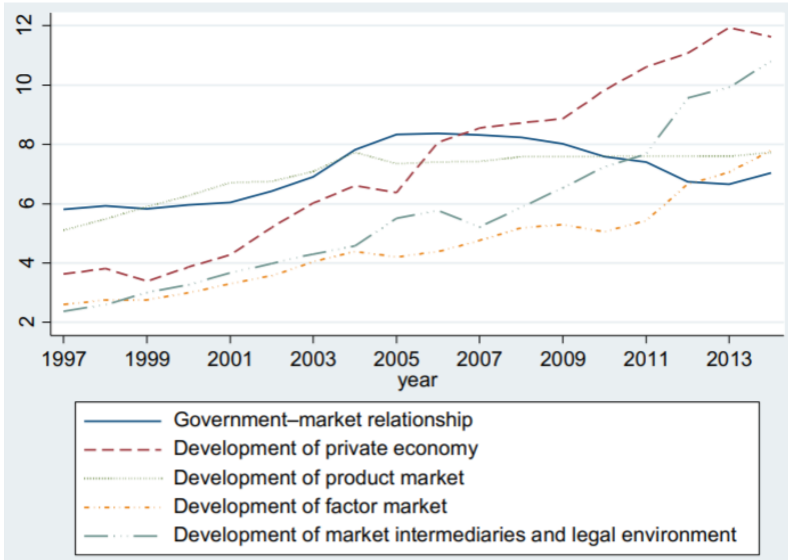
NERI index is a significant indicator that shows the overall progress in Chinese market. Rapid progress has been made in development of the private sector, market intermediaries and the legal environment and the development of market oriented product markets. In terms of government-market relationship, there's still large gaps to go over. This indicates there is still significant government intervention.

NERI index for progress in marketisation in Chinese provinces



Source: Fan et al. (2016) and China's 40 Years of Reform and Development 1978-2018

Scores for five aspects of marketisation, 1997-2014

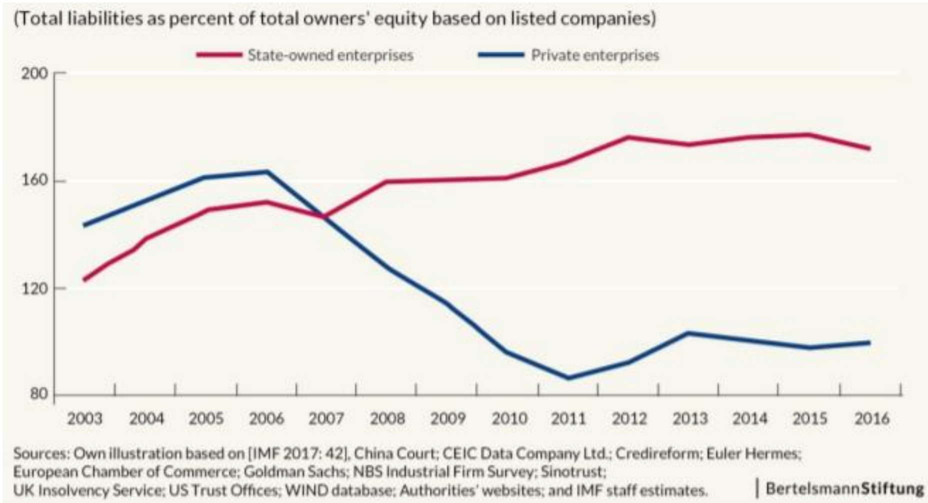


Source: Fan et al. (2016) and China's 40 Years of Reform and Development 1978-2018

As largely discussed in recent years, international investor community's biggest worries about the Chinese economy is its high leverage ratio. Over the past 10 years or so, state sector's leverage ratio has risen, the private sector's has declined. National Bureau of Statistics (NBS) revealed a survey using the large industrial enterprise dataset. The average debt-asset ratio of SOEs (90^{th} quantile) rose from %292 in 2006 to %349 in 2013, and that of non-SOEs (90^{th} quantile) declined from %304 to %206 during the same period, which, again the efficiency of private enterprises is shown by a valid data (Tan and Yin, 2016). As the economic policy uncertainity increases, private companies become more cautious and they are inclined to postpone their critical investment decisions whereas SOEs continue to expand (Wang et al 2014). The overall leverage that consists of households and corporations shows an increase from %117 in 2008 to %180 in 2013[6]. The graph below shows the debt-equity ratio of sectors in the last years, showing the more cautious financial resources allocation in terms of leverage ratios[7].

[6] https://piie.com/blogs/china-economic-watch/deleveraging-state-china
[7] https://www.bertelsmann-stiftung.de/fileadmin/files/BSt/Publikationen/GrauePublikationen/MT_China_Great_Wall_of_Debt.pdf

High Average Leverage Ratios, 2003-2016



Since the global financial crisis in 2008, the productivity gap between the state and private industrial firms had widened significantly. The returns of state-owned enterprises had fallen by almost three fifths from their high point in 2007, to only %3. On the other hand, private industry firms' returns increased by more than 1 percentage point than in 2007. It indicates the largest gap in almost 20 years (China' 40 Years of Reform and Development: 1978-2018 p.331).

Return on assets of state and private industrial enterprises, 1998-2016

Source: NBS (2017: 424-5, 430-1); Netional Bureau of Statistics of China website; China's 40 Years of Reform and Development 1978-201

5. Resurgence of the state?

The private sector is playing a steadily increasing role in the country's economy because private-sector firms consistently outperformed state-controlled firms. In the nineteenth party congress Chairman Xi Jinping's three-hour speech made it clear that China, especially in these years recently, has no intention of moving all the way to having a fully market dominated economy. Beijing and the party committees in the enterprises -both public and private- will continue to play an important and possibly dominant role. Throughout the world, private companies are always proved to be more productive than their state-owned counterparts (China' 40 Years of Reform and Development: 1978-2018 p.140).

In 2013, President Xi Xinping and Premier Li Keqiang, the CPC endorsed an economic reform program that called for the market to play the dominant role in the allocation of resources (CPC Central Committee 2013). Five years later, instead of this policy, it's been argued that different path has been followed. China has announced new series of policies that promote SOEs at the expense of foreign and private firms. Through president Xi's anticorruption campaign, the goal was to reduce inefficient managements and to increase the productivity in state sector. Until 2011 (from 2006), the growth of private industry investment had been quite strong. But after 2011 we see a significant increase in the share of state investment. By 2016 state investment rose at several times more than the private investment. The significant increase in investment spending (also can be realised through the leverage graph) is shown below (China' 40 Years of Reform and Development: 1978-2018 p.338).

Growth of state and private investment, 2007- 2016 (percent, year over year)

Source: NBS (2017: 310-11); National Bureau of Statistics of China website; China's 40 Years of Reform and Development 1978-2018

The final conclusion is that the China's economic growth in the reform era has been driven by the private sector in an increasing market-oriented environment. In recent years, however, the state banks have been allocating growing share of their loans to SOEs despite the obvious poor financial performance relative to privately owned enterprises.

China's GDP growth in the first three-and-a-half decades of economic reform was largely due to an expanding role of markets and private firms. Because Xi Jinping came to power in 2012, there has been more emphasis on the state enterprises, industrial policy and the role of the Communist Party in the economy. In spite of the evidence of the poor performance of SOEs the policy seems to be grasped strongly by the efforts of president and current rulers (China' 40 Years of Reform and Development: 1978-2018 p.341).

6. Policy recommendation to the current government

From my personal point of view, there's still large room for more economical

liberalisation and privatisation. More market supportive regulatory changes and private industry incentives should be implemented through laws and policies that can attract more innovative private capital investments. We can see from the data that in the past state sector has been lagging behind in terms of financial performance, productivity or other financial efficiency measures. China should provide more equal rights for its domestic entrepreneurs and international entrepereneurs. Equal access to land and credits should be encouraged more widely, in contrast to Xi Jinping's latest policies. More transparent procedures for fundings (for example, reducing the opaqueness of shadow banking), government subsidies for R&D and the promotion of value-added-goods production for private sector should be the necessary policies for Communist Party. The transperancy of SOEs domestic operations as well as international operations should be succeeded in order to attract more foreign capital and it should be regulated by law. Excessive party control and absolute authority cannot be managed at the same time with liberal market, so more caution needs to be exercised. Because these all will discourage the entry of private capital and avoid more broad commercial operations of effective enterprises. I think the Communist Party's announcement in 2018 about tariff reduction and market entry will enhance the private investments, as opposed to the state's resurgence. But trade conflicts with U.S. made it far from the achivement that can be done.

Additional reforms can be done for the China's potential growth. Very large SOEs need very careful studies and management system, also inhibits the competition which can be a disaster for self-regulating market. The M&A system should be inhibited because of the reasons mentioned in this paragraph. But liberal and market-driven M&As should be encouraged so that efficient private firms can acquire the assets of state firms that has been remained underperforming.

7. Conclusion

After 1978 and strong policy reforms of the Chinese leader Deng Xiaoping, we see a large privatistion and capitalisation in the market. SOE reforms increased the efficiency of the state-owned firms through the experienced private sector. For the last four decades, the government has encoured the free market and private sector but still hold the large part of the SOEs. Step by step achievemans towards more market-oriented economy come into existance in the data through efficiency indicators like return-on-assets, return-on-equity rates. China managed to sustain its long term high growth rate in last decades by the help of private sector. After Xi Xiaoping's presidency and anti-corruption campaign, it became evident that state began to surge again even though they also promise to provide more free markets and encouraging steps towards free-market. We need time to see the long term effects of the Xi's governancy, but it's obvious that China owes its past economical growth to its SOE reforms and private sector.

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