3

China's Failing Strategy to Reform State-Owned Enterprises

The analysis in chapter 2 demonstrates that the faltering economic performance of state firms has dragged down China's growth since the global financial crisis. The Communist Party of China and the government, however, claim to be implementing policies to improve the performance of state companies.

China initiated reform of state companies in the 1980s. The priority the party and government have given to this effort has waxed and waned over the ensuing decades and the results have varied widely—from the relatively successful reforms of the Zhu Rongji era to the near complete failure of the past decade. The current approach has six key dimensions: corporatization of traditional state firms, mergers to reduce the number of state firms, mixed ownership, debt-to-equity swaps, governance reforms, and financial reforms.

Corporatization

The first component of the current reform effort is to accelerate and complete the program of corporatization in which traditional state firms are converted to limited liability companies or joint stock companies. However, corporatization of state firms is not new, rather it has been an ongoing process since the National People's Congress passed the Company Law in 1994, which sets forth the process for converting traditional state-owned companies into corporations. The Company Law created the opportunity for the establishment of limited liability companies and shareholder limited companies (the latter sometimes translated as joint stock companies). Firms with either of these forms of ownership enjoy limited liability, have shareholders and must hold shareholder meetings, maintain shareholder lists, and issue stock certificates to shareholders. In both legal forms of ownership decision making is nominally vested in a board of directors (Zimmerman 2005, 129). The authorities expect these changes in corporate governance to improve efficiency and increase state-owned assets.

By 2011 about 106,000 state-owned companies, about 40 percent of the total number of state-owned companies, had been corporatized; this share rose to 119,000, or 43 percent of all state-owned companies, the following year (National Bureau of Statistics of China 2012, 27–28; 2013, 27–8). At the central level, by the end of 2016 the authorities had corporatized more than 92 percent of the subsidiaries of 101 central state firms.

The gradual and long-term nature of the corporatization process is confirmed in time series data for the corporatization of state-owned industrial firms (table 3.1). There were approximately 120,000 state industrial firms in 1995, the year after the National People's Congress enacted the Company Law (National Bureau of Statistics of China 1999, 421). These were all traditional state firms, known formally as "enterprises owned by the whole people." By 2000 the reported number of these firms had plummeted to only 42,000 (National Bureau of Statistics of China 2001, 401). This decline was not primarily because of corporatization but largely because the reform of state firms undertaken by Premier Zhu Rongji closed or privatized tens of thousands of loss-making state industrial firms. In 2000 there were only 11,000 corporatized state industrial firms, meaning that just under 10 percent of the state industrial firms in existence in 1995 had been corporatized (National Bureau of Statistics of China 2001, 401).[1] By 2006 the number of corporatized state industrial firms was basically unchanged while the number of traditional noncorporatized state industrial companies had fallen to less than 15,000 (National Bureau of Statistics of China 2006, 505). The decline presumably was because some combination of corporatization or exit of traditional state firms, mergers within the universe of traditional state firms, and takeovers of traditional state firms by corporatized state firms more than offset the number of new traditional state industrial firms that may have been created during this period.

The scope of the data reported by the statistical authorities on the number of state industrial firms changed first in 2007 and again in 2011, as indicated in table 3.1. But the share of state companies that were corporatized rose

1. The share would have been less than 10 percent if new state corporatized firms had been established between 1995 and 2000.

throughout. By 2015 corporatized state industrial firms controlled more than four-fifths of the assets of all state-owned industrial firms (National Bureau of Statistics of China 2016b, 419, 426).

A new push on corporatization was approved at the Central Economic Work Conference in December 2016 and confirmed by Premier Li Keqiang in March 2017 in his speech to the National People's Congress (Li Keqiang 2017). Shortly thereafter, in July 2017, the State Council formally announced plans to complete the corporatization of all central state firms, except those in the financial and cultural sectors, by the end of 2017 (State Council 2017b). This program will entail corporatizing an additional 3,200 subsidiaries of 69 central state firms.[2]

Further corporatization of state firms, now even more strongly embraced by the government as a policy goal, will not be transformative. As discussed in chapter 2, the financial performance of state-owned enterprises improved dramatically starting in the late 1990s continuing through the middle of the last decade. But it would be hard to credit this improvement to corporatization. As noted above, less than 10 percent of state industrial firms had been corporatized through 2000. The increasing return on assets of state industrial firms starting in the late 1990s and continuing until the eve of the global financial crisis, shown in figure 2.2, appears to be more the result of two factors. First, and most obvious, was exit or privatization of tens of thousands of the worst-performing state firms. Second, the significant increase in competition in the domestic market during China's lengthy negotiations to join the World Trade Organization (WTO) presumably stimulated some state companies to cut costs and adopt new technologies.

It is important to recognize that the increase in competition resulting from lower trade barriers did not begin in late 2001, when China formally entered the WTO. Rather, most of the reduction in tariffs and elimination of nontariff barriers, such as import quotas and import licensing requirements, occurred as part of the negotiation over the terms of China's formal entry. Existing WTO members argued that China had not participated in previous rounds of trade negotiations that had led to significant tariff reductions for existing WTO members and thus China needed to reduce its tariffs as a precondition of entry. During the long, drawn-out entry negotiations, China therefore unilaterally reduced its tariffs from an average statutory rate of 43 percent in 1985, on the eve of its formal request in mid-1986 to join the General Agreement on Tariffs and Trade (the predecessor to the WTO), to 15 percent in 2001,

2. Hu Yongqi and Zheng Xin, "Central SOEs reform will be done in 2017," *China Daily*, July 27, 2017, 1.

Table 3.1 Corporatization of state-owned industrial enterprises, 1995–2016 (number of enterprises)

Year	All industrial SOEs		Industrial SOEs with revenues more than RMB5 million		Industrial SOEs with revenues more than RMB20 million	
	Noncorporatized	Corporatized	Noncorporatized	Corporatized	Noncorporatized	Corporatized
1995	118,000	0	n.a.	n.a.	n.a.	n.a.
1996	113,800	0	n.a.	n.a.	n.a.	n.a.
1997	98,600	0	n.a.	n.a.	n.a.	n.a.
1998	64,700	0	n.a.	n.a.	n.a.	n.a.
1999	50,651	49	n.a.	n.a.	n.a.	n.a.
2000	42,426	11,074	n.a.	n.a.	n.a.	n.a.
2001	34,530	12,270	n.a.	n.a.	n.a.	n.a.
2002	29,449	11,651	n.a.	n.a.	n.a.	n.a.
2003	23,228	11,072	n.a.	n.a.	n.a.	n.a.
2004	23,417	12,183	n.a.	n.a.	n.a.	n.a.
2005	16,824	10,676	n.a.	n.a.	n.a.	n.a.
2006	14,555	10,445	n.a.	n.a.	n.a.	n.a.

2007	n.a.	n.a.	10,074	10,626	n.a.	n.a.
2008	n.a.	n.a.	9,682	11,018	n.a.	n.a.
2009	n.a.	n.a.	9,105	11,395	n.a.	n.a.
2010	n.a.	n.a.	8,726	11,574	n.a.	n.a.
2011	n.a.	n.a.	n.a.	n.a.	6,707	10,393
2012	n.a.	n.a.	n.a.	n.a.	6,770	11,130
2013	n.a.	n.a.	n.a.	n.a.	6,831	11,769
2014	n.a.	n.a.	n.a.	n.a.	3,450	15,350
2015	n.a.	n.a.	n.a.	n.a.	3,234	16,066
2016	n.a.	n.a.	n.a.	n.a.	2,459	16,563

SOEs = state-owned enterprises; n.a. = not available

Sources: National Bureau of Statistics of China (2017e, 413, 420); National Bureau of Statistics of China, data.stats.gov.cn (accessed on September 5, 2017); National Bureau of Statistics of China via Wind Financial Information (accessed on August 1, 2018).

on the eve of its accession (Lardy 2002, 34). In the next 15 years the tariff rate fell by only 5 percentage points to reach 10 percent.[3]

And the significant decline in the number of noncorporatized state industrial firms after 2007 coincided with a sharp decline in the average return on assets of state industrial companies. Perhaps the productivity decline would have been even larger in the absence of the corporatization program, but this would be a tough case to make. In any case, it appears very unlikely that the corporatization of the remaining traditional, noncorporatized state firms, which account for roughly one-fifth of state industrial assets, will transform the performance of state industrial firms.

Mergers

The second key component of China's state enterprise reform strategy is mergers among the largest state companies, invariably orchestrated by the State-Owned Assets Supervision and Administration Commission (SASAC).[4] Formally established in March 2003 at the central government level, SASAC initially was charged with improving the performance of 196 of China's largest nonfinancial state firms, including the three large state-owned oil companies, the three large state-owned telecommunication companies, most of the large state-owned electric power generation and steel companies, the two state-owned electric power distribution companies, the three largest state-owned airlines, and so forth (Lardy 2014, 50).

The economic footprint of the firms under central SASAC far exceeds the impression given by the relatively small number of firms it oversees. But these firms are invariably group companies or holding companies that control multiple subsidiaries. Counting subsidiary firms three levels down from the parent, these group and holding companies in 2010 controlled 23,738 firms, about one-fifth of all state nonfinancial companies. Including 52,371 subsidiaries of

3. See data at www.wto.org/english/res_e/statis_e/daily_update_e/tariff_profiles/CN_E.pdf.

4. These mergers typically do not involve any payments, as two state companies are in effect inserted into a newly created third state company. In August 2017, for example, Guodian Group Corporation, one of China's largest power generating companies, and Shenhua Group Limited Liability Company, China's largest coal mining company, merged to form the National Energy Investment Group Limited Company. While the merger creates a firm with more than $250 billion in assets, no value for the transaction was given, presumably since both firms were 100 percent owned by SASAC, as is the newly created firm (Zheng Xin and Lin Wenjie, "Shenhua and Guodian merger gets official nod," *China Daily*, August 29, 2017, 13). Mergers of this type are not included in the data in table 4.1 in chapter 4 or in merger and acquisition activity announced by the China Securities Regulatory Commission.

companies controlled by SASAC entities at the provincial level, SASAC controls three-fifths of all state nonfinancial companies (SASAC 2011, 737). It is little wonder that the US-China Economic and Security Review Commission (2012, 48) characterized SASAC as "the world's largest and most powerful holding company."

Initially, the Ministry of Finance sought to limit SASAC's direct intervention in the day-to-day operations of this universe of large state nonfinancial companies (Naughton 2016a). Rather, SASAC would assume a role like Temasek in Singapore, a financial holding company that manages Singapore's state-owned companies on behalf of the Ministry of Finance (Tidrick 2012). Temasek is charged with generating sustainable returns over a multigenerational period. Actual day-to-day operations of Temasek's portfolio of companies, which includes such iconic firms as Singapore Airlines, are in the hands of professional management. This view, however, did not prevail, and SASAC assumed direct management of its subordinate firms.

Almost immediately after its formation, central SASAC began orchestrating many mergers of firms largely within individual industries; indeed, that appears to have been its major strategy for improving the economic and financial performance of these large state firms.[5] By 2013 these mergers had reduced the number of state firms in the central SASAC universe from around 200 to only 113.

After a brief hiatus between 2012 and 2014, when only five mergers took place, central SASAC resumed its more rapid pace of mergers in the second half of 2015, as shown in table 3.2 (Leutert 2016, 2). The new drive was part of a September 2015 State Council and Central Committee document "Guiding Opinion on Deepening the Reform of State-owned Enterprises" (Chinese Communist Party Central Committee and State Council 2015). By

5. In addition to organizing mergers of firms within the same industry, in 2010 SASAC created China Reform Holdings. One of its functions was to serve as a holding company for some SASAC firms in industries where the SASAC universe includes only a single firm. In addition, China Reform Holdings invests both domestically and abroad. It has, for example, taken a 6 percent stake in China Tower, the entity holding the mobile communications infrastructure assets divested by China's three major telecom companies, and it purchased half of the Central Asia Pipeline of PetroChina ("PetroChina: Reform and Substance," *China Daily*, November 27, 2015, 12). Internationally, for example, China Reform Holdings financially backs both Canyon Bridge, a Silicon Valley–based private equity fund that invests in technology assets, and CNIC Corporation, a Hong Kong–registered business that is majority-owned by China's State Administration of Foreign Exchange. See Don Weinland, Leslie Hook, Lucy Hornby, and Peter Wise, "China's Safe agency revealed as holder of 5% stake in EDP," *Financial Times*, June 20, 2018, 15.

Table 3.2 SASAC-orchestrated mergers, 2015–17

Company name	Company name	Date of merger
Shenhua Group	China Guodian Corporation	August 2017
China National Machinery Industry Corporation (Sinomach)	China High-Tech Group	June 2017
China Grain Reserves Corporation (Sinograin)	China National Cotton Reserves Corporation	November 2016
China National Building Materials Group Corporation	China National Materials Corporation (Sinoma)	August 2016
China National Cereals, Oils and Foodstuffs Corporation (COFCO)	Chinatex Corporation	July 2016
China National Travel Service (HK) Group Corporation	China International Trade Services Group Corporation	July 2016
China Merchants Group	Sinotrans & CSC Holding Company	December 2015
China Ocean Shipping Group	China Shipping Group	December 2015
China Metallurgical Group	China Minmetals Corporation	December 2015
China Nam Kwong Group	Zhuhai Zhenrong Corporation	December 2015
CNR Corporation	CSR Corporation	August 2015
China Power Investment Corporation	State Nuclear Power Technology Corporation	June 2015

Source: State-Owned Assets Supervision and Administration Commission of the State Council (SASAC), www.sasac.gov.cn (accessed on September 5, 2017).

the late summer of 2017 this new round of mergers had reduced the number of central SASAC firms to fewer than 100.

But SASAC's own data, reflected in table 3.3, show that these mergers failed to improve the financial performance of the state firms administered by central SASAC; indeed, the opposite is true. Initially, the return on assets of these firms rose slightly to 6.7 percent in 2007 but then plummeted to 3.9 percent in 2008–09 at the height of the global financial crisis. Returns recovered slightly in 2010 but fell to a low of 2.4 percent in 2016 before recovering slightly to 2.6 percent in 2017. But the recovery in 2017 appears to have been driven by a cyclical recovery in global commodity prices, which boosted profits of state companies in some upstream industries, rather than an across-the-board improvement in the operation of SASAC firms. In upstream oil and gas, for example, above-scale companies recorded profits of RMB39 billion in 2017, compared with losses of RMB48 billion in 2016 (National Bureau of Statistics of China 2018c). Since state companies dominate upstream oil and

Table 3.3 Return on assets of central SASAC enterprises, 2005–17

Year	Profits (billions of renminbi)	Assets (billions of renminbi)	Return on assets (percent)	Liabilities/ assets ratio (percent)
2005	641	10,630	6.0	56.1
2006	765	12,192	6.3	55.8
2007	997	14,927	6.7	55.7
2008	696	17,629	3.9	58.4
2009	815	21,058	3.9	60.1
2010	1,143	24,427	4.7	60.8
2011	1,266	28,036	4.5	62.1
2012	1,300	31,357	4.1	62.7
2013	1,300	35,017	3.7	63.4
2014	1,400	38,669	3.6	63.0
2015	1,167	47,581	2.5	66.7
2016	1,233	50,500	2.4	66.7
2017	1,423	54,500	2.6	66.3

Source: State-Owned Assets Supervision and Administration Commission (SASAC), sasac.gov.cn (accessed on March 14, 2018).

gas, this swing in profitability in a single industry accounts for a third of the increased profits of SASAC companies in 2017.[6]

The long-term decline in the return on assets was implicitly acknowledged by the top leaders of SASAC in a 2017 review of SASAC's performance following the 18th Party Congress. They pointed out that between 2012 and 2016 cumulative pretax profits of central SASAC enterprises were RMB6.4 trillion, an increase of 30.6 percent compared with the previous five-year period. But they also acknowledged that assets of these firms by the end of 2016 were 80 percent larger than in 2011, implying but not stating that the return on assets of central SASAC firms had plummeted.[7] SASAC has also publicly acknowl-

6. In 2015, for example, state-owned upstream oil and gas firms (i.e., firms in the exploration and extraction end of the industry) accounted for about 85 percent of the revenues and 70 percent of the profits in the industry. Total SASAC profits in 2017 increased by RMB190 billion compared with 2016, so one can estimate that the increase in state oil firm profits (= 0.7 x RMB90 billion) accounted for about a third of the increase in profits of firms in the SASAC universe.

7. "Xiao Yaqing and Huang Danhua attend a news conference on enterprise reform conducted by the State Council Information Office," September 30, 2017, sasac.gov.cn (accessed on October 3, 2017). Xiao and Huang are, respectively, the chairman and vice chairwoman of SASAC.

edged that at the end of 2016 there were 2,041 zombie companies among the subsidiaries of its group companies.[8]

Two additional points are worth underscoring. First, the deteriorating performance of central SASAC firms is particularly telling since this universe of firms is not limited to state industrial companies (for which more complete data are available) but includes many state-owned service sector firms (but not any financial services firms).

Second, SASAC's management has not focused entirely on using mergers to reduce the number of firms under its purview. It has also overseen a stunning increase in the assets of SASAC firms, far beyond what could have been financed with retained earnings. As shown in table 3.3, assets of these firms at the end of 2017 were almost RMB55 trillion, an increase of more than RMB40 trillion over 2005. This increase in assets is fully four times the cumulative after-tax profits generated by these firms over the same period.[9] The increase in the indebtedness of these firms is confirmed in the final column of the table, which shows that the ratio of liabilities to assets for this group of firms rose steadily from about 56 percent prior to the global financial crisis to 66 percent in 2015–17. In short, even though these firms' return on assets, and thus also the retained earnings that could be used to finance investment, was plummeting, they had access to enormous amounts of funding through bank loans and bond and equity issuance. Perhaps the deterioration in the returns of central SASAC firms would have been even more pronounced in the absence of the merger program, but there is no evidence in favor of this hypothesis. The view of the *Financial Times* that the consolidation of Chinese state-owned groups has led to "reduced leverage and higher margins" is complete fiction.[10]

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8. Zheng Xin, "Exit fund for enterprises can help ease bad debt issue," *China Daily*, July 12, 2018, 14.

9. After-tax profits are calculated by applying the 25 percent corporate tax rate to the annual pretax profit figures in table 3.3. This analysis assumes that depreciation funds, also part of cash flow, are invested to offset real depreciation. The asset figures in the table are net assets, i.e., depreciated assets. Thus, for example, in 2016 net investment was about RMB2.9 trillion, of which only a maximum of RMB1.2 trillion could have been financed with after-tax profits. SASAC firms are required to pay into the state capital management budget, and some listed subsidiaries of SASAC group companies pay dividends to shareholders. Both are financed from after-tax profits, so the amount of investment SASAC firms as a group can finance internally is less than their after-tax profits.

10. Lex, "Sinochem/ChemChina: Trading Places," *Financial Times*, July 3, 2018, 10.

Mixed Ownership

The third key component of the government's plan to transform state companies is mixed ownership—introducing collective or private capital into state firms to rejuvenate them. This program too is not new but, like corporatization and top-down mergers, is a long-standing government policy. Former president Jiang Zemin promoted mixed ownership more than two decades ago. In his speech to the 15th Party Congress in September 1997, Jiang, who served as general secretary of the Chinese Communist Party from 1989 to 2002, argued that public ownership was not limited to state and collective enterprises but included so-called mixed ownership (Jiang Zemin 1997). The Central Committee of the Chinese Communist Party endorsed mixed ownership in a major reform document approved at the 3rd Plenum of the 18th Central Committee in 2013. And the highest level of the government further promoted mixed ownership two years later (State Council 2015b).

By mid-2017 over two-thirds of all central state firms and over half of their subsidiaries had introduced mixed ownership.[11] But the spread of mixed ownership also coincides with a continuous and marked decline in the financial performance of state firms since 2007. It is not clear why the authorities expect that introducing mixed ownership in more state firms will transform them. Some critics of the program argue that mixed ownership is simply a means of bringing in private capital, thereby reducing the burden on state banks to support state companies (Economy 2018, 113).

An example may help to explain the limits of the campaign to promote mixed ownership. In mid-2017 Alibaba and Tencent, two of China's most successful private internet companies, entered into an agreement to set up two research and development centers with China United Network Communications Group Co. Ltd., sometimes referred to as China Unicom Group, China's second largest telecommunications company.[12] Shortly thereafter, Alibaba, Tencent, and two other large private technology firms, Baidu and JD.com, joined a few large state firms to invest RMB78 billion ($11.7 billion) to acquire a 35 percent stake in China United Network Communications Ltd., more commonly known as China Unicom, the Shanghai-listed subsidiary of the group company that holds most of the group company's operating assets. Since retail investors, by definition nonpublic entities, held about

11. "Reform of State-Owned Enterprises Has Achieved Great Success Since the 18th Party Congress," July 27, 2017, www.sasac.gov.cn (accessed on July 28, 2017).

12. Ma Si, "Alibaba, Tencent want pieces of telecom giant," *China Daily*, August 2, 2017, 2; Ma Si, "Alibaba to expand in telecom sector," *China Daily*, August 2, 2017, 13.

a third of the shares of this listed company prior to the transaction, it was already a mixed ownership company.[13] The sale of shares to new investors by the unlisted parent, China Unicom Group, reduced its ownership stake in the listed company from 63 to 37 percent.[14]

China's leading technology companies may indirectly benefit from the transaction, since it will provide funds for the cellular carrier to expand its 4G cellular network and develop 5G technology, both of which will further develop the online services these companies offer (Xie 2017).

Whether it will improve the operations of Unicom is less clear. While the transaction was hailed in the Chinese press as a "milestone in SOE reform," little seems to have changed.[15] The four private technology companies have acquired small minority stakes in the Shanghai-listed subsidiary, but as noted above, the subsidiary was already a mixed ownership company prior to this transaction. Digging through the details, it appears as if China Unicom Group and the other large state companies combined retain a 58 percent ownership stake in the listed company, so it remains a state-controlled company (Xie 2017). And China Unicom Group remains 100 percent state-owned and the dominant, controlling shareholder of its Shanghai listed subsidiary. The only innovation of this transaction is that 3 percent of the shares of the subsidiary have been set aside for managers and workers as part of an employee shareholding scheme (Xie 2017).

In 2018 mixed ownership took a negative turn as state companies began to buy up distressed private companies in involuntary transactions. A declining domestic stock market squeezed private entrepreneurs who had pledged their stakes as collateral for bank loans. "Faced with margin calls and cut off from the banking system, some entrepreneurs had little choice but to accept state money."[16]

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13. The public holds 37.25 percent of the shares of China United Network Communications Ltd., the subsidiary listed in Shanghai, and 25.64 percent of the shares of a second subsidiary, China United Network Communications (Hong Kong) Limited, listed in Hong Kong and commonly known as China Unicom (Hong Kong). These and other details on the ownership structure of the group company and its subsidiaries are available at www.chinaunicom-a.com/wcm/aboutUs/equityStructure (accessed on August 2, 2017).

14. Don Weinland, "Alibaba and Tencent join state-owned groups in $11.7 billion China Unicom Investment," *Financial Times*, August 17, 2017, 12.

15. Fan Feifei, "China Unicom shakeup a milestone in SOE reform," *China Daily*, August 18, 2017, 7.

16. "China Is Buying Distressed Private Companies as Markets Sink," Bloomberg News, October 29, 2018. Available at https://www.bloomberg.com/new/articles (accessed on November 12, 2018).

Debt-to-Equity Swaps

The fourth component of the government's program to reform state-owned enterprises is debt-to-equity swaps in which banks forgive loans outstanding to an enterprise in exchange for equity in the firm.[17] The logic is straightforward—the profitability of a firm that is only marginally profitable or even loss making will be improved if more of its funding takes the form of equity rather than debt. Premier Zhu Rongji used this approach as part of the state enterprise restructuring program he implemented beginning in the late 1990s and the government resurrected it in a modified form starting in 2016 (State Council 2016b).

In practice, to date debt-to-equity swaps have been limited in scale, partly by design and partly because of difficulties in implementation. By the end of 2017 banks had reached swap agreements with only 102 companies with a total amount of RMB1.6 trillion. However, only RMB230 billion in swaps had been executed, a rounding error relative to RMB132 trillion in loans outstanding to nonfinancial corporations at the end of 2017.[18] Almost all swaps have been with state-owned rather than private companies.[19] To encourage more swaps the central bank in mid-2018 cut the required reserve ratio of almost 20 banks by 0.5 percentage point, freeing up about RMB500 billion, on the condition that the banks use the funds to complete debt-to-equity projects already approved but not yet executed.[20]

The central bank guidelines on the swap program suggest its limits. First, zombie firms are not eligible to participate in the program. The swaps are aimed primarily at firms with "special mention loans" outstanding, one step

17. Banks do not directly own equity. They inject capital into a legally separate, wholly owned vehicle, which purchases the loans from the bank and then swaps them for equity in the initial borrower. The banks thus technically avoid violating the Commercial Bank Law, which prohibits them from directly owning equity in nonfinancial corporations. Banks, however, remain at risk because if the vehicle can't eventually sell the equity for at least the amount of the initial loan, the value of the vehicle will fall, an event that would have to be reflected on the bank's consolidated balance sheet.

18. "Five Large Banks Have Signed Debt-to-Equity Swaps Valued at RMB1.6 trillion," *Securities News*, June 12, 2018, www.xinhuanet.com/money (accessed on June 25, 2018).

19. According to public information on 81 cases of debt-to-equity swaps reached through September 2017, involving a total of RMB1.3 trillion, only one case involved a private company; the rest were all state companies, mostly controlled by local governments. UBS Global Research, "SOE reform and bank NPL series (1): Debt-to equity swaps—positive but likely modest impact," October 10, 2017.

20. China International Capital Corporation, "PBoC announces another relatively broad-based RRR cut of 50bp," Macroeconomy Research, PBoC Watch, June 24, 2018.

above nonperforming in China's loan classification scheme,[21] or normal loans. Second, in principle pricing of swaps should be market-oriented. But very few firms are publicly listed, which would provide at least a starting point for negotiation on price. So in practice the book value of the firm frequently is the starting point, followed by lengthy negotiation on the size of the discount to be applied to the book value. Third, to encourage mixed ownership, outside nonfinancial investors should match the banks' funding. Finally, the nonfinancial investors should participate in the management of the firm after the swap. Negotiation on the nature of this participation could be a major hurdle. An outside nonfinancial investor presumably would seek control, probably a deal breaker for incumbent managers.

Governance Reforms

A few years ago, when the government launched an initiative to divide state nonfinancial firms into two categories—commercial and public service—China seemed to be moving in the direction of requiring most state enterprises to focus primarily on improving their financial performance (Naughton 2018, 380–81; Song 2018, 362). Clearly most state enterprises would be classified as commercial and judged primarily based on profitability and other familiar financial metrics.[22] Loss-making firms in this universe thus would no longer have ongoing access to bank loans and other sources of finance, presumably meaning that continued loss making by these firms would lead to bankruptcy or a takeover by another firm. On the other hand, a small share of state firms that provide public services, such as local utility and subway companies, which operate in a regulated price environment, can't easily be judged solely on profitability and other financial metrics. These firms may lose money because the state sets prices at a low level, so they were to be judged partly on the quality of the goods and services they provide. Commercial state firms were also authorized to raise money from outside investors, even to the point where the state's share fell under 50 percent, thus tying in with the mixed ownership reforms.

21. China has a five-tier loan classification system: performing, no overdue payments; special mention, payments overdue less than 90 days; substandard, payments overdue more than 90 but less than 180 days; doubtful, payments overdue more than 180 but less than 360 days; and loss, payments more than 360 days overdue. The last three categories comprise the universe of nonperforming loans.

22. Some commercial enterprises in sectors key to national security would be judged in part on additional, unspecified criteria.

SASAC, which was responsible for dividing the firms it controls into the two categories, reportedly completed the process in 2014. But, for unexplained reasons, this mapping of firms was rejected, and the process restarted. SASAC again declared the process complete in 2017 both at the central level and at all 31 provincial-level SASACs, but no information has been released on the number of firms in each category or which firms they are (Naughton 2018, 380–81). The most plausible conjecture for this result is that powerful vested interests at large state companies that were tentatively classified as commercial were able to fend off the attempt to make their firms responsible for their own profits and losses.

Financial Reforms

The first essential step in financial reform is for the regulatory and other authorities to obtain more accurate information on the banks themselves. Chinese financial authorities understand that the reported levels of nonperforming loans to state-owned enterprises are understated, resulting in an overstatement of bank profits. After all, since 2011, the China Banking Regulatory Commission[23] has allowed banks to classify loans in the "overdue but not impaired" category in their long-form financial statements, which more than 200 banks have done to dodge categorizing bad loans as nonperforming (Bedford 2018). Thus, profits are overstated by uncertain amounts, making evaluation of banks on financial metrics problematic. That, in turn, makes it possible for banks to continue to lend to loss-making companies.

In the first half of 2018 the China Banking and Insurance Regulatory Commission took two steps that should lead to more accurate measurement of the quality of loans in the Chinese banking system. First, in early 2018 the regulator reduced the amount of funds banks have to set aside to cover bad loans in order to reward banks that more accurately report nonperforming loans.[24] For example, required provisions as a share of nonperforming loans would be reduced from 150 to 120 percent, conditional on fulfilling certain other conditions.[25] A few months later the regulator, in a further attempt to

23. The China Banking Regulatory Commission (CBRC) and China Insurance Regulatory Commission (CIRC) merged to form China Banking and Insurance Regulatory Commission in April 2018.

24. Jiang Xueqing and Chen Jia, "Bad debt disposal seen improving," *China Daily*, March 18, 2018, 15.

25. The required level of provisioning for the five categories of loans (see footnote 21) are 1 percent; 2–3 percent; 25–30 percent; 50–60 percent; and 100 percent (Bedford 2018, 12). Provisions are also required to reach 150 percent of total nonperforming loans.

improve bad loan recognition, eliminated the practice of classifying loans as "overdue but not impaired." City and rural commercial banks, which are most disproportionately affected by the new rule, are allowed to delay implementation until 2019 (Bedford 2018).

There is no visible progress on the second critical reform in the financial sector—the capture of second-tier banks by local officials. Even when these banks are listed, local governments often exercise control. The more general problem is that there is "no substantial competition between fully private and publicly owned banks" (IMF 2018). The number of truly private domestic banks is tiny and their role in the financial sector is quite limited. Similarly, foreign banks are so few that they do not enhance competition in the financial sector. Central bank governor Zhou Xiaochuan long sought to further open the financial system to more foreign competition. He argued that too much protection for domestic institutions weakens the industry and can lead to financial instability.[26] Zhou appears to have been the architect of the financial liberalization program finally announced in late 2017.[27] The program entails lifting caps on foreign ownership, which have long prevailed in banking, asset management, securities, and insurance.[28] Once fully implemented, this program could contribute to more efficient allocation of financial resources, especially bank credit. However, foreign banks are likely to play a small role in the dozens of smaller administrative regions where city and rural commercial banks operate, so local zombie companies may continue to get bank support.

Conclusion

It is not surprising that corporatization, mergers, mixed ownership, debt-to-equity swaps, and governance and financial reforms have thus far failed to improve the performance of state-owned companies. The first three programs appear to involve more form than substance. Most of the state firms that are corporatized and adopt mixed ownership remain state-controlled, meaning that the state continues to be the majority or at least the dominant, controlling shareholder. And the group companies that have been merged to date

26. Bloomberg News, "Zhou's Jibe at 'Lazy' Banks Signals China More Open for Business," June 19, 2017, www.bloomberg.com (accessed on March 6, 2018).

27. Bloomberg News, "China PBOC to Draft Package for Financial Market Opening, Sources Say," September 18, 2017, www.bloomberg.com (accessed on September 20, 2017).

28. "China's financial groups opened to foreign owners," *Financial Times*, November 13, 2017, 8.

under SASAC guidance remain 100 percent state-owned.[29] The Organization Department of the Chinese Communist Party in many cases continues to appoint the top management; the Party Committee within each firm retains a central role in major corporate decisions; and there is little or no increase in transparency.

While the State Council (2017a) advises strengthening the role of the board of directors in state companies converting to corporate ownership, these boards appear to be largely window dressing. In market economies, the key function of any corporate board is to select and remove top management, decisions that are only nominally controlled by the board in Chinese state companies. Technically the Organization Department nominates and boards confirm candidates to the top three management positions in large state companies. But there are no known cases where the board of a state-controlled company has failed to confirm the nominees chosen by the party's Organization Department.

Since they are subject to stricter disclosure requirements, transparency is improved in corporatized state-owned firms that are subsequently listed on the Shanghai or Shenzhen stock exchanges. But it is important to keep in mind that this group of firms is a tiny subset of corporatized state firms in China. For example, of the almost 120,000 corporatized state-owned nonfinancial firms in 2012, only 966 were listed on either the Shanghai or Shenzhen Stock Exchange.[30]

SASAC's merger program has not improved corporate governance but has reduced competition and created new monopolies, impeding innovation, productivity, and financial performance of SASAC firms.

While the objectives of the debt-to-equity program are laudable, its scale to date has been too small to reduce the leverage or improve the financial performance of China's state-owned companies.

Finally, the corporate governance and financial reform programs have barely gotten off the ground, making the goal of judging state banks or state firms based on financial metrics elusive.

29. In mid-2018 SASAC announced that it would begin introducing mixed ownership in group companies.

30. Data from Wind Financial Information.