GavekalDragonomics

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The State Of The State Sector

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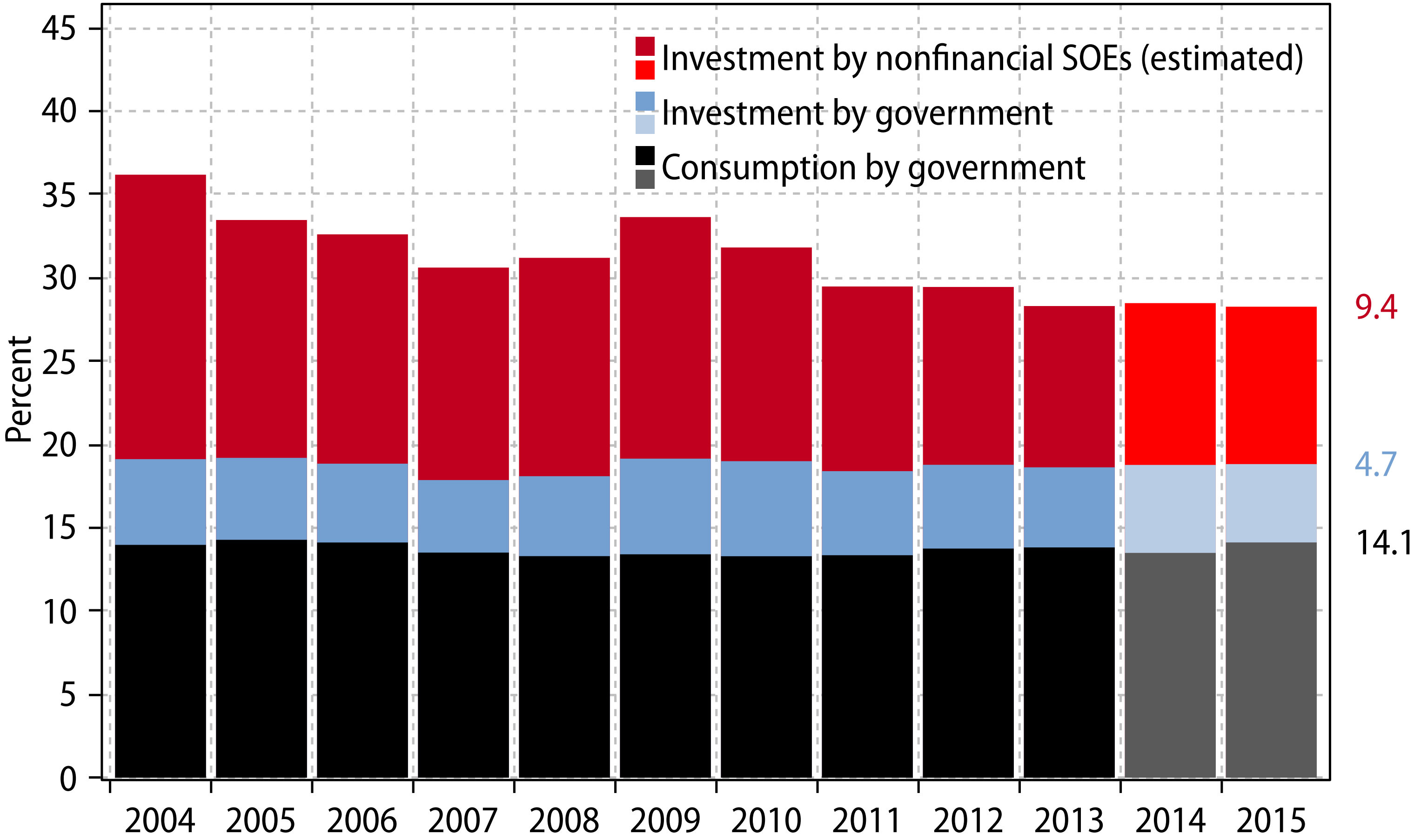
Economic role

The size and functions of China's SOE sector

State share of GDP

Government entities account for about 30% of the Chinese economy

State share of China GDP, estimated based on flow of funds and FAI



CEIC, Gavekal Data/Macrobond

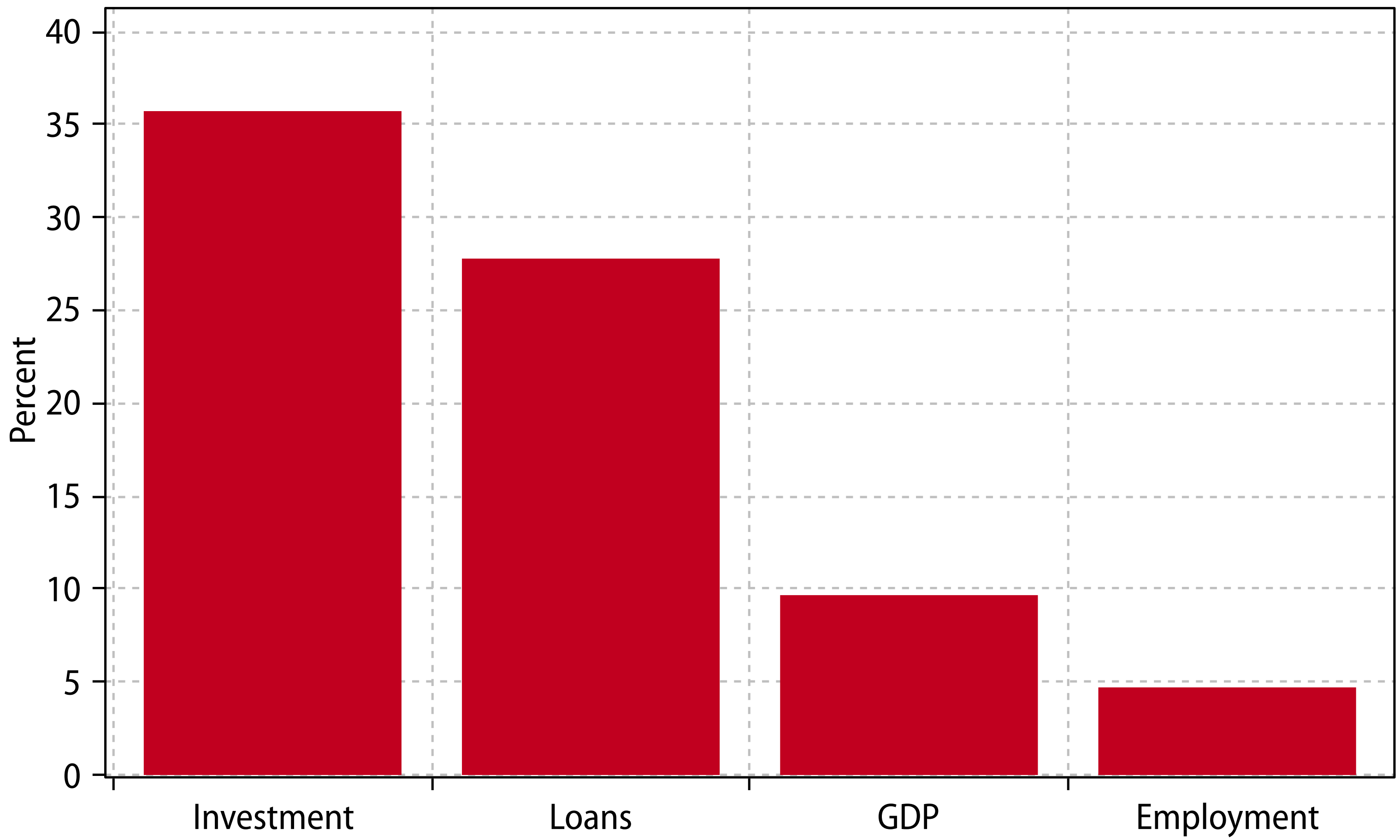
While China does not publish official data on the economic size of SOEs, a rough estimate is possible. Capital formation by corporations accounts for about 30% of GDP; applying SOEs' one-third share of fixed-asset investment suggests SOEs account for about 10% of GDP directly. Government spending makes up another 20% or so.

While some may find these estimates low, they are not. Even in the statist 1960s-70s, SOEs in France and the UK did not account for more than 15-20% of capital formation; in the 1980s the developed-nation average was around 8%, and it dropped below 5% in the 1990s. SOEs' role in China is many times larger.

The economic contribution of SOEs

SOEs borrow and invest a lot while contributing less to GDP and jobs

State-owned enterprises share of economic aggregates, latest available



CEIC, PBOC, MOF, Gavekal Data/Macrobond

The SOE sector in China is certainly the world's biggest in absolute terms, and is also extremely large in relative terms (Russia's is probably still larger, estimated to be around 30% of GDP and employment in 2009).

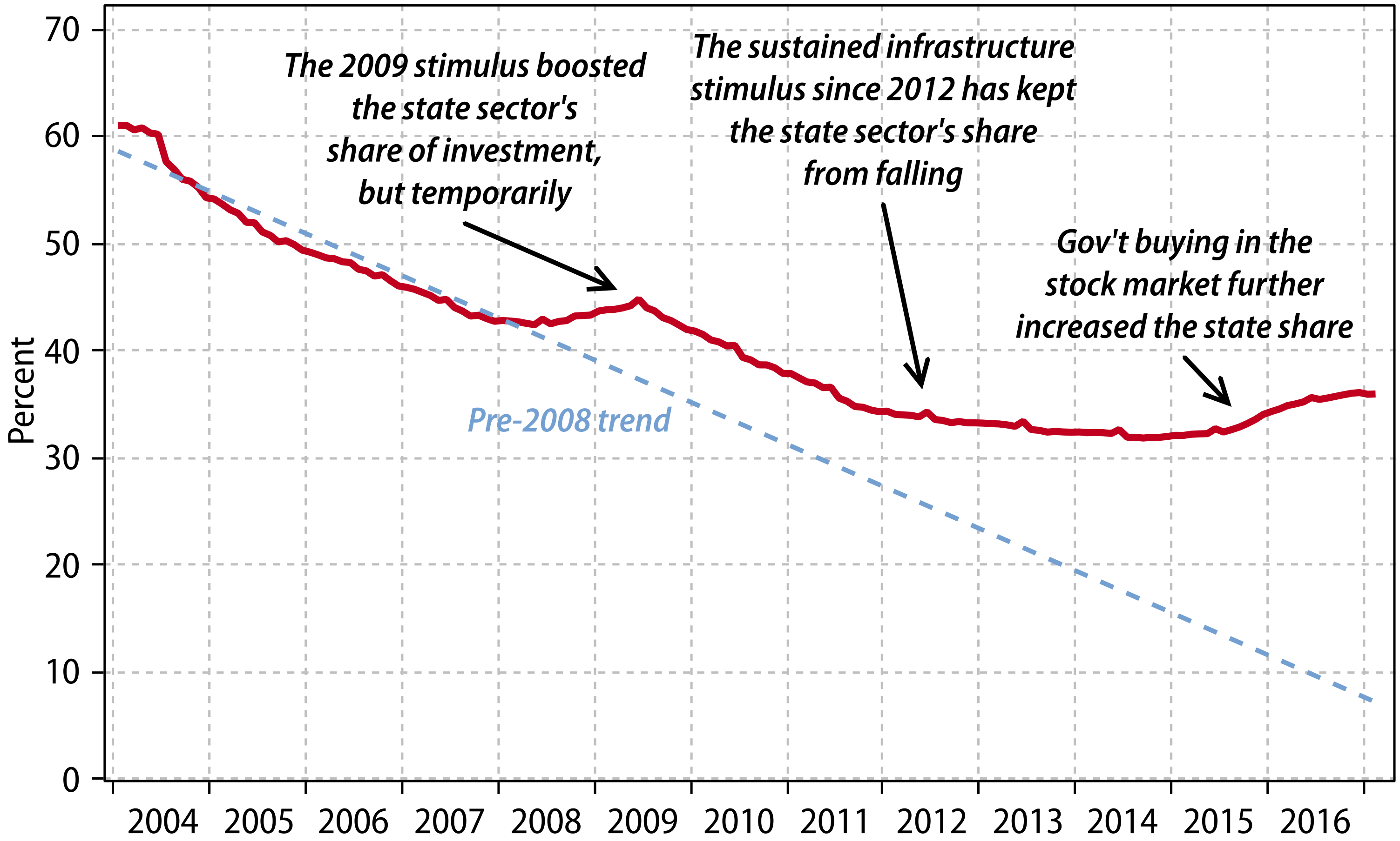
While the size of the SOE sector does not capture all the many ways in which the government influences the economy, it is clear that China's modern economy has mostly grown outside of formal state ownership.

The debate today is over is what role the state sector plays in a mostly private economy: SOEs account for a disproportionate share of bank lending and capital spending, but underperform in terms of growth and job creation.

State share of investment

The retreat of the state sector has ended

State-controlled firms' share of fixed-asset investment, 13mcma



CEIC, Gavekal Data/Macrobond

There has been regular debate over the "advance" or "retreat" of the state sector in China.

The best high-frequency indicator of SOEs' presence in the economy is probably their share of fixed-asset investment. This data series uses a broad, and therefore more accurate, definition of state ownership.

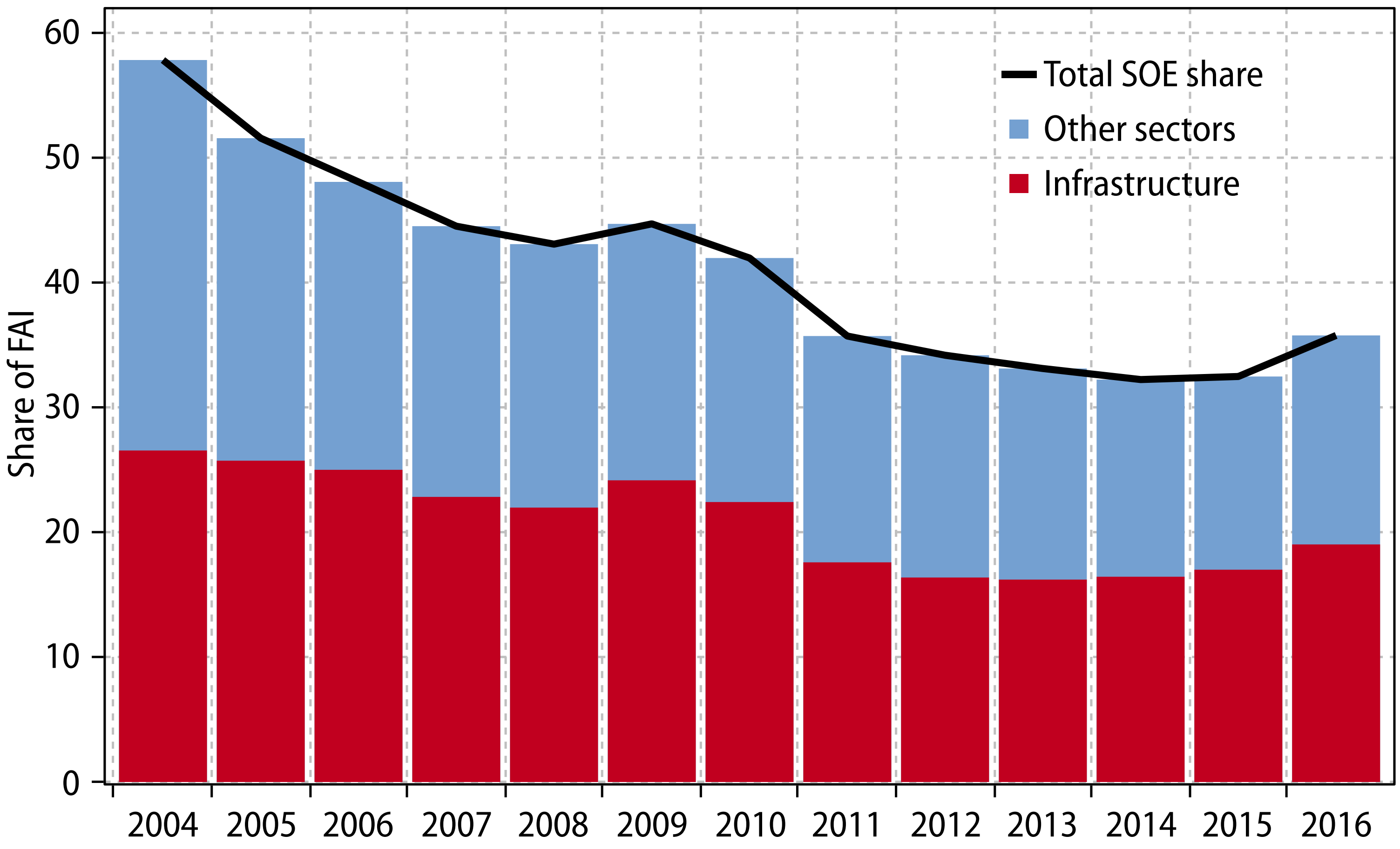
Before 2008, the state share of investment steadily declined—not because of privatization, but because private firms grew faster and invested more.

But the state share stopped falling around 2012 and has made a comeback. Given the poor performance of SOEs, this is negative for China's longer-term prospects.

Infrastructure and SOEs

Infrastructure stimulus keeps the SOE share of investment high

Contribution to SOE share of total fixed-asset investment, by sector



NBS, Gavekal Data/Macrobond

SOEs have consistently accounted for 70-80% of infrastructure investment in recent years. An infrastructure stimulus is by definition an SOE stimulus, and the central government has repeatedly used public works spending to stimulate the economy since 2008.

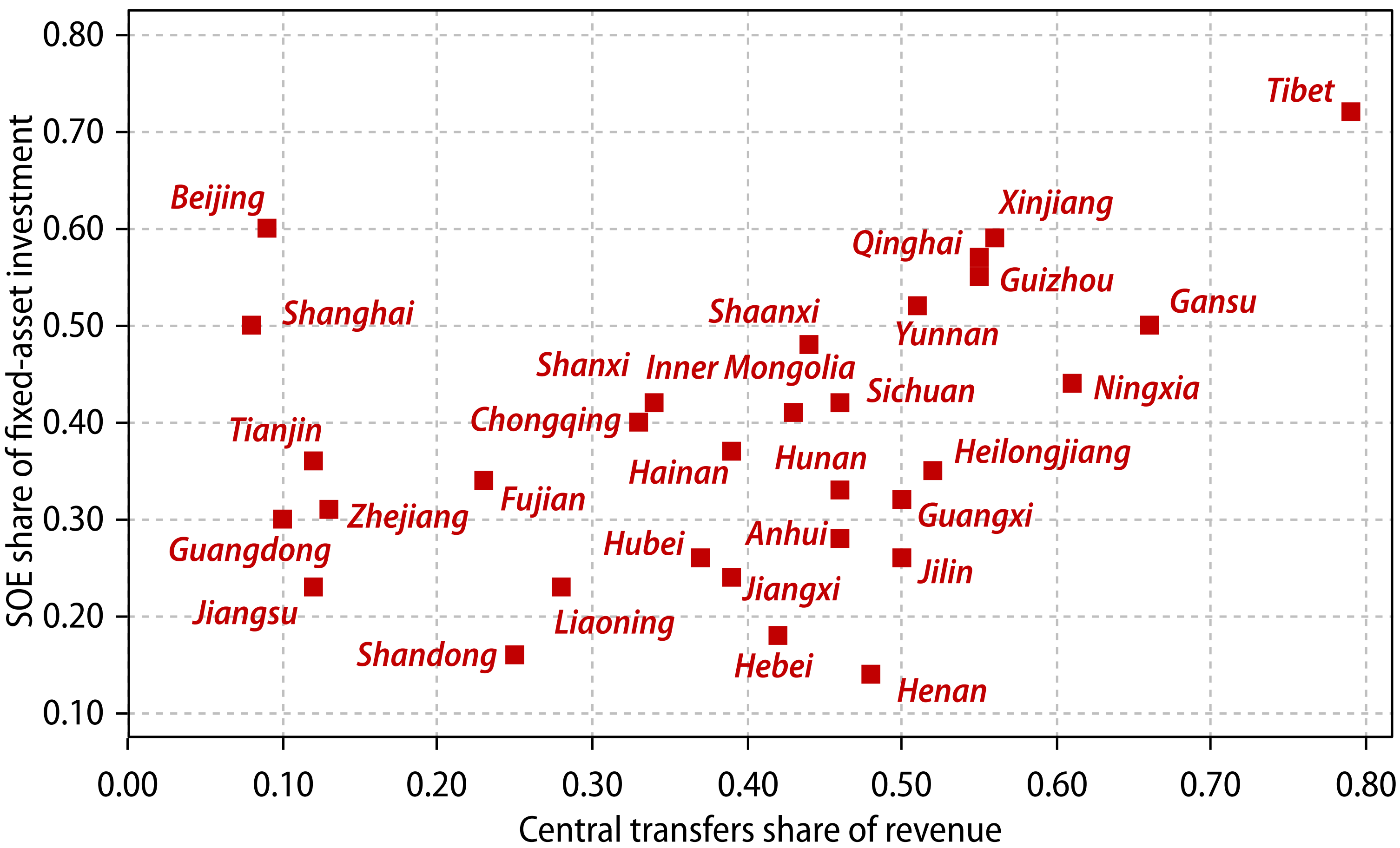
So the most important economic role of SOEs in recent years has been to act as government agents to support growth. Local-level SOEs of course take the lead in infrastructure, but central-level SOEs must also respond to government priorities.

The idea that SOEs should primarily be independent, profit-seeking companies has been largely abandoned. Rhetoric now emphasizes them serving the Party.

SOE support to provinces

SOEs are used to deliver investment to poor and inland provinces

Two dimensions of state support are correlated: fiscal transfers and SOE investment

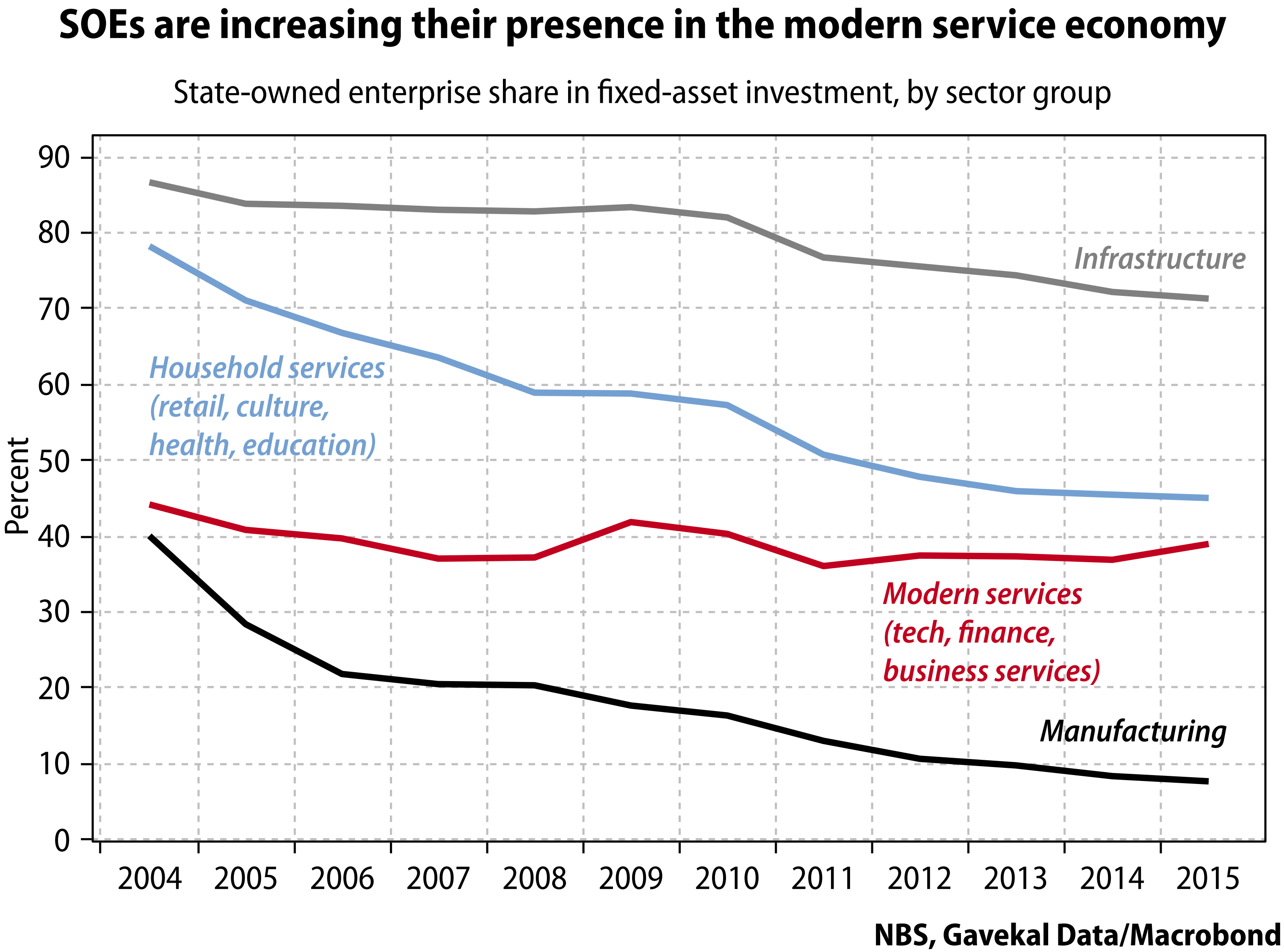


CEIC, CNKI, Gavekal Data/Macrobond

About 60% of fixed-asset investment by SOEs goes to inland provinces, mostly in the form of infrastructure. As these provinces account for less than half of national GDP, SOE investment is clearly part of a strategy to redistribute income and support poorer provinces. Also, the share of SOE investment in provincial economies is highly correlated with fiscal transfers from the center.

SOEs' economic role is thus not just to support national economic growth, but also to deliver regional aid. However inland provinces' heavy reliance on state support may hinder them from developing more sustainable growth models.

SOE share of investment by sector



Another important economic role of SOEs is fulfilling the government's goal of having a state presence in strategic sectors of the economy.

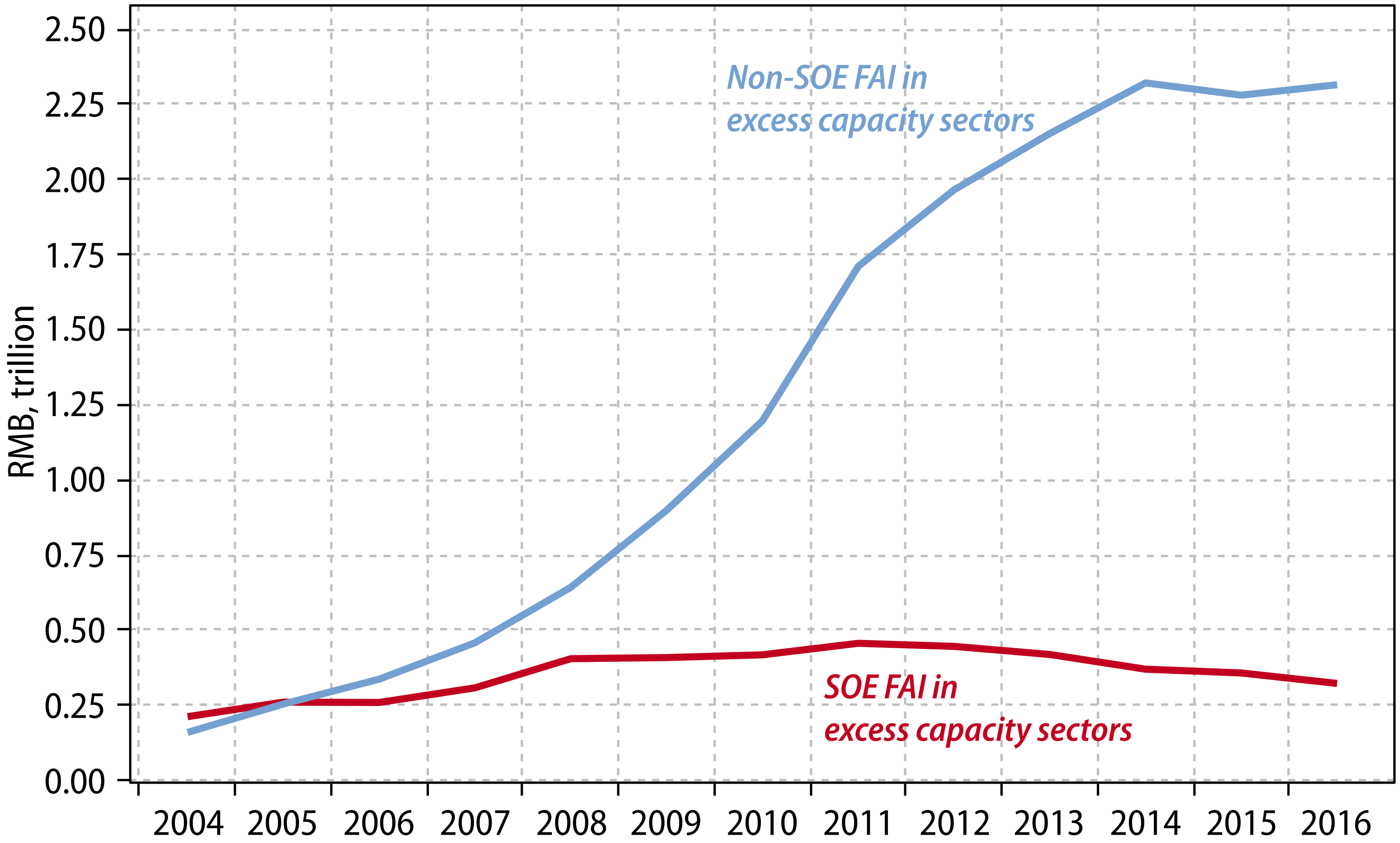
In the past this meant SOEs controlling the "lifelines" of energy, communication and transport networks. These strategic sectors are still dominated by SOEs, though private firms' role in local infrastructure is increasing.

But SOEs are now also boosting their presence in the fast-growing technology and services sectors. Their share of less-strategic sectors is still gradually declining, but at a much slower pace than in the pre-2008 period. This points to some crowding-out of private investment.

Excess capacity sectors

Who is responsible for the buildup in excess capacity?

Excess capacity sectors = coal, iron, steel, building materials



NBS, Gavekal Data/Macrobond

The extreme downturn in China's heavy industrial sectors since 2012 has focused attention on the role of SOEs in these sectors.

The excess capacity sectors (defined here as coal, iron, steel and building materials) account for about 10% of total SOE assets.

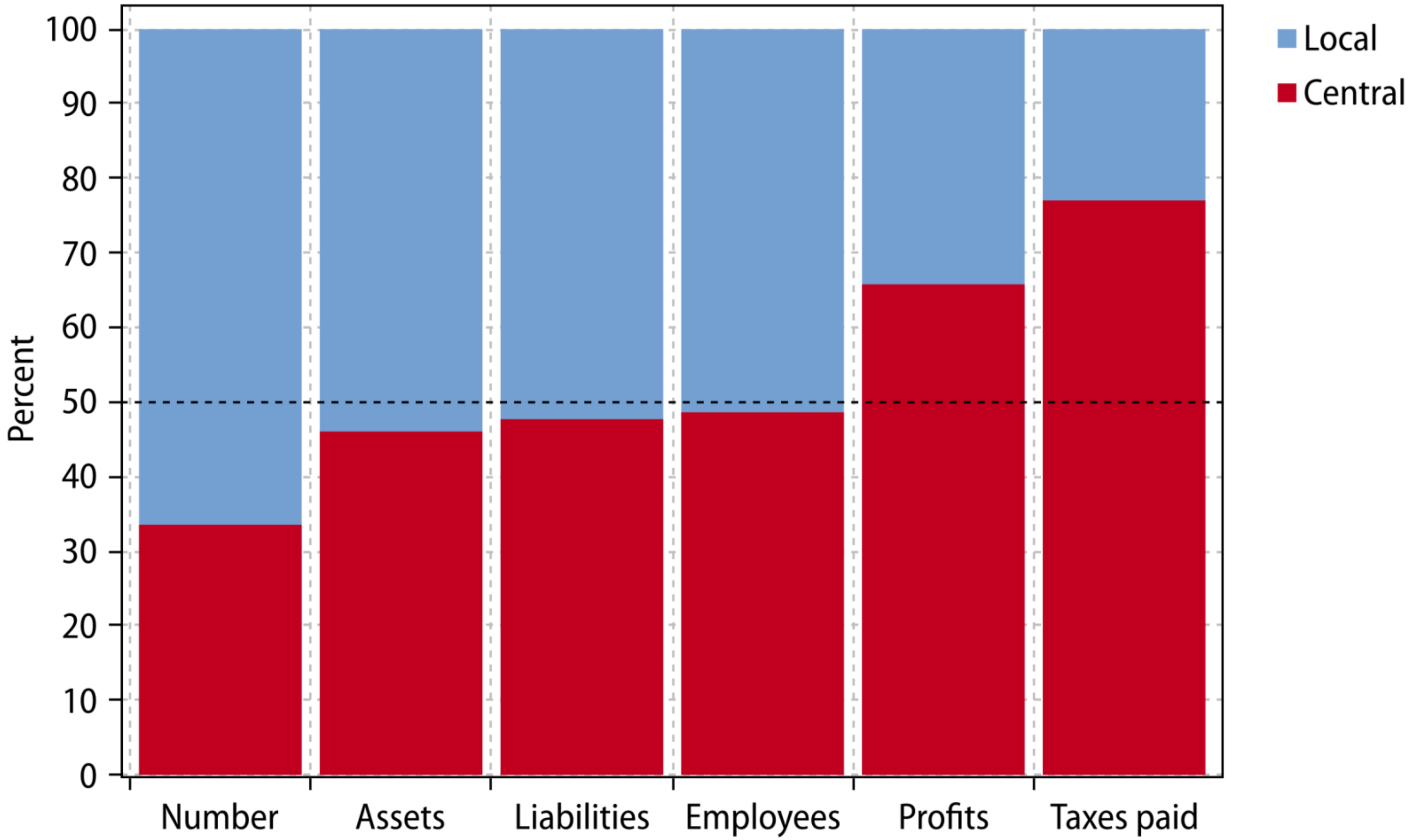
These sectors performed so poorly over 2012-15 that they had a huge impact on total SOE profits. But most SOEs are not in excess capacity sectors, and most of the capacity was not created by SOEs but by private firms chasing high prices.

Policymakers' recent focus on excess capacity sectors therefore will not solve the broader economic problem of poor SOE performance.

Central and local SOEs

Central SOEs are fewer, larger and more profitable

Share of total for nonfinancial SOEs, central vs local



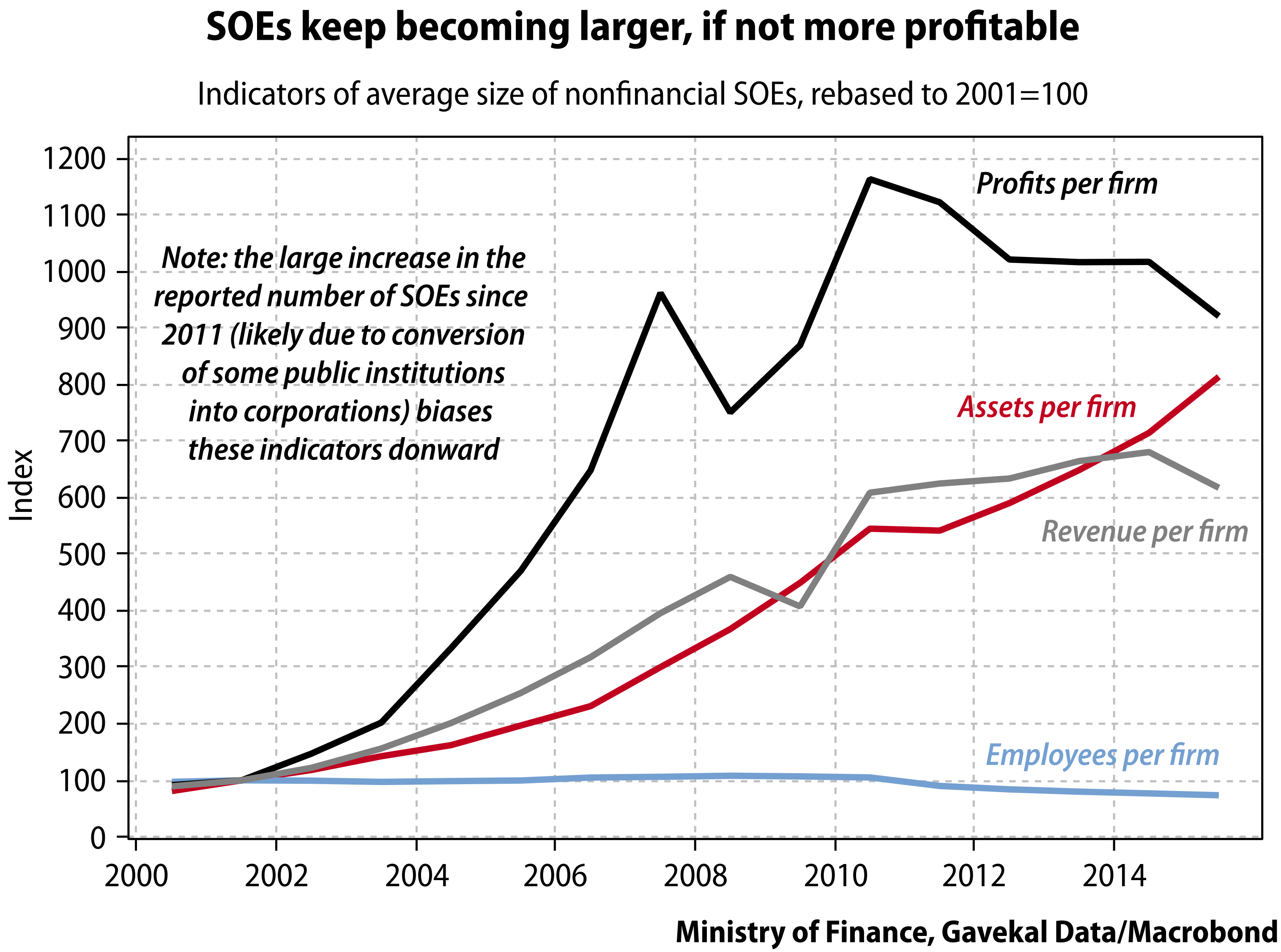
Ministry of Finance, Gavekal Data/Macrobond

China's state-owned enterprises are owned by different parts of the state; the main division is between those controlled by the central government and those owned by various levels of local government.

Local SOEs account for the majority of state sector companies, assets, and employees. But they tend to be smaller and less concentrated in strategic or highly desirable sectors. Therefore central SOEs make most of the profits.

In terms of their economic roles, local SOEs handle a lot of the growth-supporting infrastructure investment, while central SOEs are expected to represent China Inc. and deliver on industrial-policy objectives.

Size of SOEs



While SOEs do not account for a majority of most economic sectors outside of infrastructure, private firms still face a challenge in competing with their state rivals. SOEs tend to be larger and more financially stable, as well as having less quantifiable advantages in terms of connections.

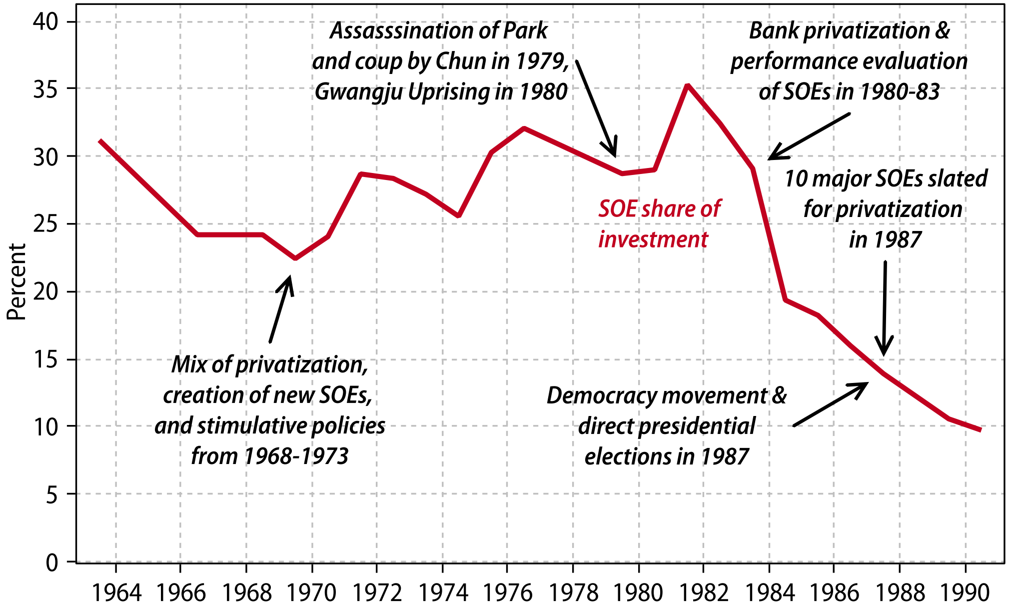
The average size of SOEs is one indicator of how tough a competitor they might be. And SOEs have consistently bulked up in terms of assets and revenues over the past decade, though they are not as profitable.

Interestingly, SOEs have not become bigger employers, maintaining discipline on this front after the mass layoffs of 1997-2005.

Asian comparisons

The decline of SOEs in South Korea was driven by the political transition

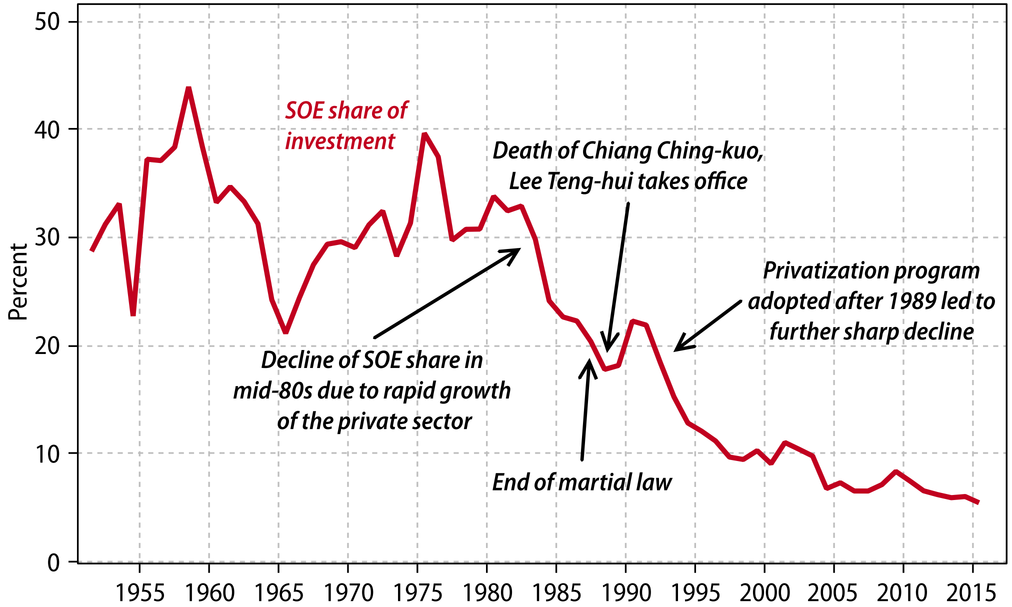
Public enterprise share of capital formation, 3ycma



KDI, IMF, World Bank, Gavekal Data/Macrobond

The privatzation of Taiwan's SOEs only came after the political transition

Public enterprise share of capital formation



Gavekal Data/Macrobond

Having a large state sector was not unusual among developing economies in the 1950s-70s. The two most successful developing economies in Asia (and indeed the world), South Korea and Taiwan, both had large state-enterprise sectors during their high-growth phases. These were gradually reduced over time, and the SOE role in both economies is now much smaller. But while China shares some features of the development model pursued by Korea and Taiwan, it is not following a similar trajectory on SOEs.

Substantial privatization of SOEs did not occur in either Taiwan or Korea until after a political regime change that began a transition to democratic rule. Trimming the state sector was as much a political statement as an economic policy. China shows no sign of going through such a political transition. And the government under Xi Jinping has become more rather than less attached to SOEs, increasingly valuing them as tools of state policy and symbols of national economic strength.

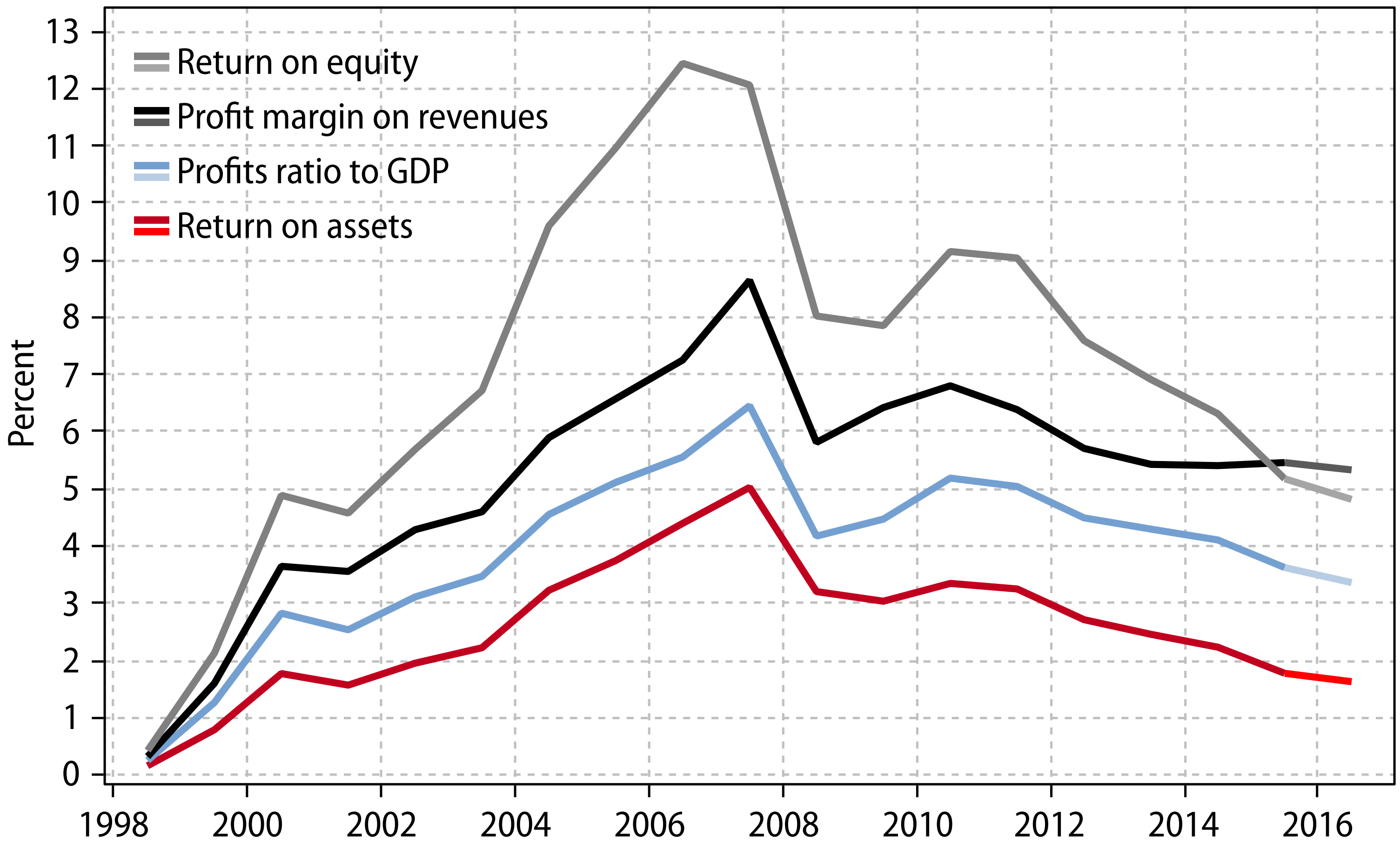
Financial performance

Anatomy of a downturn

Profitability indicators

China's SOEs have been performing poorly since 2008

Aggregate indicators for nonfinancial state-owned enterprises; estimates for 2016



Ministry of Finance, Gavekal Data/Macrobond

After large-scale SOE reform began in 1997, the profitability of the state sector steadily improved. Layoffs totaled around 30mn people over 1997-2004, and around 100,000 state firms were closed, privatized or acquired. But major SOE restructuring stopped after about 2006, and SOE profitability has steadily declined since the 2008 financial crisis.

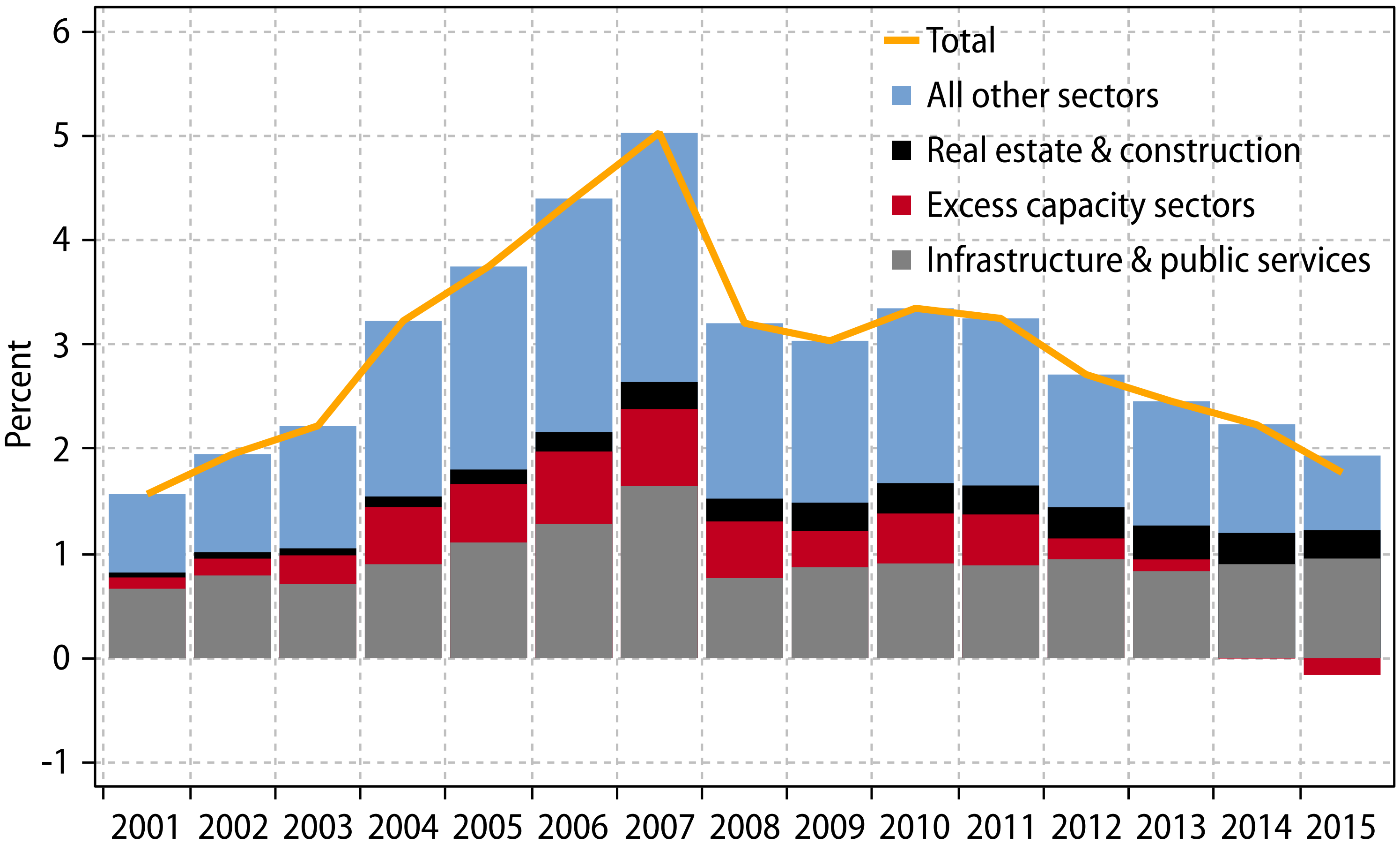
The 1997-2007 surge in SOE profits now looks less structural and more cyclical; SOEs were benefiting from the overall economic boom.

SOEs have handled the post-2008 slowdown poorly, hampered by less pressure to reform and more pressure to spend to support growth.

Breaking down the decline in profitability

The general economic slowdown has weighed on SOE profitability

Contribution to total ROA of nonfinancial SOEs, by sector



Ministry of Finance, Gavekal Data/Macrobond

The return on assets of the state sector has declined about 2.9 pp from its peak in 2007 (using an average of 2013-15). This decline can be broken down into:

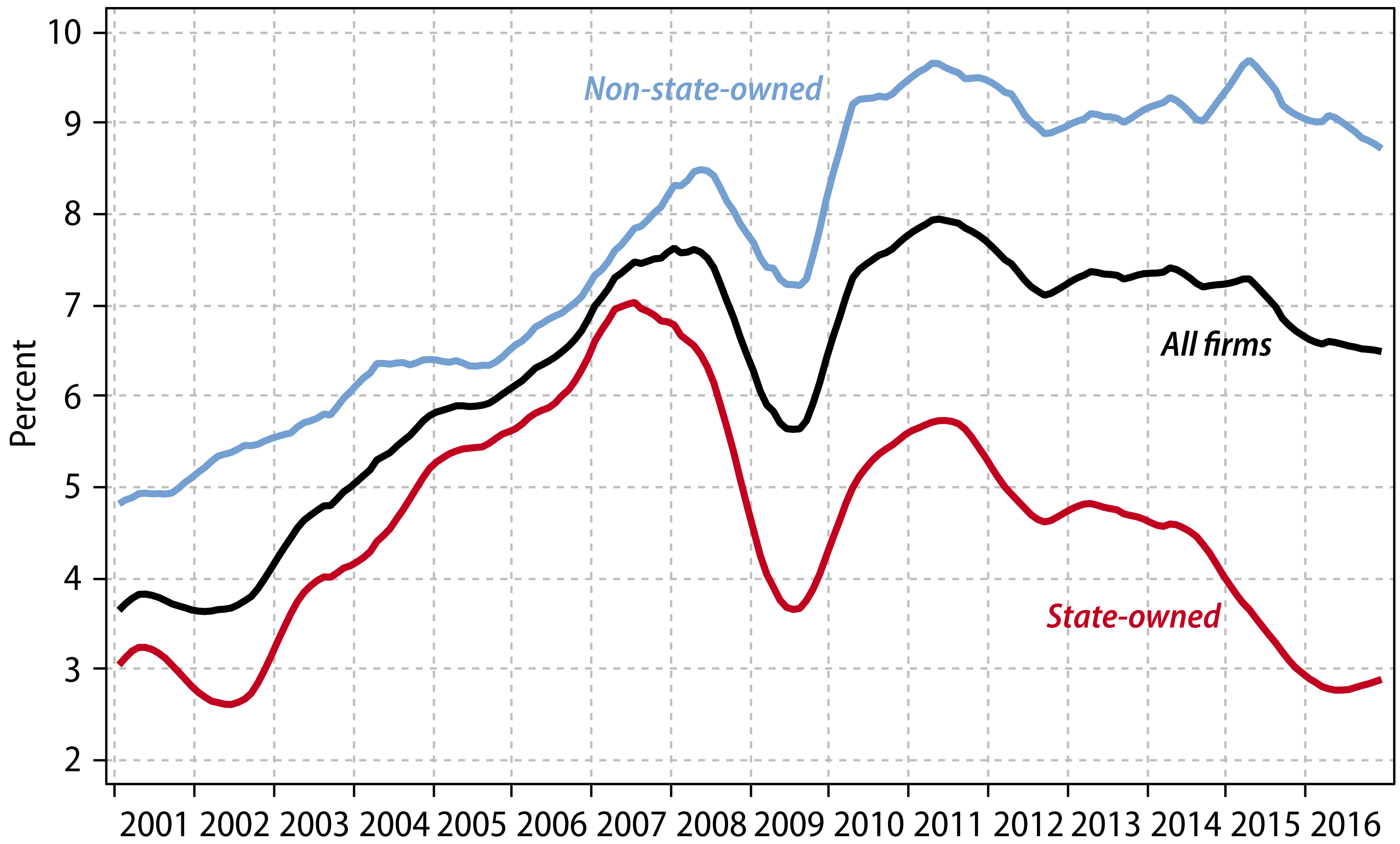
- 0.76 pp from excess capacity sectors
- 0.75 pp from infrastructure & public services
- Negligible change in construction & real estate
- 1.40 pp from other industry and service sectors

The fall in SOE profitability is thus roughly 50% due to the overall economic slowdown, 25% due to the heavy industry downturn, and 25% due to lower returns on public-sector investment.

State vs private profitability

Within industry, the gap with private firms has widened

Return on assets of Chinese industrial enterprises, by ownership, 7mcma



CEIC, Gavekal Data/Macrobond

In the post-2008 economic slowdown, the longstanding gap in profitability between state and private firms in the industrial sector has widened (comparable data on services is not available).

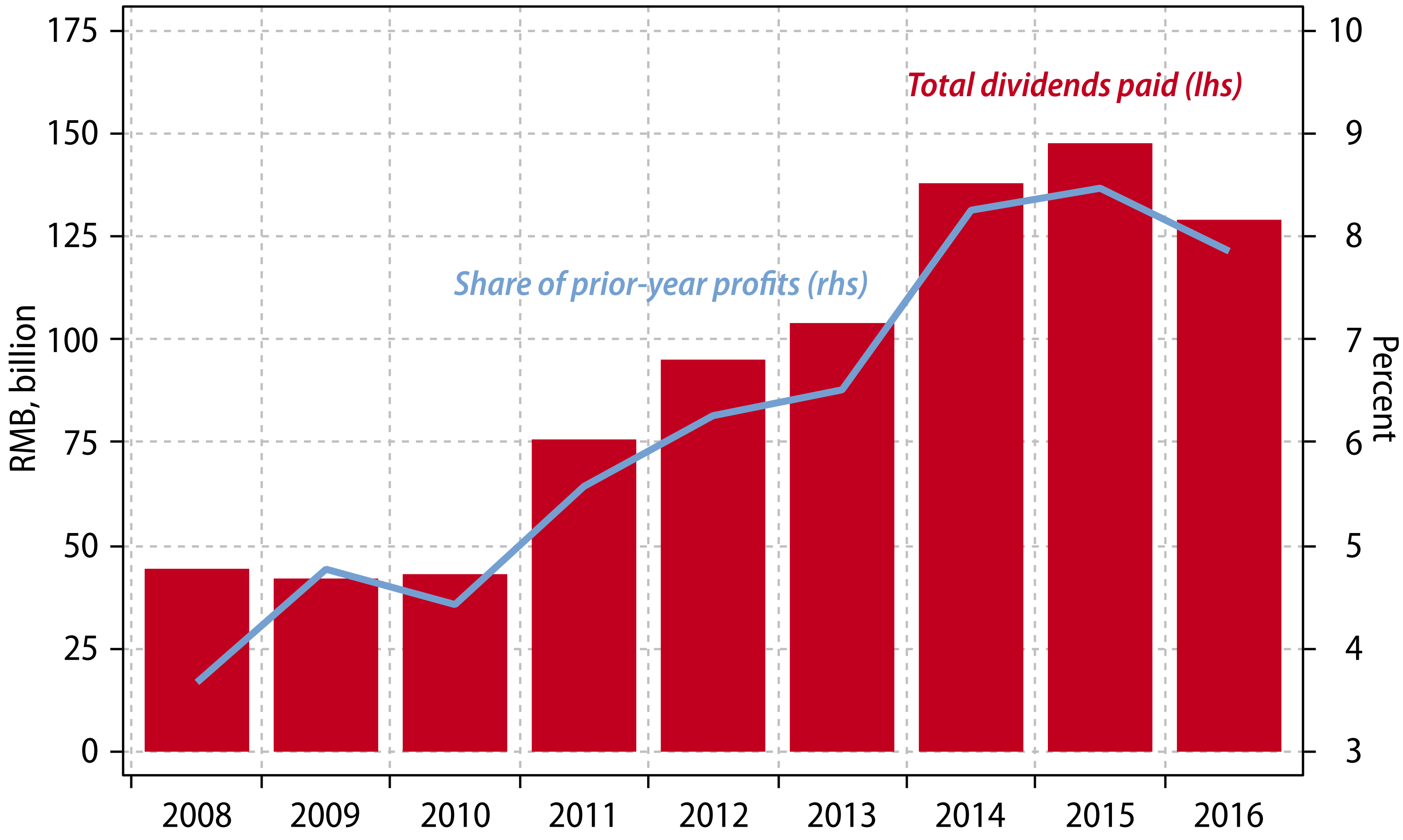
Some combination of poor management, pursuit of non-economic goals, and capture of rents by insiders helps explain why SOEs underperform private firms.

It is true that SOEs are more concentrated in highly cyclical heavy-industry sectors than private firms, so their profits are more driven by commodity-price swings. But a sector effect can't explain all the gap: SOEs did not outperform in the commodity-price upcycle, but have underperformed in the downcycle.

Dividends

Dividend payments have been ramped up as profitability declines

Dividends paid to government by central state-owned enterprises



Ministry of Finance, Gavekal Data/Macrobond

Before 2008, there was a vigorous debate about large SOE profits, which led to a new system for SOEs to pay dividends to the government. This dividend policy was based on the idea that SOEs made profits that were consistently and abnormally high—which has been proved false by their post-2008 performance.

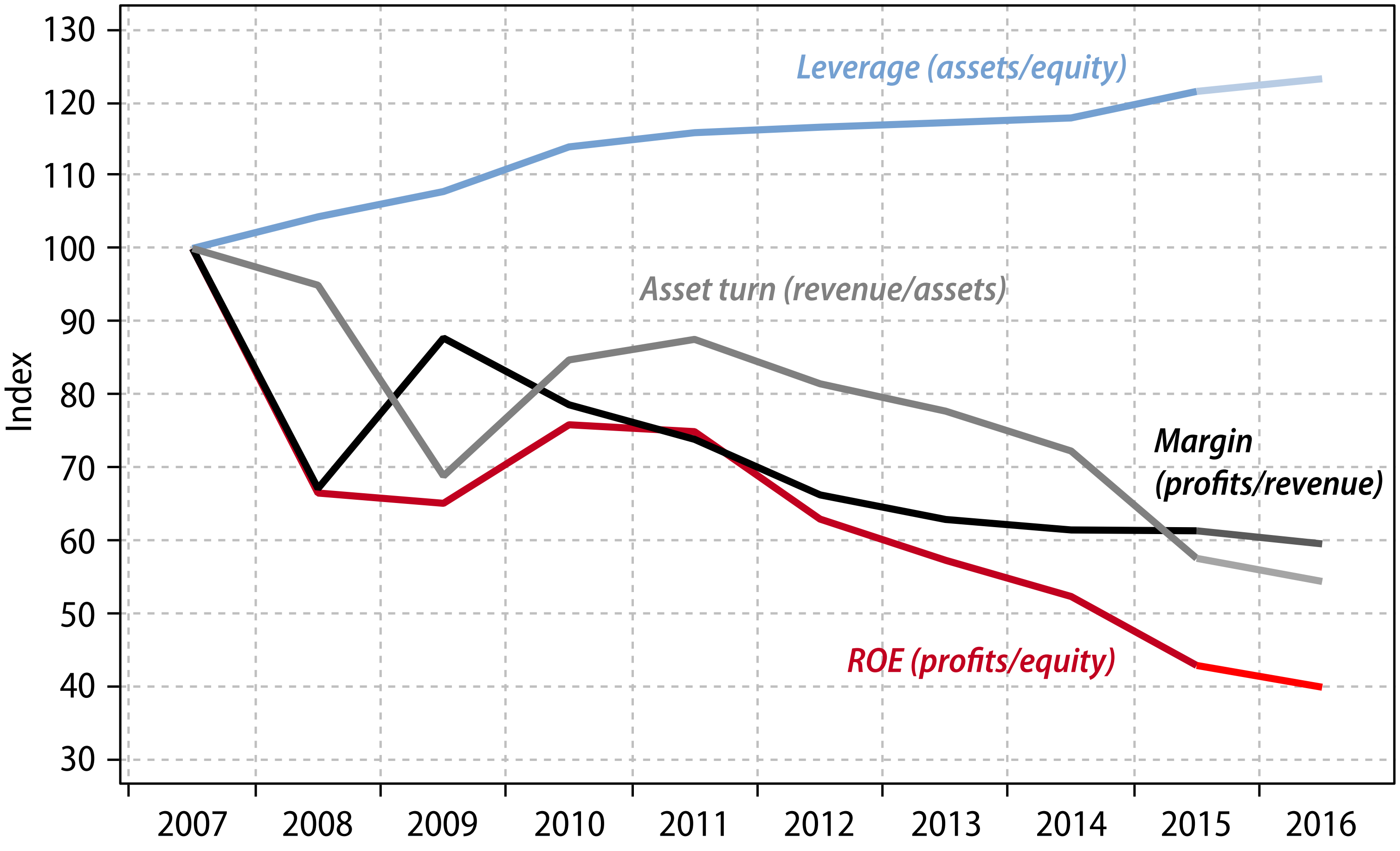
The result has been that required dividend payments have been ramped up just as SOE profits worsened. This leaves SOEs with fewer retained earnings, which could be a factor increasing their reliance on debt.

The real problem with Chinese SOEs is not that they make too much money, but that they are inefficient and unprofitable.

Return on equity analysis

Rising leverage has been used to support declining profitability

Drivers of nonfinancial SOEs' return on equity, rebased to 2007=100



Ministry of Finance, Gavekal Data/Macrobond

A look at the drivers of return on equity helps clarify the dynamics of the post-2008 decline in SOE profitability.

While SOEs' profit margin on revenues is down from its 2007 peak, it has been fairly stable since 2012. However, SOEs have greatly increased the size of their assets, and these assets are not generating much new revenue. The increase in assets has also been largely funded by debt rather than retained profits.

Higher leverage is thus keeping state-sector ROE from falling even more than it already has. But this does not look like a good long-term strategy as SOEs are now burdened with lots of low-return assets.

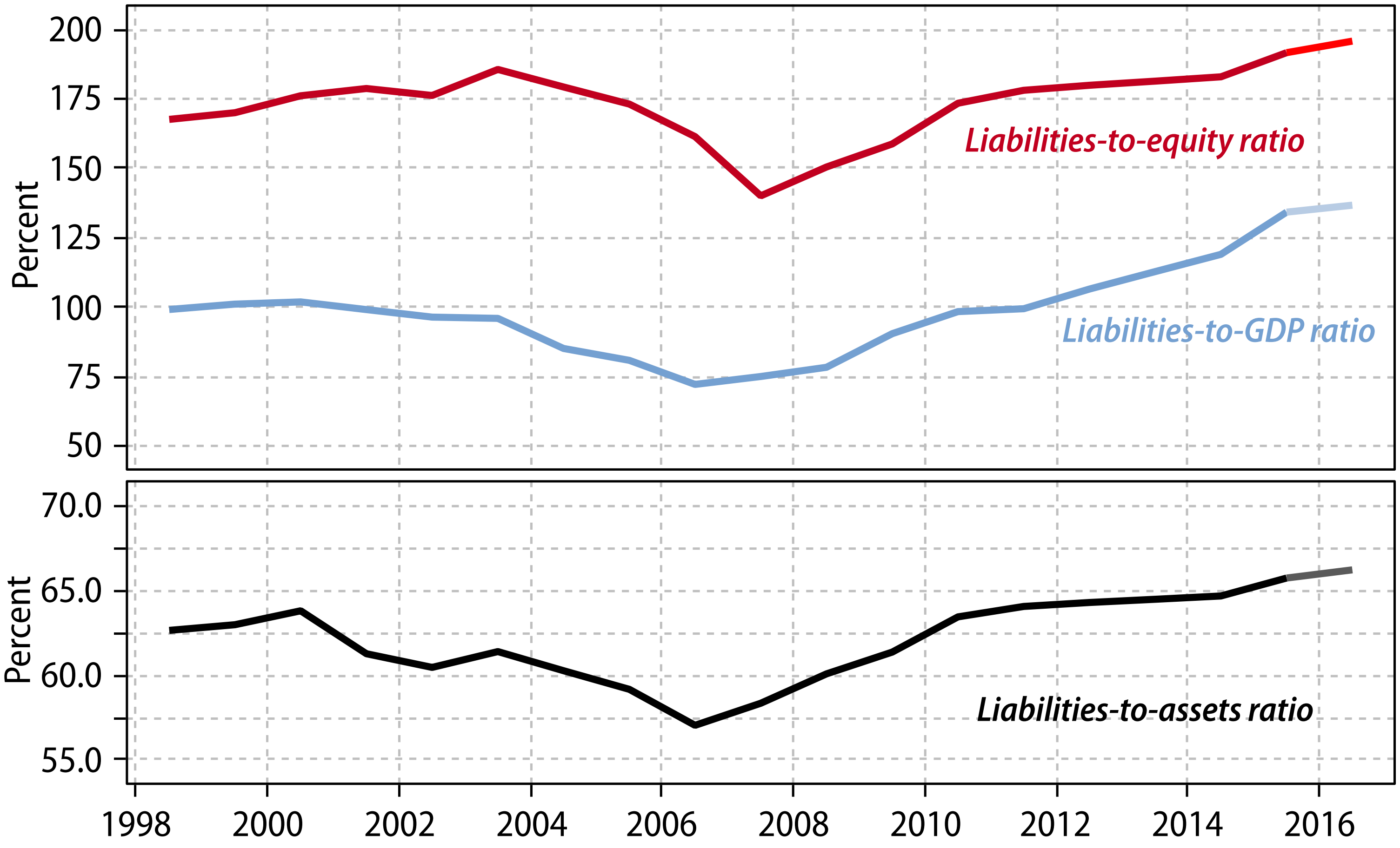
Balance sheet

High debts and low-return assets

Leverage ratios

Leverage in the SOE sector has been on the rise

Leverage indicators for all nonfinancial SOEs; estimates for 2016



Ministry of Finance, Gavekal Data/Macrobond

The leverage of the state sector has steadily increased since around 2008, regardless of which indicator is preferred. The surge in borrowing is driven by a combination of heavy infrastructure spending and a need for cash to survive the economic slowdown.

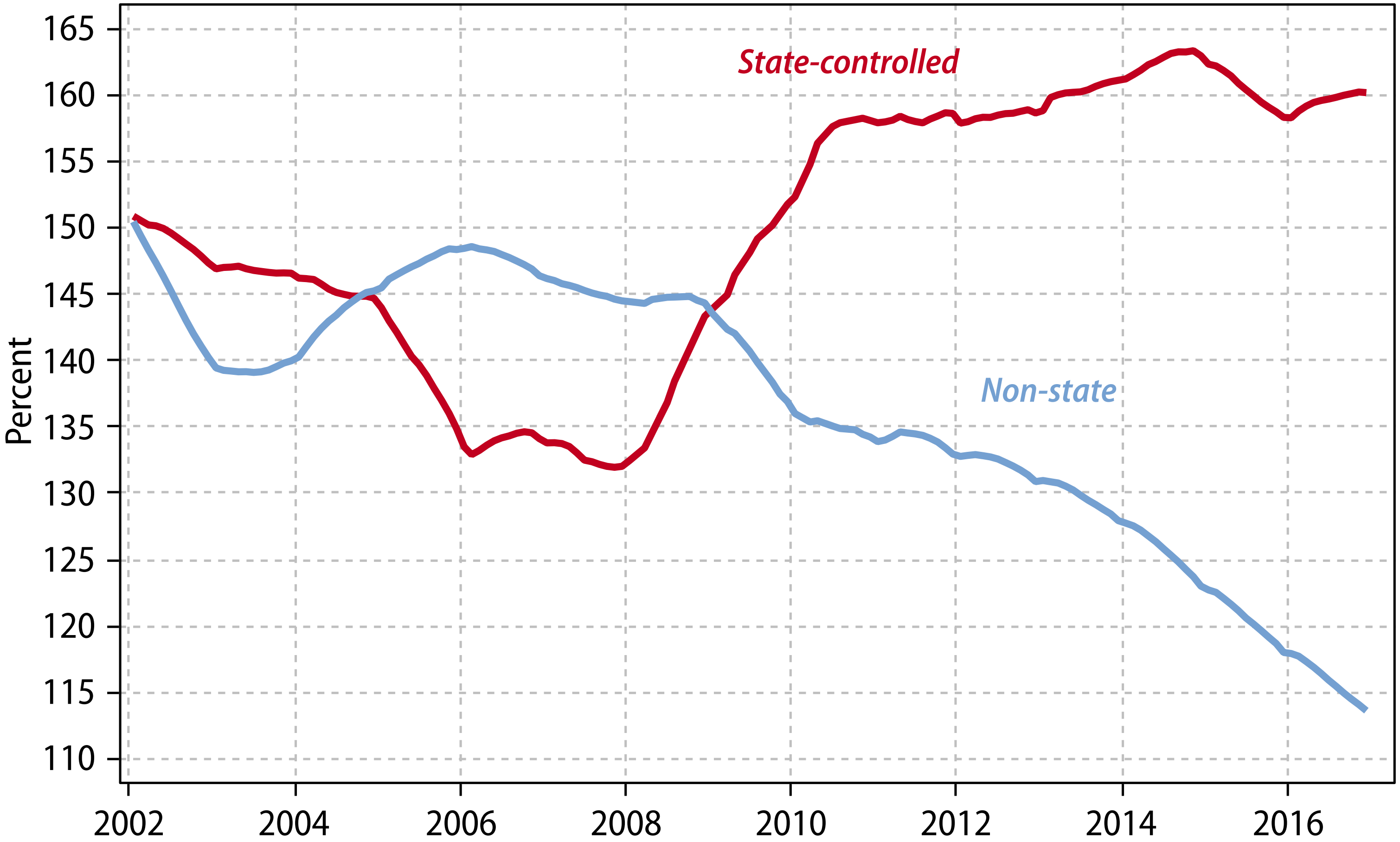
Listed company data suggest about 46% of SOE liabilities are financial debts. This ratio implies that SOEs had about RMB47trn in outstanding debt in 2016, equivalent to 63% of GDP and 31% of private credit.

While the government recently began focusing on reducing high corporate leverage, the aggregate leverage of the state sector still rose in 2016, if more slowly than in 2015.

State vs private leverage ratios

SOEs' growth in leverage has greatly outpaced private firms

Liabilities-to-equity ratio for industrial enterprises, 12mma



Gavekal Data/Macrobond

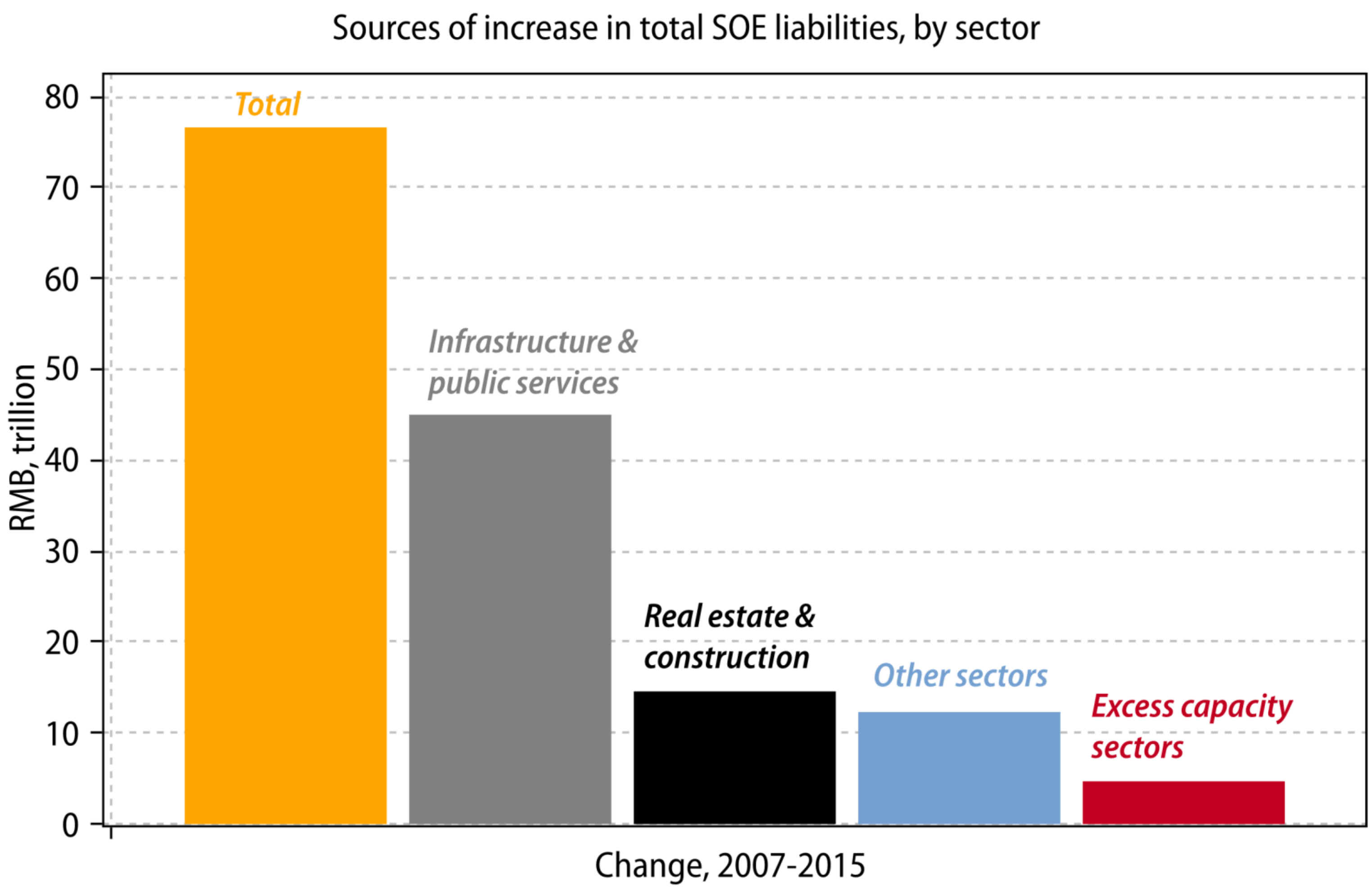
Comparing the leverage trajectory of state and non-state companies in the industrial sector shows a dramatic divergence (similar data for the service sector is not available).

The reason non-state industrial companies have been able to keep reducing their leverage ratio is not that they have been restrained about taking on debt—far from it.

But they remain systematically more profitable than state firms, and as retained profits keep building up equity, their corporate leverage ratio is still falling. The problem of high leverage at SOEs is thus inseparable from their poor profitability.

Debt increase by sector

The biggest increase in debt is from infrastructure and related sectors

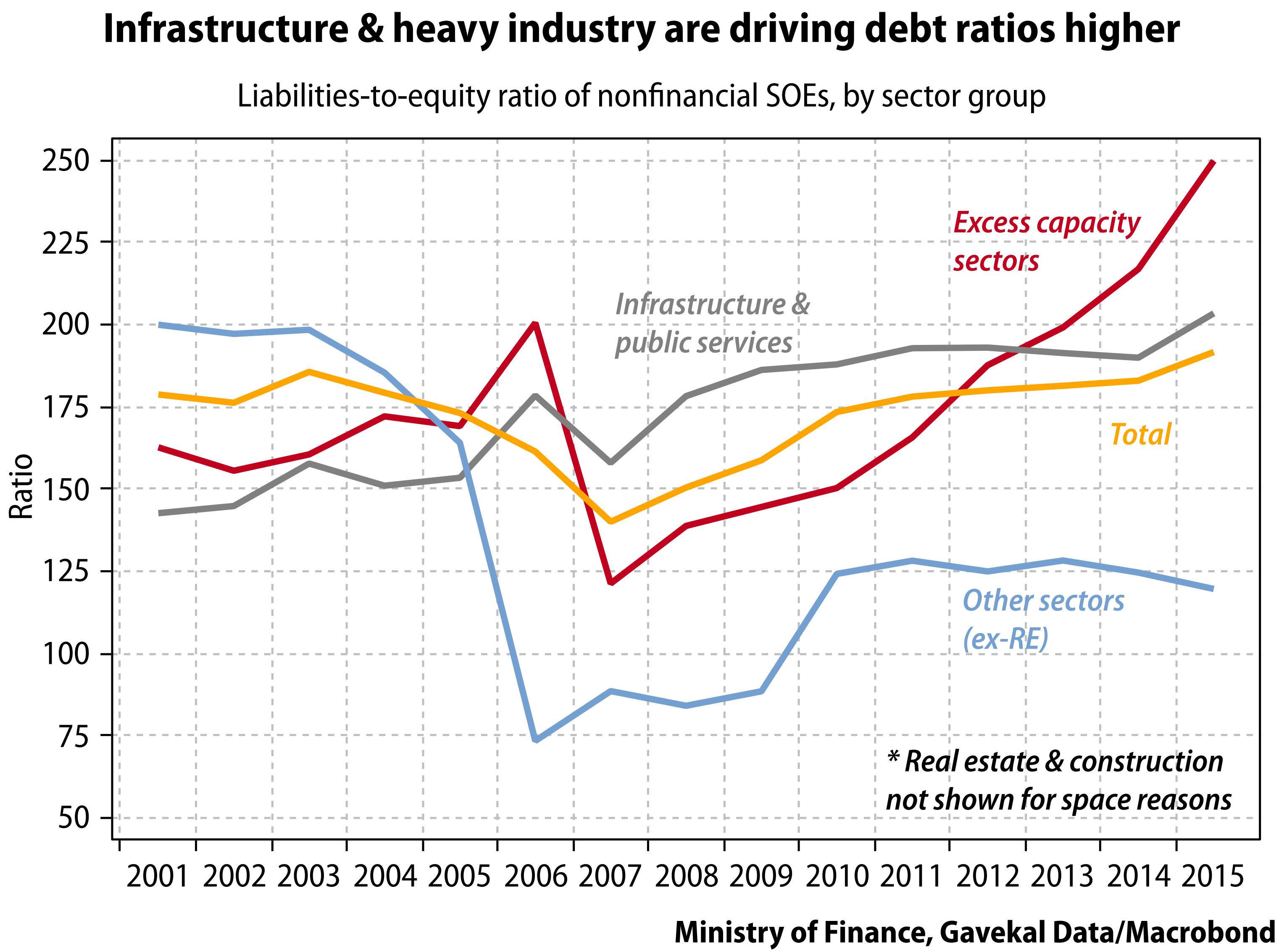


Ministry of Finance, Gavekal Data/Macrobond

Looking at the nominal growth in liabilities since the financial crisis makes clear how much the rise in SOE debt has been driven by the repeated rounds of infrastructure stimulus. Infrastructure and other quasi-government services account for more than half of the total increase.

Another big contributor to the increase in SOE debts is the real estate sector, which has also benefited from repeated rounds of government stimulus. SOEs have been steadily boosting their real-estate investments, despite occasional pushback from the government, which wants them to focus on more “strategic” sectors.

Leverage ratios by sector



The rise in the overall leverage ratio for the state sector is basically driven by infrastructure and the other public-service sectors.

The leverage ratio for the financially-stressed excess capacity sectors has exploded as profitability collapsed, but they still represent a relatively small part of the SOE sector.

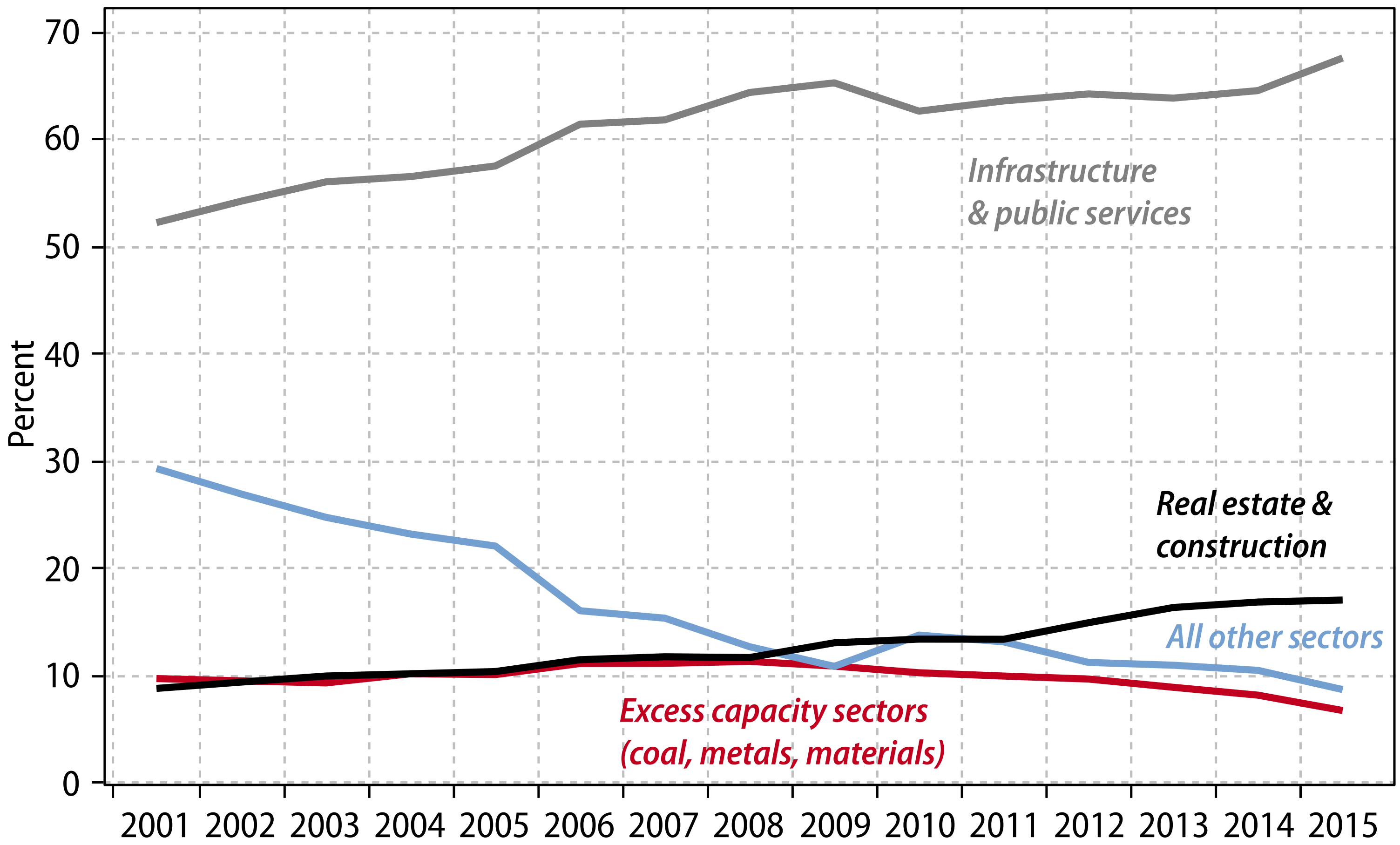
Other industrial service sectors have higher leverage ratios than they did in the boom years of 2006-7, but their leverage has actually been relatively stable in recent years.

Note: the leverage ratio for the real estate sector is so high that it is not shown in the chart.

Asset allocation

SOE assets are increasingly concentrated in low-return sectors

Share of total assets of nonfinancial SOEs



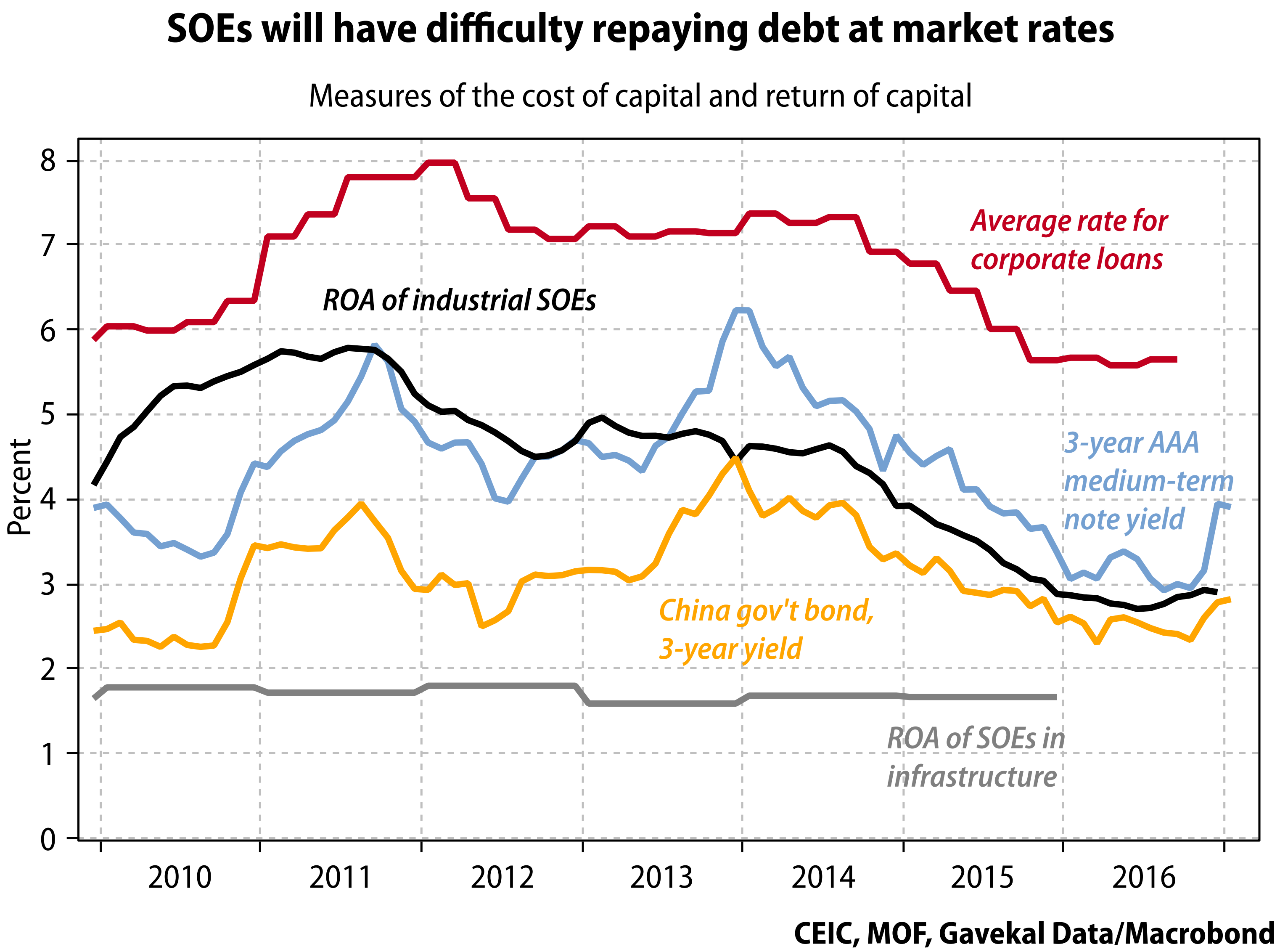
Ministry of Finance, Gavekal Data/Macrobond

The counterpart of the growth in SOE liabilities is the buildup in assets these liabilities are financing.

The share of SOE assets in infrastructure and other quasi-government sectors has steadily risen over time. There has also been a substantial increase in the share of SOE assets in real estate, which many firms see as more attractive than traditional industry.

The increasing concentration of SOE assets in low-return public-service sectors will weigh down their future financial performance. SOE profits are also increasingly dependent on the government, since profits in these sectors are largely set by regulation.

Funding costs



China's decision to finance huge amounts of infrastructure spending through SOEs rather than the government budget has at least one very obvious financial downside.

SOEs are not formally part of the government and so must finance themselves via banks and the corporate bond market. Their cost of capital may be low but it is not as low as the government's own risk-free borrowing rate.

The returns on infrastructure and other SOE investments are so low that they may not be able to pay back these debts. This puts pressure on the government to keep interest rates low. It also means many of these SOE debts will eventually have to be nationalized.

Summary & conclusion

- Almost forty years after its market reforms began, China's state-owned enterprise sector retains an exceptionally large role in the economy. SOEs are called on to support economic growth, deliver regional aid, and satisfy planners' industrial-policy ambitions.
- SOEs' financial performance has now been deteriorating for a decade—longer than the period of improvement after the 1997 reforms. SOEs underperform private firms in competitive sectors, and are also increasingly being pushed into low-return infrastructure and public service sectors.
- SOEs have also run up huge amounts of debt as they pursue government priorities, but there is a risky mismatch between their low public-sector return on capital and their high private-sector cost of capital.
- SOEs' role in the economy is nevertheless growing, not shrinking—a trend that will push down future productivity growth and push up public debt. Current government policies are neither tackling the root causes of poor SOE performance nor reducing the size of the SOE sector.

More Dragonomics research on SOEs

- **The Rise Of A New Conglomerate**

At the local level, SOE “reform” is not leading to better governance and financial performance for SOEs, but instead allowing them to become even larger, more complicated and less transparent conglomerates. Yankuang Group in Shandong is a case study.

- **Villains Or Victims? The Role Of SOEs In China’s Economy**

The idea that SOEs should be competitive, profit-seeking companies is dead; it is now taken now taken for granted that SOEs should be instruments of government policy. Their mandate to act as growth stabilizers however requires them to make investments that deliver low public-sector returns while funding themselves at a high private-sector cost of capital.

- **The Mixed-Up Case Of Mixed-Ownership Reform**

While the SOE reform plan welcomes private capital in rhetoric, in practice fears of the “loss of state assets” have stymied significant privatization. In some cases SOE ownership is just “mixed” by setting up cross-shareholdings with other SOEs.

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