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Will Market Forces Start to Play a Role in China?

Executive Summary

- This Note focuses on the new leadership's decision to allow market forces to play a "decisive" role in the Chinese economy
- This is one of the key elements of China's reform programme established at the recent Third Plenum meeting
- It will slowly but surely erode the privileged position of State Owned Enterprises
- This will be one of the largest privatisation programmes ever seen, and will create major new opportunities for international strategic and financial investors
- This highlights the potential global implications of China's reform programme

1. Introduction

The new Chinese leadership team, officially titled the Politburo Standing Committee and headed by President Xi Jinping, was first presented to the world in November 2012, after the First Plenum (plenary session) of the 18th Central Committee. At the time, most observers focused on the political backgrounds of the top seven leaders. Few tried to anticipate the real changes that Xi is now attempting to implement. Yet if he succeeds, his period in office will be as revolutionary and important as was Deng Xiaoping's 1980/90'.

Xi has moved slowly but surely to develop his plans to the point of implementation. But they are now becoming fully visible for the first time. Our aim in 'Your Compass on China' will therefore be to present these ambitions, and measure them against the reality on the ground. We will also evaluate the likelihood of their succeeding, and explain the potential impact for foreign businesses already in China or envisaging entering China.

We intend to achieve this in a series of notes, each exploring a key element in more depth.

2. The importance of the Third Plenum in November 2013

The Third Plenum was held exactly a year after the leadership team was first presented. Historically it has been the moment for important directional changes to be announced, as the Second Plenum generally focuses on administrative appointments.

Last November confirmed this pattern, as can be seen by the title of its main report which summarised its major decisions:

"The Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning **Comprehensively Deepening the Reform**". (The Decision)

Deepening reform is indeed the overriding message of the document:

- It highlights plans for reform on a very large number of fronts: financial, fiscal, environmental, political and legal are just a few mentioned
- The vast and broad scope of the reform plans underline the urgency that the Government attaches to this
- At the same time, of course, this also multiplies the risks of failure
- It is also important to appreciate that the programme is intended to extend until well into Xi's second term of office (due to in 2018), as The Decision confirms that the aim is to have the various reform policies in place by 2020

This is why we have decided to publish 'Your Compass for China'. We begin today by focusing on a key reform path, namely the relationship between the Government and markets in its broadest sense, where The Decision makes some dramatic announcements:

- *"Ensuring that the market has a decisive role in allocating resources in deepening economic structural reform"*
- *"The market deciding resource allocation is a common law of market economics, to complete the Socialist market economy system, we must respect this law"*

This is strong language, and quite different from the previous concept of the market having only a "fundamental role". It is supported by the official Communique from the Third Plenum which stated:

"The key to comprehensive and profound reform is in economic reform, and the core question is to properly manage the relations between the government and market, so that the market can play a decisive role in resource allocation and the government can play its role better".

3. What might this mean for companies and investors?

The Decision makes clear that the government intends, slowly but surely, to allow market forces to play "a decisive role", whilst also reducing government intervention. This is a very important announcement, with major implications for the future. Clearly, however, change on this scale has to take place gradually, or risk backfiring.

One sign of the change underway was highlighted earlier this month by Premier Li Keqiang when he stated during his annual press conference that defaults in the Chinese economy were “unavoidable”. The government’s current role as both a shareholder and manager of the State Owned Enterprises (SOE's) is also like to see major change. Markets clearly cannot play a decisive role whilst important industries are dominated by SOEs enjoying government support with regard to the markets they serve and their access to capital.

The government seems to be signalling that although the SOEs will remain, their Golden Age may soon be over. Thus The Decision states that “*we must persist in the dominant position of public ownership*”, it goes on in the same paragraph to highlight that “*we must unwaveringly encourage, support and guide the development of the non-public economy*”.

Our reading is that represents an essentially pragmatic position. It would be politically very unwise to signal the immediate end to the SOEs dominant position in the economy. They carry much political support, have strong vested interests, employ millions of staff, and have largely been the driving force in Chinese outbound investment. Equally worth remembering is that 67 of the 89 Chinese companies in the Fortune 500 list are SOEs.

The Decision thus goes on to explain that the strategy is to “Vigorously develop a mixed ownership economy”. It explains that this means having a shareholding structure that “blends” State-owned capital, collective capital and non-public capital. For example, it suggests that “It is permitted that non-State-owned capital holds shares in State-owned capital investment programmes”. In other words private companies will be able to take minority positions in SOEs. Over time, perhaps some could even be fully privatised?

A further key area of reform is that the SOEs will have to increase their dividend pay-out to the State from today’s 15% of profit to 30% by 2020. This will reduce their free cashflow, and help to create a more level playing field with private companies, thus helping to erode their current privileged position over time.

Until now, private investment in SOEs has been very rare. One example is the minority stake owned by Blackstone, the US private equity group, in China Bluestar. It is the speciality chemical subsidiary of ChemChina (China National Chemical Corporation), China’s largest pure chemical group and a top-level SOE reporting into SASAC (the State-owned Assets Supervision and Administration Commission of the State Council).

The Bluestar example demonstrates that participation is potentially open to international capital as well as Chinese private capital. But it did, of course, take place under the previous leadership, which also took a minority stake in Blackstone itself - raising perhaps a question about the ‘foreign-ness’ of the funds Blackstone invested.

The Decision makes clear that private investment in the SOEs is viewed as an important tool for reform. The aim is not just "raising competitiveness", but also to force them to adopt to a more international landscape by becoming more efficient. This will in turn require improved governance structures, modernised and democratised hiring and reward structures, and the professionalization of management. The aim is to ensure that SOEs – insofar that this is not already the case – become professional to be able to thrive and compete in domestic and global markets via the use of global best practices,.

The pool of state-owned companies which may be opened to private investors is huge. According to the National Bureau of Statistics, SOE assets totalled €13tn at 31 December 2011. As KPMG have noted, "this will be one of the largest (partial) privatization waves in history". There have already been a number of sectors specifically mentioned, such as medical services, unconventional energy and logistics, which could potentially provide interesting opportunities for international strategic and financial investors.

4. Will private companies be better able to compete with SOEs?

The Decision thus makes clear that private capital will be encouraged to invest in most SOEs, (with the exception of those in sensitive industries). It also suggests that stand-alone private companies will be allowed to compete with SOEs on a more level playing field.

Some sectors will move faster than others, but the desired overall direction is becoming clear. China wants to rebalance the state and private sector roles in an effort to boost productivity, reduce inefficiencies and thereby enable its long-term growth targets to be met.

The Decision also suggests that the gradual levelling of the playing field will also apply to international private companies as well as domestic ones. The need for SOEs to learn to thrive in an environment in which markets determine prices for resources (including capital), means that access to these resources will be equal for all in theory:

"All prices that can be formed by markets should be submitted to the market, governments are not to carry out improper interventions. Move forward with pricing reform in water, oil, natural gas, electricity, traffic, telecommunications and other such areas, set competitive market prices free".,

5. Conclusions

It is clear that the Third Plenum has outlined a plan which, even if only half- implemented, will have major consequences both in China and internationally.

The far-reaching changes which it envisages will obviously not be implemented overnight. But over the next 6 years the skeleton should start to become more of a body. No doubt some of its reforms will be watered down over time for either political or pragmatic reasons. But the overall direction is not going to change. Things take time in China, and patience is key.

The same principle applies for international firms looking to benefit from the gradual changes. Whilst the financial rewards will not be immediate, the seeds for success must be planted as early as possible.

We believe that the definition of the proposed partial privatisation of the SOEs as a "Key Reform Area" by the Third Plenum is a critically important signpost for the future. It will create an opportunity for companies and investors to take minority stakes in SOEs, with a view to combining the SOE's inside knowledge, domestic customer base and network with international best practice.

This could hold significant potential for international companies wishing to take a stake in the major sector players in China, even accepting that overcoming current cultural and working differences will often take time to achieve.

We welcome your comments, questions and feedback. Our aim will be continue our focus on The Decision of the Third Plenum by analysing the ongoing and proposed further reform of China's financial sector.

About Polarwide: **Polarwide is a Hong Kong-based financial and strategic advisory firm advising international companies with their Asian strategy.**

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was the first foreigner to be granted permission to run the finance company of a top-tier Chinese State Owned Enterprise, when establishing and managing ChemChina Finance Company. Previously, Daniël held a variety of senior positions in corporate and investment banking, including as Asia Pacific Head of Chemicals and Asia Head Asset Based Finance for ABN AMRO.

He has lived in Hong Kong for 14 years, and continues to spend much of his time in China, advising both international and Chinese firms, as well as leaders in the public and private sectors. Daniël is a graduate of Leiden University in the Netherlands, holding a Master of Law degree with a speciality of International law.

About IeC: **IeC is a London-based strategy consultancy advising Fortune 500 and FTSE 100 companies, investment banks and fund managers.**

Paul Hodges

is a trusted adviser to major companies and the investment community, and has a proven track record of accurately identifying key trends in global marketplaces. He has been widely recognised for correctly forewarning of the 2008 global financial crisis. His analysis of the key role of demographics in driving the global economy is now attracting increasing interest from senior policymakers and executives.

Paul is Chairman of International eChem (IeC) and non-executive Chairman of NiTech Solutions Ltd. Prior to launching IeC in 1995, Paul spent 17 years with Imperial Chemical Industries (ICI), both in England and the USA, where he held senior executive positions in petrochemicals and chloralkali, and was Executive Director of a $1 billion ICI business. Paul is a Freeman of the City of London and is a graduate of the University of York, and subsequently studied with the IMD business school in Switzerland