Ownership Key to Fixing China's SOEs

By Eswar Prasad

China’s state-owned enterprises—constitute some one of the world’s biggest corporate entities. By Beijing today SOEs play an outsized role in China’s overall economic activity, the state’s economy, even though they are a major source of competition and in efficiency. So it was encouraging when China’s Party Secretary general Xi Jinping announced several months ago that the government was going to reform the country’s state-owned enterprises.

Increasing competition and private ownership would help spur the changes needed to root out corruption and to make the country’s state-owned enterprises more efficient.

But Beijing has been going about the wrong way. Instead of forcing SOEs to operate as competitive entities free of political interference, Beijing is increasing state control. Recent reforms with Chinese businesses have been overtaken by events. By leaning on well-connected business leaders to provide stability, safety and adequate returns, these SOEs now provide stability, safety and adequate returns.

China’s reluctance to reform the SOEs is rooted in its determination to control social stability. Laying off workers is not a necessity. The party does not need a financial reserve to look after workers who lose their jobs, as the recent wave of bankruptcies shows. It is not a desirable side effect. One consequence is that fiscal resources are directed through the financial system is the form of cheap and abundant credit, perpetuating the impression that the government has the power to control economic outcomes.

China’s government is meant to prevent asset-stripping by raising interest rates to reflect international interest rates. For example, in mid-2007, the People’s Bank of China raised interest rates to reflect international interest rates.

But Beijing’s tightened SOE rules led by the letter, not the spirit. This is not a viable strategy by which Beijing can achieve its inflation target.

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