A Tale of Two Companies

By Ivan Png and Changqi Wu

South China Morning Post, “Enterprises that survived market competition and expanded deserve the support of government... those bleeding red ink should be auctioned, merged or left to go bankrupt.” Addressing China’s National People’s Congress in March, Prime Minister Li Peng emphasized that the central task in economic restructuring was the reform of state-owned enterprises.

The problem is better understood with a closer look at Shanghai Petrochemical and Jilin Chemical’s fertilizer division. Crude oil accounts for almost half of Shanghai Petrochemical’s costs. While the government controls the price of crude oil, it has relaxed restrictions on chemical prices. Shanghai Petrochemical consequently has been able to raise prices of synthetic fibres by 30-35% in 1994 and a further 40% in the first half of this year.

In 1994, the government supplied Shanghai Petrochemical with 4.5 million tonnes of crude oil at a controlled price of 670 renminbi per tonne. Compared with the free-market price of 1,100 renminbi per tonne, this represents an implicit subsidy of 1.95 billion renminbi. In 1994, the company’s profit was 1.78 billion renminbi. When the value of the subsidized crude is subtracted, Shanghai Petrochemical’s bottom line no longer looks rosy.

What about that relic of central planning—Jilin Chemical’s fertilizer division? To placate urban residents, China has tightened controls on food prices. (Some cities have even re-instituted rationing through food coupons.) Because these controls have cut farm income, the government has also controlled fertilizer prices in an effort to redress the balance. This, of course, is bad news for Jilin Chemical.

Worse news is that the government has allowed the cost of key inputs to rise. The cost of electricity, for instance, has risen 10 times. Caught between fixed fertilizer prices and rapidly increasing costs, Jilin Chemical’s fertilizer division loses money on every tonne that it produces.

In a free-market system, a business that persistently loses money is delivering products that nobody wants or that are too costly. Society would be better off if such losers shut down and released their human and physical resources to other users.

But it is a mistake to apply this theory to China’s state-owned enterprises without taking account of their unique circumstances. Many markets in China remain subject to state control despite almost two decades of economic reform. The degree of government intervention, moreover, varies from one market to another. Thus, a company like Jilin Chemical’s fertilizer division may be drowning in red ink, but that doesn’t necessarily mean it is inefficient. And a company like Shanghai Petrochemical may be making millions of dollars without really succeeding in market terms.

To use the present quiltwork of partly controlled, partly free-market prices to decide the fate of China’s state-owned sector is to put the cart before the horse.