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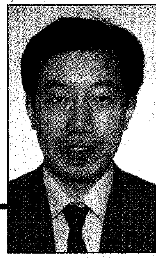

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A Tale of Two Companies

By Ivan Png and Changqi Wu

New York Stock Exchange-listed Shanghai Petrochemical announced its half-year results to acclaim from analysts. One of the first Chinese state-owned enterprises to be restructured and listed on an international exchange, Shanghai Petrochemical recorded a 56% increase in profit to 1.2 billion renminbi ($141 million) for the first half of 1995.

In sharp contrast to Shanghai Petrochemical, Jilin Chemical's fertilizer division has been much less affected by China's economic liberalization. Jilin's Soviet-made machinery dates from the 1950s and consumes twice the energy of modern Western equipment. In 1994, its production fell 20% from the year before, to 360,000 tonnes. The division reported a loss of 30 million renminbi on fertilizers.

The disparities between Shanghai Petrochemical and Jilin Chemical's fertilizer division mirror broader differences between their respective regions. Shanghai is aggressively pushing to regain its pre-war position as Asia's financial and industrial centre. Its property market is so hot that rents for prime office space exceed those in Hong Kong. Jilin province, on the other hand, lies in China's cold northwest, and is known for heavy industries such as chemicals, energy and engineering much favoured by orthodox Marxist-Leninist central planners.

This tale of two companies seems to provide some clear lessons. Chinese business should adopt Shanghai Petrochemical as a model, while money-losers like Jilin Chemical's fertilizer division should be closed, the sooner the better.

Experts from all over are urging the Chinese government to quickly stem the tide of red ink among state-owned companies—losses that amount to as much as 5% of China's gross domestic product. According to the international management consulting firm McKinsey & Co., government subsidies to these companies are "unsustainable." Likewise, the World Bank says that reform of state-owned enterprises is necessary to maintain economic growth and avert social instability.

Chinese officials seem to concur. As one official of China's State Council Development Research Centre said in the *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.

> ‘ To use the present quiltwork of prices to decide the fate of China's state-owned sector is to put the cart before the horse ’

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. What the Chinese government should do is relax controls on all markets, whether the products are "necessities" or not. Only then will profits and losses truly distinguish between inefficient and efficient businesses. Only then will it be appropriate to let the enterprises "bleeding red ink" be "auctioned, merged, or left to go bankrupt." ■