Executive Summary

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Spontaneous Privatization, the Rise and Decline of MEBO

Privatization of public enterprises in China started with small and medium state-owned and collective enterprises under the jurisdiction of county-level governments. The drive was triggered by the deterioration of business at these enterprises stemming from increasing market competition since the early 1990s and the resultant financial plight of local governments.

At the earlier stage of privatization, the dominant form was conversion to employee-owned enterprises by means of management-employee buyout(MEBO) which was more palatable to employees and was likely to raise few ideological issues. Privatization through MEBO helped privatized entities slip out from under the protective wings of governments and strengthen their internal discipline. However, the egalitarian ownership by virtually all employees had serious setbacks such as inefficiency in decision-making, which could not be left unattended. With the growing awareness of this problem, privatization through the concentration of capital in the hands of managers and executives or straightforward buyout by private companies was increasingly encouraged.

From Corporatization to Privatization of Large Enterprises

The wave of privatization has gradually spread to larger enterprises after political constraints imposed on privatization of public enterprises and on private companies were significantly eased following the 15th Congress of the Communist Party of China (CPC) in 1997. In particular, some public enterprises that have seen remarkable development by successfully adapting to an evolving environment under transition to a market economy thanks to the exceptional capabilities of their managers are now moving toward genuine privatization at the initiative of those managers.

Since the mid-1990s, the Chinese government has been pressing ahead with reorganization of large state-owned and collective enterprises into joint-stock companies and their listings on the stock market as an integral part of enterprise reform. Reorganization into joint-stock companies and their exchange listings can be regarded virtually as a process of phased privatization. But the ratio of state-owned shares in listed enterprises is still as high as thirty to forty percent on average. There have been frequent cases where parent state-owned enterprises that control state-owned shares have taken advantage of their effective control over listed enterprises to act against the interests of minority shareholders, which in some cases have gone so far as to destabilize the financial sustainability of listed enterprises. This problem, combined with the pressing need to raise resources to cover the huge implicit public pension debt,prompted the government to launch a divestiture policy of state-owned shares in listed enterprises in 2001. Attention is now being focused on the fostering of institutional investors as entities to watch over corporate governance of listed enterprises, in place of state shareholders.

Major Constraints

In moving toward full-fledged privatization of large public enterprises, the nascent state of China's capital market is posing the biggest problem. As the government withdraws from the arena of corporate governance by selling off state-owned shares, there would arise the risk of increased instability in

enterprise management unless a new framework of corporate governance is developed. Expectations are that an efficient capital market, with the participation of institutional investors with a long-term investment posture, will provide such a new framework. But it will be some time before the efficient capital market is developed, making it inevitable for the process of privatization of large enterprises to be only gradual.

China seems to have no choice but to keep for the time being the transitional system under which the government continue to play a certain role in corporate governance of large enterprises.

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