The Role of M&A Fund Development in Reforming Chinese State-Owned Enterprises

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In recent years, the Chinese economy has been facing an economic slowdown in which the growth rate is sliding to between 6% and 7%, in stark comparison to the average annual growth of 10% from 2002 through 2011. To achieve sustainable economic development, China needs a new growth impetus distinguished from the traditional demand-side polices. Against this backdrop, on November 10, 2015, President Xi Jinping announced that China will strengthen "reform of the supply front" to increase the quality and efficiency of the supply system.

China's reform of the supply front is a comprehensive strategic deployment that involves various aspects including micro and macro control, labor and capital, and the fiscal and taxation systems. The most crucial aspect of the plan would be the proper execution of stronger reform across state-owned enterprises (SOEs). Chinese SOEs are notorious for their low efficiency, and have been blamed for overinvestment and excessive production capacity stemming from easy access to public banking. It has long been argued that such problems should be solved by improving SOEs' corporate governance structure. In the 2000s, the Chinese government implemented polices involving debt-equity swaps by state banks or stock-market flotation in the stock market to improve the efficiencies of SOE corporate governance, but they have not been very successful. Many large SOEs are still dominantly controlled by state-owned capital instead of being managed by market mechanisms. Such 'indirect' methods previously employed to reform SOEs have failed to boost their efficiency. SOEs are still suffering from overcapacity and increasing debt, which could ultimately damage China's financial stability.

The Chinese M&A fund (*Binggoujijin*) is an emerging restructuring method for oversupplied Chinese SOEs. Chinese M&A funds have been developing rapidly since the mid-2000s. In 2015 alone, 185 M&A funds were established in China; the total fund collection was 84 billion yuan, which is the largest amount to date. Both the number of newly established funds and the size of total fund collection nearly doubled compared with those of the previous year. Recently, the Chinese government has adopted several policies to stimulate M&A funds in inducing private capital and expediting the restructuring of SOEs, particularly the listed ones. These policies also include relaxing the limitations on investment areas and shares.

The Chinese M&A fund can play the following roles in the reform process. First, the M&A fund can induce the market-oriented restructuring of SOEs because it has a transition effect on investors as they shift from the public to the private sector. Second, the financial burden on the Chinese government is eased because M&A funds are financed by private capital. Accordingly, private enterprises join the restructuring process led by the government. Third, the management structure of SOEs is improved because M&A funds require the takeover of SOE shares by private ownership. Finally, as a platform that induces not only private capital in China but also globally, the M&A fund can lower the possibility of a Chinese economic crisis that may result from excessive oversupply.[1]

If private financing through the M&A fund takes on a prominent role in Chinese industrial and SOE restructuring, then this complicated process can be delivered smoothly and help achieve the policy goal of supply-side reform. Moreover, the risk of an economic crisis from the insolvent obligations of the banking sector, or a sovereign debt crisis, can be mitigated. Non-performing loans of insolvent enterprises or banks is a problem that occurs naturally in any period. However, whether this problem leads to a crisis for the financial system or even an economic

[1] SEO Bongkyo, LEE Hyuntai and PARK Junki (2016), "Characteristics of the Chinese M&A fund and its Effect on Industrial Restructuring," *The Journal of Contemporary China Studies,* Vol. 18, No. 1: 121-164. (in Korean)

crisis depends on how the cost of reconstructing insolvent enterprises and the financial sector is minimized. KIEP