This paper examines China’s equity-for-debt swap program through a detailed case study of the reform process in one state-owned enterprise. We use a property rights conceptual framework to examine the extent to which Asset Management Companies have been able to exercise their ownership rights as well as related reforms to wage structure, managerial appointments and separation of social welfare responsibilities. Our main finding is that the Asset Management Companies have been unable to exercise their bundle of ownership rights. On the basis of this finding we suggest that it is going to take much longer for the Chinese government to realize its objectives compared with many previous debt-workout programs such as Savings and Loans reform in the United States.

KEYWORDS: China, State-owned Enterprises, Equity-for-Debt-Swaps

1. Introduction

The equity-for-debt swap (EDS) scheme is one of the most significant recent reform initiatives to restructure China’s state-owned enterprises (SOEs) and clear up the bad loans of the state-owned banks. The EDS scheme was first announced in 1999 and it came into operation in 2000 when the State Council promulgated regulations on the operation of the Asset Management Companies (AMCs) (AMC Regulations 2000). The four big state-owned banks have each set up one AMC to handle their bad loans. The four AMCs are Xinda (attached to China Construction Bank), Great Wall (attached to the Agricultural Bank of China), Orient (attached to the Bank of China) and Huarong (attached to the Industrial and Commercial Bank of China). The Ministry of Finance has provided each AMC with registered capital of RMB 10

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④ The first author acknowledges financial support from a Grant from the Faculty of Business and Economics, Monash University. The second author acknowledges financial support from the China Scholarship Council. We thank Wang Gensheng for assistance with the project and Zhai Qingguo for comments on an earlier version of this paper. The views expressed in this paper are our own and should not be attributed to CSIC.
billion (AMC Regulations, 2000, Item 5). The State Council appoints the general manager and vice-general manager of the AMCs, while the banks provide the other staff (AMC Regulations, 2000, Item 8).

While the EDS program is attracting increasing attention in the business literature (see eg Steinfeld and Hulme 2000, Zhou 2000, Bonin and Huang 2001, Steinfeld 2001, Smyth and Zhai 2002), because it is a recent phenomenon the mechanics of the reform are still evolving. The objective of this paper is to examine recent developments in the implementation of the reforms through a detailed case study of the EDS in “Northern Shipbuilding”, which is a subsidiary of China Shipbuilding Industry Corporation (CSIC). The case study is based on interviews conducted at the firm in October and November 2002. To supplement the information obtained from the case study, we also interviewed a representative from Huarong AMC in December 2002. This interview was used to supplement the firm interviews and update our information on the EDS.

The conceptual framework which we use to analyze the EDS is grounded in the property rights literature. The property rights framework proffers that ownership consists of a bundle of rights such as control rights, right to receive a dividend and the right to transfer shares to third parties (see eg Comisso 1991, Yang 1993, Smyth 1998). The state-owned banks and AMCs have a good bank-bad bank relationship. The AMCs purchase the designated debt of the state-owned bank with which they are paired at face value. In order to pay for the debt the AMCs issue bonds to the banks at par value. After the debt owing to the bank is converted into equity, the AMC becomes a shareholder in the debtor enterprise. This gives the AMC ownership rights in the firm. Our approach is to examine to what extent the AMCs in Northern Shipbuilding can exercise their bundle of rights. The balance of the paper is set out as follows. The next section provides a brief review of progress with the reforms. Section three presents the case study of the EDS in Northern Shipbuilding. We first describe the mechanics of the EDS in the firm and then examine whether the AMCs can exercise an effective bundle of ownership rights.

Foreshadowing our main findings, while the AMCs involved in the swap are receiving a nominal dividend, the control rights of the AMCs are curtailed and the prospects for transferring their shares to third parties in the short-term are limited. On the basis of this finding we suggest that it is going to take much longer for the Chinese government to realize its objectives compared with debt-workout programs such as Savings and Loans reform in the United States. While western commentators are often critical of the seeming failure of the EDS program to move faster, we stress the need to see the EDS in the context of the social and political realities of enterprise reform in China.

2. Objectives and Progress with the Equity-for Debt Swaps

AMCs in other countries have been set up for a range of reasons. These include (a) privatization of government owned banks; (b) restructuring of distressed, although

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Because much of the information provided in the interviews was sensitive, we use the pseudonym Northern Shipbuilding to protect the confidentiality of the firm.
viable financial institutions and (c) the disposition of insolvent assets from non-viable financial institutions (Klingebiel 2001, Sundarajan and Seelig 2001). The United States Resolution Trust Company (RTC), which was established in the 1990s to deal with the Savings and Loans crisis, is an instance of (c). The Chinese AMCs are a mixture of (b) and (c) (Smyth and Zhai, 2002). The EDS in China has three objectives. The first is to improve the performance of SOEs participating in the scheme and provide a basis for ownership diversification through transferring a bundle of ownership rights to AMCs. The second is to reduce the debt levels of SOEs and turn those firms participating in the scheme from loss-makers to profit makers. The third objective is to enable the banks to improve their balance sheets through selling bad debts to the AMCs attached to them.

Three important differences between China’s EDS and the United States (RTC) are worth highlighting (see Bonin and Huang 2001 for more details). One major difference between China’s EDS and the Savings and Loans reforms in the United States is that in the latter financial markets were well developed with a lot of institutional investors. In China the capital markets are not large enough to handle the size of the bad debts and most investors are individuals who are unable to judge the risks involved with purchasing low quality assets. Second, the RTC was established to deal mainly with real estate loans from Savings and Loans which had ceased to operate as independent entities. Thus, there was no new flow of bad loans. In contrast, in China, the state banks are still lending and continuing to accrue bad loans. Third, in the United States as in some Central Eastern European countries which have used debt-workout programs such as the Czech Republic, a substantial proportion of the transferred loans were good loans, while in China all of the assets transferred to the AMCs have been non-performing loans.

In China the composition and volume of the debt to be swapped is decided by the State Economic and Trade Commission (SETC) in consultation with the Ministry of Finance. The debt must be owed to one of the four main commercial banks or to the State Development Bank. The regulations explicitly exclude debts owing to other financial institutions such as credit cooperatives and investment trust companies. The SETC recommends to the AMCs which enterprises should be involved in the EDS. The regulations governing the operation of the AMCs state that the AMCs are to evaluate each of the recommended firms independently and that the AMCs sign the EDS with the enterprise (AMC Regulations 2000, Item 18). When the EDS scheme was announced, 2000 of China’s large and medium-sized SOEs applied (Steinfeld, 2001). The SETC selected 601 mainly “key” SOEs in the initial round. The total value of the debt of the 601 enterprises involved in the swap is RMB 400-500 billion, which was about 50 per cent of the outstanding loans of the banking sector at the end of 1997 (Huang 2001).

At the end of 2001, the official estimate was that non-performing loans held by Chinese banks were worth 1.8 trillion RMB ($US 217 billion) or 25.4 per cent of bank lending (Xinhua News Agency 2002). However, an Ernst & Young study estimates that the total value of unprofitable loans to be $US 480 billion or 44 per cent
of bank lending (Chandler 2002). A total of 1.4 trillion RMB ($US 170 billion) was transferred to the four AMCs in the first round (Tam 2002). In November 2002 the State Council announced that it was considering a second transfer of non-performing loans to AMCs. At the time of the announcement, Wang Weiwei, Deputy Director General of Economic Restructuring in the State Council stated that the scale of the second swap would not be larger than the first transfer which commenced in 1999 (Kynge 2002).

It is important to realize that not all of the assets which AMCs hold are acquired through EDS. At the end of 1999 Huarong held 100 billion RMB, for which it issued bonds to the Industrial and Commercial Bank at face value under the EDS program. It also held a further 300 billion RMB worth of bad loans, which it purchased from the Industrial and Commercial Bank at a discount to par. In the latter case, the amount which it paid for the bad loans depended on the quality of the assets. Huarong has paid up to 90 per cent of face value to purchase bad loans, but the most common value is 30 per cent of the face value of the asset. The distinction between equity acquired at par under the EDS scheme and bad loans purchased at a discount is important because the rights which are conferred differ. When debt is purchased at par under the EDS program, the AMCs get a bundle of ownership rights. However with bad loans purchased at a discount the AMCs do not get the right to participate in the running of the enterprise, but only acquire the right to collect the loan through liquidating the asset or selling it to third parties.

At the end of September 2002, the four AMCs had disposed of bad loans worth 232.3 billion RMB ($US 28.09 billion). Of the bad loans disposed to September 2002, the four AMCs recovered 84.6 billion RMB ($US 10.2 billion), which is a recovery rate of 36.4 per cent. Of this amount, 52.5 billion RMB ($US 6.3 billion) was in cash, which represents a cash recovery rate of 22.6 per cent. Huarong has the highest cash recovery rate on bad loans among the four AMCs. In Huarong, the cash recovery rate on its 300 billion RMB worth of bad loans since 1999 has been about 30 per cent.

However, the return on the debt converted to equity under the EDS is not as good. Of the 100 billion RMB purchased by Huarong from the Industrial and Commercial Bank at face value under the EDS program, about 0.5 per cent has been sold to third parties. Moreover, out of the 500 million RMB that has been sold to third parties, less than 10 per cent has been sold to foreign investors. Most foreign investors are only interested in industries with growth potential, such as computers, electronics, food processing and telecommunications, and in assets in large and medium-sized cities. The reason it is difficult for the AMCs to sell debt/equity acquired under the EDS program is that it must be sold at par, unless the AMC gets special permission from the Ministry of Finance.

One innovative development, which Huarong has pioneered is to put together asset packages to sell to foreign investors. Huarong has a good relationship with the top five international accounting firms, who have assisted it to price the asset packages. In

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1 Interview at Huarong AMC, December 2002.
2 Interview at Huarong AMC, December 2002.
3 Interview at Huarong AMC, December 2002.
November 2001 Huarong AMC sold asset packages to international investment consortiums led by Morgan Stanley (with a face value of 10.8 billion RMB) and Goldman Sachs (with a face value of 1.97 billion RMB) (Kynge, 2002a, Xinhua News Agency 2002a). Most of these assets were bad loans, which Huarong had purchased at a discount to par, but there were also some assets, which it had acquired at face value under the EDS with the Industrial and Commercial Bank.\(^1\) The overall return on these asset packages was slightly less than 10 per cent of face value (Kynge 2002a). At the same time as selling the assets, Huarong signed separate agreements with the Morgan Stanley and Goldman Sachs consortiums to set up joint ventures to dispose of the assets. Morgan Stanley proposed a two-tier structure, consisting of a joint venture that owns the debts and an offshore entity that charges a service fee to dispose of the assets (McGregor 2002). The problem was that there was no precedent for the establishment of a joint venture such as this to collect bad debts in China. This caused a delay of just over 12 months before the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) gave approval for the joint ventures to proceed in December 2002 (Kynge 2002a).

Huarong also provides management consulting services for firms in which it holds shares. This includes packaging companies for listing on the stock market and acting as an underwriter for stock market listing.\(^2\) Great Wall and Xinda AMCs are following Huarong’s lead. In April 2002 Great Wall auctioned 15 billion RMB worth of bad loans to international investors. Xinda has signed an agreement with Goldman Sachs, Deutsche Bank and Lonestar Capital to dispose of bad loans from the China Construction Bank. Xinda has also applied to the Central Bank for permission to pack up better quality assets for securitization. It wants to pledge indebted assets as bonds in enterprises which report good cash flow in the water, power and transport industries (McGregor, 2002).

3. Case Study of the Equity-for-Debt Swap in Northern Shipbuilding

3.1 Background and Methodology

Northern Shipbuilding was established at the beginning of the 1990s and became a subsidiary of CSIC in 1999. In 2001, it was among the five largest shipbuilding companies in China in terms of exports, jobs completed and output value and the 10 largest shipbuilding companies in China in terms of new orders received (British Embassy 2002). In terms of sales revenue it ranks between the 200\(^{th}\) and 300\(^{th}\) biggest SOE in China (SSB, various and firm interviews). We conducted multiple in-depth interviews with a member of the senior management group of Northern Shipbuilding, who was in charge of economic restructuring in the firm in October/November 2002. These interviews were supplemented with a further interview with the financial manager who was in charge of the EDS in the firm. The questions were supplied to the firm in advance of the interviews and we were provided with written responses to those questions before the interviews took place. The interviews were therefore used to get clarification on issues that were unclear as well as seek further elaboration on the written answers. The information below on Northern Shipbuilding is based on the

\(^1\) Interview at Huarong AMC, December 2002.
\(^2\) Interview at Huarong AMC, December 2002.
interviews conducted at the firm and material supplied by the firm unless indicated otherwise.

Northern Shipbuilding is typical of many large firms in the shipbuilding sector and state sector more generally. In 2001 it had approximately 4500 formal employees and another 5000-6000 contract workers. It resembles a large diversified manufacturer. Apart from shipbuilding, ship repair and marine products, Northern Shipbuilding produces large-scale steel structures for high buildings and bridges. Case studies of large SOEs suggest that surplus labour between 10 and 60 per cent of the workforce in the state sector is common (Morris et al, 2001 pp. 699-700). At the interviews we were told that at Northern Shipbuilding administrative/managerial staff could be reduced by one-half to two-thirds and production workers could be reduced by one-half without a fall in output. In common with many large SOEs, the firm has also shouldered a large social welfare burden, which is considered in more detail below. The debt levels in the firm prior to the swap were a bit higher than the average for large SOEs, but are fairly typical of the shipbuilding industry. In 1999, prior to the EDS the debt-asset ratio of the firm was 94 per cent. Subsequent to the EDS, the debt-asset ratio fell to 65 per cent.

3.2 Situation Before the EDS

From the start of the 1990s up until 1994 the firm made a small annual profit and experienced stable growth in sales revenue. During this period, the firm had one Slipway, which meant that it could only build one ship at a time. However, at the end of 1994 there was a change in the leadership of the firm and a Dry Dock was constructed in addition to the existing Slipway. It was possible to produce two ships at the one time in the Dry Dock. Therefore, there was an increase from one production line (on the Slipway) to three production lines (one on the Slipway and two in the Dry Dock). With the installation of the Dry Dock, similar to other SOEs at the time, the new leadership focused on maximizing output without much attention to cost or profit considerations.  

With three production lines Northern Shipbuilding signed contracts for the delivery of several ships in short sequence. According to the contracts, each ship had to be delivered at six-month intervals. This resulted in chaos on the production lines and created several problems. First, in order to operate the three production lines simultaneously and attempt to meet the contract deadlines, the firm had to borrow to bring delivery of the second and third ships forward. As the interest rate at the time was high (around 10 per cent per annum), the total cost of the borrowing was about 25 million RMB per annum. Second, the firm could not match production schedules with delivery targets. As a result, some ships were built ahead of the scheduled time, while some were well behind schedule and, in the case of these ships, the firm had to pay penalties on late deliveries. Third, in order to meet the extra production, the firm was forced to hire more contract workers. Most of the contract workers came from outsourcing teams. According to the National Regulations contract workers cannot mix with formal employees in the firm, so outsourcing teams had to be brought in for entire jobs. Before 1995 Northern Shipbuilding had three outsourcing teams, but after

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1995 this figure increased to 10.

The firm continued to make small profits in 1995 and 1996, but the focus on maximizing output combined with the effects of the Asian financial crisis meant that the firm made a substantial loss for the first time in its history in 1997. Following the Asian Financial Crisis there was a 20 per cent drop in world shipping prices. This had little or no effect on South Korean shipbuilders, who along with Japanese shipbuilders are China’s main competitors. This is because the Won depreciated significantly relative to the US dollar over the same period, while the RMB has been stable relative to the US dollar. After the Asian Financial Crisis, Northern Shipbuilding took no orders for several months and experienced slow business for at least two full years. At the end of 1999, it had two long-term loans denominated in RMB with the State Development Bank and the Construction Bank and one long-term loan from the Bank of China, which was denominated in Yen.

3.3 The Mechanics of the EDS

In November 1999, CSIC and Northern Shipbuilding signed a preliminary EDS with the State Development Bank and the Orient, Huarong and Xinda Asset AMCs. Huarong was involved in the EDS because Northern Shipbuilding had some bad current loans from the Industrial and Commercial Bank, although they had no long-term loans. Theoretically only long-term loans are included in EDS, but in practice some current loans have also been swapped. While the loans with the Industrial and Commercial Bank were listed as current loans, in practice they were used for construction and infrastructure purposes and thus qualified for the EDS. The first shareholders coordination meeting was held in December 1999, where a working group was established. The EDS agreement was formally signed in March 2000, at which time it was approved by the State Council.

Table 1 shows the debt transferred in the swap. All of the debt owing to the State Development Bank, Industrial and Commercial Bank and the Construction Bank was transferred into equity owned by their paired AMCs. However, not all of the debt owing to the Bank of China, which is paired with Orient, was due. Thus, only loans that were due were included in the EDS. Table 2 shows the shares and seats on the Board of Directors and Supervision Committee of each of the parties following the EDS. There are 13 seats on the Board of Directors. The seats, which each of the parties hold on the Board is proportional with their equity in the firm as shareholders. There are seven seats on the Supervision Committee. On the Supervision Committee each of the parties (including CSIC) holds one seat, except Northern Shipbuilding, which holds two seats.

CSIC and Northern Shipbuilding hold six seats on the Board between them and provide the Chairman. However, prior to the EDS, Northern Shipbuilding’s net assets were initially valued at approximately 600 million RMB. This was not enough to give CSIC and Northern Shipbuilding control of the Board. The total area of the land on which Northern Shipbuilding is located, which CSIC owns and which it leased to Northern Shipbuilding in return for rent is 1.14 million square metres. To

① The asset evaluation was conducted by an independent auditing company. Northern Shipbuilding also arranged for a second audit, which was carried out by auditors, which it appointed.
ensure CSIC and Northern Shipbuilding maintained control of the Board, CSIC included 300,000 square metres of this land as part of the assets of Northern Shipbuilding prior to the EDS. This means that CSIC no longer receive rent on this 300,000 square metres, but instead receive a dividend on their shareholding, along with the other shareholders, provided that the firm makes a profit. Theoretically CSIC could continue to cede land to Northern Shipbuilding to inflate its shareholding. CSIC, though, can get a higher and guaranteed return on the land if they lease it to Northern Shipbuilding. Thus, as long as CSIC maintains control of the Board, it does not want to include more land in the EDS.

3.4. The AMCs’ Bundle of Ownership Rights

As discussed in the introduction, as part of the EDS, AMCs are supposed to receive a bundle of ownership rights. The main ownership rights, which are conferred on AMCs are control rights, the right to receive a dividend and the right to transfer their equity to third parties. Here we examine whether, and to what extent, each of these bundle of ownership rights can be exercised by the AMCs in Northern Shipbuilding.

The AMC provisions state: “The AMC as a shareholder of the enterprise can send people to join the board of directors and supervision committee and enforce its rights as a shareholder” (AMC Regulations, 2000, Item 20). In theory, the shareholders and the Board sit at the top of the decision-making tree (Production Bureau of National Reform Committee, 1999). However, in practice, it is the government which continues to appoint senior management in large SOEs and outside shareholders cannot interfere in the day-to-day management of the firm. Even in cases where the AMCs own the majority of the shares they will typically not interfere in the day-to-day management of the firm. Generally the input of the AMCs is restricted to decisions regarding the policy direction of the enterprise. In fact Huarong has downsized its EDS division, focusing instead on collecting and packaging bad loans. The reason is that most of the work in the EDS division is completed in a three-month period each year when representatives from Huarong attend Board meetings. But because Huarong does not participate in day-to-day management, there is little for its EDS division to do at other times of the year.

At Northern Shipbuilding, one effect of the EDS is that the decision-making structure has become more formalized. Since the EDS, decisions are taken through the Board of Directors and Supervisory Committee. Hence, it can be argued that the governance structure has improved. If CSIC and the AMCs are in dispute, the parties will first attempt to negotiate a solution informally in a shareholders coordination meeting, but if no solution can be reached there will be a formal vote through the Board of Directors.

The AMCs can exercise their voting rights through the Board of Directors; however, in practice their influence is limited on most decisions because they lack expertise in

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① Interview at Huarong AMC, December 2002.
② Interview at Huarong AMC, December 2002.
the shipbuilding industry. For this reason, the view was expressed in the interviews at Northern Shipbuilding that the Directors appointed by the AMCs are not as influential as the Directors appointed by CSIC and the firm itself. Most of the time the AMCs just vote for the proposals which CSIC puts forward. The attitude of Huarong is representative of the other AMCs involved in the EDS. The representative from Huarong whom we interviewed pointed out that Huarong is involved in approximately 500 EDS, which are spread over several industries and that it does not have the time or expertise to be involved in the management of the enterprises in which it is a shareholder.

There are two issues on which the AMCs have outvoted CSIC. One issue concerned a management fee, which CSIC collected from Northern Shipbuilding prior to the EDS with the sanction of the taxation office. Following the EDS, the AMCs considered that CSIC, as just one shareholder, should not continue to collect a management fee from the firm at the expense of the other shareholders. Thus, in 2001 the other Directors voted against CSIC getting a management fee and now CSIC no longer collects the fee.

The other issue concerned a proposal by Northern Shipbuilding not to allocate dividends in 2000-01. This is because the firm was not performing well following the Asian Financial Crisis, although it still made a small profit in that financial year. The AMCs voted against that proposal, with the result that a nominal amount of dividends were paid. At the interview we conducted at Huarong we were told that getting firms to pay some dividends is one issue on which the AMCs have exercised their ownership rights. The representative from Huarong pointed out that in order to avoid paying dividends, companies will often fiddle with the balance sheet to conceal that they are making a profit. The AMCs are well aware of this, such that the veracity of the balance sheet is one aspect of firms’ operations to which the AMCs pay particular attention.

The AMCs at Northern Shipbuilding intend to sell their shares to third parties if possible and we were told at the interviews that some potential purchasers had shown an interest. Northern Shipbuilding would like what was described as a “powerful shareholder” to purchase the AMCs’ shares, preferably, in an allied industry such as shipping, which would provide raw materials, new technologies and guaranteed orders. One of the big international shipping companies would fit this bill, but it will be difficult for the AMCs to sell their shares to overseas investors who generally would want a controlling interest. It seems unlikely that CSIC would countenance giving up its controlling interest in the firm. In this respect, it has priority in purchasing shares from the AMCs, which it can exercise if it looks like losing its controlling interest. At the same time, there are few opportunities for the AMCs to sell

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\[1\] This has also been observed in case studies of other EDS. In particular, Steinfeld emphasizes this in his case study of an EDS in an aluminum SOE in Chongqing – see Steinfeld (2001).

\[2\] Note that most of the AMC representatives come from the AMCs themselves. However, AMCs also hire some outside experts, such as academics, “industry experts” and retired managers to act as independent representatives on the Board -Interview at Huarong AMC, December 2002.

\[3\] Interview at Huarong AMC, December 2002.
their interests to non-state enterprises in China because it is difficult for such firms to invest in a shipbuilding firm the size of Northern Shipbuilding given the capital expenditure needed. Thus, unless the AMCs were to sell their shares to another SOE, which would defeat the ultimate object of ownership diversification, the prospects for the AMCs to exit the firm in the short-term are slim.

3.5. Enterprise Reforms Since the EDS

The AMC regulations provide that “after the EDS, the enterprise should change its operation mechanism according to the requirements of the modern enterprise. The management should be improved and the local government should help the enterprise to reduce its number of workers and separate its social welfare functions” (AMC Regulations, 2000, Item 19). Candidates for the EDS were required to give a plan to the SETC prior to the swap for reforming their management mechanism and wage structure and following the EDS, the local committee of the SETC oversees its implementation.

Management and Wage Reform

As part of the plan put forward to the SETC to be given permission to undertake the EDS, Northern Shipbuilding proposed that it would reform the wage structure within the firm. Since the EDS was completed, in addition to wage reform, Northern Shipbuilding has also introduced open competition for managerial positions. The reforms are linked. Introducing competition for managerial positions is seen as an important step towards wage reform because workers are less likely to resist the idea of the firm paying higher salaries to management if they are given the opportunity to compete for the positions.

In Northern Shipbuilding each manager receives an annual performance assessment conducted by the human resources department and a supervisor’s assessment conducted by the manager’s supervisor. Since the EDS, all managerial positions are thrown open to competition in March each year, once the results for the previous year are known. In theory, anyone within the firm who satisfies the minimum criteria in terms of age, experience and qualification can apply for a managerial position in the open competition. However, in practice the real competition for positions will be restricted to those where the manager fails his/her annual assessment and/or supervisor’s assessment. Northern Shipbuilding has also used the introduction of competition to restructure the firm. Thus, there have been a series of department mergers and the firm has introduced semi-retirement arrangements for older managers approaching retirement age. The annual turnover of management, due to poor performance and restructuring of managerial positions in the short period since the reforms were introduced has been 10-15 per cent.

In Northern Shipbuilding wages consist of four components: (i) position wage, (ii) experience wage, (iii) skill subsidy and (iv) bonus. Following the EDS the coefficient bands for the position wage component were widened between positions in order to reward better performance. The base wage for the position component is 800 RMB per month, which has a coefficient of 1. Following the EDS the coefficient bands are
as follows: General Manager (5-6.5), Deputy General Manager (4-5.25), head of a major department (3-4), head of a lesser department (2.6-3.5), supervisor of a workshop (2-3.5) and technical workers (1-1.75). For service workers the coefficient band varies between 0.75 and 1.5. The position within the band is assessed each month according to targets.

Production workers are paid on a piece-wage basis. The firm allocates a fixed number of hours per job and assigns a unit price to each job. The number of hours allocated to each job is reviewed from time to time according to whether production targets are being met. For jobs related to shipbuilding the unit price is 9.6 RMB per hour, while for all other jobs it is 5.6 RMB per hour. If the job is completed within the allocated time to the required standard, workers will receive the full amount for the job (allocated hours per job times unit price) and can move on to the next job. The norm is for production workers to work 176 hours per month, but some work up to 250 hours per month.

Following the wage reform, wages in Northern Shipbuilding are now in the medium to high range for its location. Prior to adjusting their position wage, the firm lost some designing staff and production managers to foreign-owned companies. However, since the reforms to the position wage, designing staff in Northern Shipbuilding can now earn 2,500-3,000 RMB per month all up plus receiving a further 40 per cent of their wage in social welfare benefits. Taking social welfare benefits into account, this amount is roughly comparable to what can be earned in foreign-owned companies where the monthly wage is about 4000-5000 RMB per month. Given that SOEs, such as Northern Shipbuilding, generally have more flexible working arrangements than foreign-owned firms, since the wage reforms some designing staff have even returned to the firm.

Separation of Social Welfare Functions

Northern Shipbuilding started to separate its social welfare functions in the mid-1990s. Until the mid-1990s the firm operated a childcare centre in the factory and a kindergarten in the residential area for use by its employees. The cost to the firm of offering these services was about 500,000 RMB per annum. These were closed in 1995-96 and, as compensation, Northern Shipbuilding introduced one year paid maternity leave (without annual bonus). Northern Shipbuilding established a bus route in 1990 because there was no public transport for workers to get to the firm. It had to transport 3000 workers to the firm in the morning, for which it had to purchase 20 to 30 buses. The firm thought that it could recoup some of the costs through charging workers a fare and running the bus service at other times of the day. However, it was making a loss of 900,000 RMB per annum and in 1999 just prior to the EDS it was transferred to the municipal government.

The process of separating social welfare functions has continued since the EDS. Northern Shipbuilding owns a hotel, which it built for 30 million RMB between 1995 and 1997. The hotel was losing 1 million RMB per annum. In 2000, it was merged with one of the firm’s service companies, which supplies marine transport equipment. The reason for the merger was that the hotel was loss making, while the marine transport company was profitable. Northern Shipbuilding is currently negotiating with the municipal government to separate its junior secondary school. The problem
is that the municipal government wants the firm to transfer all of the school’s assets, make an initial lump-sum payment of 6 million RMB and pay an annual subsidy starting at 1.2 million RMB to be phased out over 10 years. The employees of Northern Shipbuilding are also opposed to transferring the school because it is currently regarded as a good quality junior secondary school with a high proportion of students gaining access to “key” secondary schools.

Raising Funds Since the Swap

After the EDS, the debt-asset ratio fell almost 30 per cent. This has made the firm an attractive lending proposition for the banks. Steinfeld (2001) notes that this is a common occurrence with the local branches of major state banks lining up to extend new loans to SOEs that have undergone EDS. He points out that there are several reasons for this phenomenon. First, banks want to lend to firms which have undergone EDS because they have been through an official vetting process and, hence, have the imprimatur of the state. Second, the debt-asset ratio in firms that have undergone EDS has fallen, so the banks consider them safer bets. Third, because AMCs have large financial obligations to the banks, the banks do not want the firms with which the AMCs are involved to get into financial difficulties in the short-term because of cash-flow problems.

Northern Shipbuilding has received preferential support for four projects since the debt-equity swap. First, it received funding for developing new technologies worth 300 million RMB over the period 1999-2002, made up of bank loans, interest subsidies from the government and contributions from CSIC. A second project for new product development worth 140 million RMB started in 2000 consisting of bank loans and government subsidies. Third, Northern Shipbuilding received a further 200 million RMB in 2001 from the SETC for new product development. The fourth project is funding to improve infrastructure capacity, which was approved in 2002. The total value of this project is 260 million RMB, made up of bank loans and contributions from CSIC.

In 2004-05, the projected debt of Northern Shipbuilding will be 600-800 million RMB. At this time, the firm expects to complete all the projects and start repaying the debt, with the objective of paying it off by 2008. To achieve this, it would need to pay off 120 million RMB per annum, but the problem is that the firm’s annual profit is only 40-60 million RMB. Thus, the firm cannot afford to service the debt. At the time of the interviews, it was considering two options to address this issue. The first is to get foreign investment. It was negotiating with a United States firm that was interested in investing in its marine engineering technologies. The second was to list on the stock market.

While Northern Shipbuilding is still weighing up the pros and cons of listing on the stock market, it has decided against it at this stage. If it were to list, the listing price and thus the amount of capital it could raise would depend on the firm’s profitability. To list at a price which was high enough to raise the funds to retire the debt, its profits would need to be about 160 million RMB per annum. The only way it could achieve this would be to inflate the profits of the listed subsidiary through directing revenue to the listed subsidiary and costs to the non-listed subsidiary. The problem, though, is that the tax levied on profits is 33 per cent. If the listed company was making 160
million RMB per annum, it would have to pay 53 million RMB per annum in taxation, while interest repayments on the debt accrued under the four projects is 30 million RMB per annum.

4. Conclusions from the Case Study

On the plus side the EDS in Northern Shipbuilding has acted as a catalyst for some related reforms to management and wages in the sense that the AMC regulations specified that labour market reforms were a precondition for the firm participating in the EDS program. These reforms have made the firm more competitive in attracting and maintaining skilled labour. However, the four new projects, which Northern Shipbuilding have started since the EDS suggest that the EDS may have done nothing to change the soft credit mentality that run up huge debts prior to the swap. If the firm cannot service the debt, it is likely that the firm will accrue further bad debts, ultimately muddying the good-bank-bad-bank relationship. The reforms have also done little to facilitate restructuring and ownership diversification. While there are now formal Board meetings, the AMCs in Northern Shipbuilding have only received a limited bundle of ownership rights. The AMCs have outvoted CSIC to ensure that they get a nominal dividend, but the extent to which they can exercise control rights is impaired by a lack of industry knowledge and there are limited prospects for transferring shares in the short term.

The failure to push the reforms through faster has to be seen in the context of social and political realities facing the reform process in China. In the mid-to-late 1990s the State Commission for Economic Restructuring estimated that the number of surplus workers in SOEs was about half the total workforce (Morris et al 2001, p. 699). The EDS has done little to reduce the prevalence of surplus labour in Northern Shipbuilding with the AMCs unable to scale-back employment. Western commentators on the EDS often express exasperation that the AMCs have been unable to address the surplus labour problem. Steinfeld’s view is a common one when he states: “Unfortunately, nothing in the debt-equity restructuring arrangement addresses the fundamental problem [of surplus labour]” (Steinfeld 2001, p. 17). However, it is also important to recognize that the socio-economic sensitivities involved in restructuring are major constraints on the reforms. The shock to society with China’s EDS program has been deliberately designed to be smaller compared with other forms of debt-workout such as asset liquidation, which would involve large-scale redundancies (Huang, 2001, Smyth and Zhai, 2002).

The regulations governing the operation of the AMCs provide for a ten-year timeframe for the AMCs. The obvious conclusion from the case study is that given the slow progress to this point with transferring shares to third parties, the process of ownership diversification is going to take much longer than ten years. Against this backdrop, the challenge for the Chinese authorities is to get the speed of reform right. It is a delicate balancing act. The reforms cannot be pushed through to fast. The number of laid-off workers already represents a major social problem in China. According to official figures there were 26 million workers laid-off from SOEs between 1998 and 2002 (Armitage, 2003). China’s embryonic social security system would be unable to cope with redundancies on the scale that would occur if all the surplus workers in large SOEs such as Northern Shipbuilding were laid-off. If this
were to occur, social stability would be potentially threatened. At the same time, if the reforms are to slow and the AMCs continue to take a backseat indefinitely it is likely that the banks and firms will treat the EDS as a free lunch, further bad debts will accrue and nothing will change.

References


Production Bureau of National Reform Committee (1999), One Hundred Questions


Table 1
Debt Transferred in the Debt-Equity Swap at Northern Shipbuilding
(Units 10,000 RMB)

<table>
<thead>
<tr>
<th>Creditor</th>
<th>Item</th>
<th>Debt</th>
<th>Debt Transferred</th>
<th>Remaining Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Development Bank</td>
<td>Total</td>
<td>42691</td>
<td>42691</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Capital</td>
<td>41100</td>
<td>41100</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Interest</td>
<td>1591</td>
<td>1591</td>
<td></td>
</tr>
<tr>
<td>Xinda AMC</td>
<td>Total</td>
<td>30029</td>
<td>30029</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Capital</td>
<td>26750</td>
<td>26750</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Interest</td>
<td>3279</td>
<td>3279</td>
<td></td>
</tr>
<tr>
<td>Huarong AMC</td>
<td>Total</td>
<td>20000</td>
<td>20000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Capital</td>
<td>20000</td>
<td>20000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Interest</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Orient AMC</td>
<td>Total</td>
<td>25530</td>
<td>14793</td>
<td>10737 (a)</td>
</tr>
<tr>
<td></td>
<td>Capital</td>
<td>24919</td>
<td>14182</td>
<td>10737</td>
</tr>
<tr>
<td></td>
<td>Interest</td>
<td>611</td>
<td>611</td>
<td></td>
</tr>
</tbody>
</table>

Notes: (a) Not all of the debt owing to the Bank of China, which is paired with Orient, was due. Only loans that were due are included in the debt-equity swap.
Source: Materials supplied by Northern Shipbuilding.

Table 2
Equity and Seats on the Board of Directors and Supervision Committee at Northern Shipbuilding Following the Debt-Equity Swap

<table>
<thead>
<tr>
<th></th>
<th>Equity (million RMB)</th>
<th>Seats Held on the Board of Directors</th>
<th>Seats Held on the Supervision Committee</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Development Bank</td>
<td>426.91</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Xinda AMC</td>
<td>300.29</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Huarong AMC</td>
<td>200.00</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Orient</td>
<td>147.93</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>CSIC (including land)</td>
<td>796.15</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Northern Shipbuilding</td>
<td>1871.28</td>
<td>4 (including chairman)</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: Materials Supplied by Northern Shipbuilding.