LEADERSHIP OF FAMILY AND STATE FIRM BOARDS

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We need to comment the three words: family, state and firm.

Let us start by firm: China has a history of 5000 years, but few firms are very old. In France, the Manufacture des Gobelins was founded in 1601 and Compagnie de Saint Gobain, founded in 1665 to produce glass, is still one of the world leaders in building materials. In China, most of the oldest firms were founded later, during the 19th or the 20th century and most of the time by foreigners. It is important to remember this fact because it explains an important difference between China and the Western world: in the West, firms have for long become an established entity with some firms having a history longer than some states or countries. In China, firms are relatively recent and haven't established a long history. As a consequence, firms are often more an instrument to serve other purposes than an entity by itself.

I. Family firms:

Among the oldest entrepreneurs in China, we have kept annals of many business people coming from Shanxi province. They were traders and bankers and they are often referred as the inventors of Chinese banking techniques during the Ming and Qing dynasties. They have left numerous "villas" in Shanxi. A villa is actually a village providing houses for a whole family. Some of them counted several thousand people living in them. One of the best preserved villas is the one of the Wang family, north of the city of Pingyao. I visited it some years ago and what stroke me was to find out that at a certain period, two brothers became the chiefs of the family: they had the biggest and richest houses in the villa, but one had a more prestigious house than his brother and the reason was that he was an official of a higher rank in the Chinese administration than his brother. It teaches us several lessons:

- There was no contradiction between being an official in the Chinese administration and being a businessman
- What was important was the prestige of the family and having a high rank in the administration was better considered than bringing more wealth to the family

- The business of the family was not important for itself, but as an instrument at the service of the family.

We can see the fact that family is more important than the firm by another anecdote: if you go to Pingyao and visit the building of the most important local bank, you are shown a circle made of iron that is a kind of gauge for the head. I was explained that, to be hired as a director in the past, the applicant had to fit the gauge exactly: if his head was too small, he was not intelligent enough, but if his head was too large, it was the sign he could be too ambitious and become a threat to the power of the family.

Allow me to give a reference taken from Hollywood. In 2000, a film was released with the title *Romeo must die,* starring the kung-fu champion Jet Li. Jet Li plays the part of a fighter escaping a prison in Hong-Kong and going to the States in order to avenge the death of his brother there. The father of the two young men is actually the boss of the local Chinese mafia. What makes the film American and not Chinese in the plot is that eventually, Jet Li discovers that it was his father who ordered the execution of his son because the son was too unreliable and could ruin the family business. Putting the family after the business is very unlikely in the Chinese tradition!

The family firms disappeared during the first years of Communist China together with private-owned enterprises. They reappeared after Deng Xiaoping launched the movement of reform and opening, especially after the second phase of the movement, when Deng made his famous Southern trip in 1992. But the characteristics that the family is more important than the firm have subsisted. It brings two problems:

1. When a family firm chooses executives, the iron circle of Pingyao still plays its part: loyalty is put before competence. It is why most frequently, executives come from the family or from the same geographical origin as the family.

2. A major problem is the transmission of the firm after the first generation of entrepreneurs. This problem is general to all Chinese culture firms, including in South East Asia. In 1991, was held in Singapore the first Chinese world entrepreneurs Forum gathering Chinese business people from all over the world with the following theme: *Is Confucian philosophy favorable to business development?* The conclusion was:

- Confucian philosophy is very favorable for enterprise creation because of its emphasis on work, honesty, loyalty, trust.
- It is not favorable to enterprise transmission for the same reasons. The factors that favor enterprise creation become an obstacle to good transmission of power. A good example was given to us at that time by the case of computer firm Wang, created in the United States by Dr Wang. At one time, it was one of the most successful computers firms in the world. But Dr Wang appointed his son as successor and the company went broke very shortly afterwards. My feeling is that things haven't changed much since that time!

II. State firms:

State firms have a very bad reputation in the western world as does communism. Let me first explain that the Chinese have other ideas. In 2007, a series called *Emergence of great nations* won a great success in China. It explained to the Chinese public why some nations became important in the world. It was surprisingly politically neutral. But the episode describing Russia was very interesting because it gave a viewpoint totally different from the Western one about the rise and fall of communism in ex-Soviet Union. We all know the dominant theory in the West according to which the fall of the Berlin Wall and the Tchernobyl accident proved the wrongness of communism. As Gorbatchev himself put it: *Tchernobyl was not only an accident, it was the evidence of the failure of the Soviet system.* The series emphasized another aspect of communism which lifted Russia from a backward, feudal, agricultural country to a modern, industrial, scientifically advanced country, in less than 50 years. That country under communism was second only to the United States and defeated the armies of Hitler. So it wasn't communism that failed, but the inability of the Soviet leaders to adapt to the changes of modern world!

So is the attitude towards State firms in China: the Chinese are not ideologically prejudiced against state firms. During the Cultural Revolution, state firms, belonging to the whole people were supposed to be the elite of Chinese firms, well above cooperative enterprises belonging to their workers. But State firms were not enterprises, they were not responsible of their P&L, they couldn't decide what to produce, what to sell, who to employ, what and where to invest. They were mere production units taking their orders from the State Planning Commission and the State Economic Commission.

Of course, it is no more the case, but the status of State firms is still unclear. They are still continuously under reform and even when the reform is accomplished, mainly with their capital divided into shares, very often partially put on the market through IPO, their ownership is still in its majority in the hands of the State. But the State is not an ordinary shareholder that wants the firm to prosper because its prosperity boosts its wealth. The State has many objectives which are often contradictory. What does the State want?

The answer is not clear and depends on a great number of factors. I remember having discussed this problem with a friend who was the general manager of a State firm belonging to the Shanghai government. He explained to me that his goal was imperatively not to lose money, but he had an important restriction: Shanghai municipality knew very well that the firm was overstaffed. In order to avoid big social problems, my friend wasn't allowed to dismiss more than 10% of his staff every year. In exchange, he didn't have to make a big profit.

Lately, China has decided to follow more the rules of market economy, including the following principles:

- No direct interference in the management of State firms: only indirect influences through macroeconomic policies should be applied
- Let competition stimulate the firms and optimize the economic situation of the country
- Return the firms acting in the competitive fields of the economy to the private sector and keep State firms only in strategic sectors.

Experience shows that none of those principles has been fully applied:

- The State still interferes directly in the management of State firms, the most important interference being the power to appoint the CEO of State firms through an opaque decision making process.
- Competition diminishes in some very crucial areas: one of the most important is the financial sector. The biggest banks are state-owned and the lending rates, as well as deposit rates are largely decided by the government.
- There are still many state-owned firms in competitive sectors, especially in the services.

In spite of those problems, with the exception of some cases which are notoriously deficient (security problems in the railways, inefficiency in the financial sectors, etc.) the State firms have not had too bad results. One can even say their problems are small compared with the subprime crisis of the United States or the problems encountered by the European financial firms.

However, a big challenge lies ahead as a recent study of the World Bank associated with the Development Research Center of the State Council has pointed out: China has arrived to the stage where the great risk is to fall into the *middle income trap.* What is it?

To put it simply, the middle income trap appears when a country has overcome the first difficulties of development: it has lifted a great proportion of its population out of poverty, its economy has taken off, it has developed some big domestic firms, its productivity has improved continuously. Then when it arrives at a stage of around 5000$ of GDP per capita, it faces a dilemma. It can follow the hard way: continue progressing, improving productivity, investing in R&D, and allow the majority of its population to reach the middle class status. Or it can follow an "easier" way: allowing its big firms to earn more money by setting up monopolies, using protectionism to artificially protect the domestic market, etc. As a result, productivity decreases, the population gets frustrated, government must subsidize products to avoid prices increases, and the country falls into an economic crisis. Most Latin American and South East Asian countries have encountered the middle income trap. A few have escaped: Singapore, Korea, Taiwan, Hong-Kong.

China has reached that point and is very aware of it. What will it do?

A great part of the answer relies on decisions taken about State-owned firms:

- For some, it is necessary to continue reforming SOE and submit them more and more to the market rules: increase competition, fight monopolies, increase flexibility,…

- For others, it is necessary to keep SOE under the firm guidance of the State because it is what has allowed China to escape the crisis of the countries that have relied too much on the market and have lost all control on economy.

I cannot tell you what the future of governance in the Chinese economy will be but I can tell you a great part of the future of China and hence of the world will depend on it.