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The Irony of the Golden Share

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Flush with confidence after the historic 15th National Congress of the Communist Party in September, China's top leaders have vowed to reform the country's haemorrhaging state-owned enterprise sector. They hope to do this in part by selling shares in SOEs both domestically and on foreign stock exchanges. And although the politically incorrect term is scrupulously avoided, they seek to do this through privatization.

But since September, stockmarkets in Hong Kong and neighbouring Asian countries have collapsed, and the prospect of spiralling deflation looms on the horizon in China. At the same time, some stock analysts are warning apocalyptically that foreign investment in China could decrease by as much as 50% next year.

While no one can predict what will happen in coming months, it is certainly clear that the days of easy money are over. So are oversubscription rates of 1,300 times for red-chip stocks listed in Hong Kong and massive foreign investment flows into Asian emerging-market funds. China will need to offer real value if it is to attract future foreign investment into its hundreds of thousands of loss-making SOEs.

Under current Chinese regulations and policies, the state must own a majority stake in large SOEs. If it owns less than a majority, then it must at least be the largest shareholder, with a greater than 30% stake. But in these times, foreign investors aren't likely to be interested in making significant investments unless they can own a majority of the shares, and thereby enjoy meaningful control over management. Unfortunately, such majority foreign ownership, like the dreaded privatization, is still politically unacceptable in today's People's Republic.

The solution to this dilemma is the "golden share," a share held by the government in a privatized company that would carry special rights greater than those of an ordinary share. For example, the golden share could entitle the government to a veto over major dispositions of assets, a change of control, mergers or other major corporate changes. With the protection of the golden share, the government could relinquish majority ownership over SOEs, yet still retain a measure of control to placate the political opposition to privatization.

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The golden share has been used extensively in privatizations in Malaysia, Singapore, Britain and numerous other countries. In Malaysia, the golden share was used in the sale of shares in Malaysia Airlines, Telekom Malaysia, Perwaja Steel and many other companies. Similarly, the Singapore government is currently devising a golden share for ST Engineering, the conglomerate to be formed from parts of Singapore Technologies. Golden shares were used in practically every privatization public offering in Britain during the 1980s.

The real beauty of the golden share idea is that while it affords the government special rights, the government can choose not to exercise them. The British government, for example, stood aside and allowed Ford to take over Jaguar and British Petroleum to acquire Britoil. Indeed, the British government has rarely exercised its golden-share rights explicitly. Similarly, Singapore recently relinquished its special golden-share rights in ST Industrial Corp., ST Capital and ST Computer Systems & Services when the government determined that special protection was no longer necessary for these companies.

The golden share is in essence a solution that addresses primarily political, rather than legal or economic, concerns. It functions to appease opponents of privatization, for example, the British Labour Party during Margaret Thatcher's privatization spree. Similarly, the golden share may be used to assure those Chinese Communist Party cadres whose parents fought for the 1949 Liberation that the state is not selling the shop.

The irony of the golden share is that although it appears regressive in an era of economic liberalization, it has often been used by reformers to provide political cover. With it, privatization may be made palatable enough to be pushed through the political process.

Permitting foreign majority ownership of SOEs (in conjunction with the golden share) will also address the recent disquieting decline in foreign investment in China, as it will certainly spark renewed foreign-investor interest in future acquisitions in the country. From China's point of view, allowing foreigners majority ownership of SOEs as an inducement to investment is perhaps preferable to restoring the customs-duty exemption on imports of capital equipment by foreign-invested enterprises; the latter would make the money-losing SOE sector even less competitive.

Establishing the golden share could also be the first step in a comprehensive reform of the Chinese shareholding system. This could eventually lead to the introduction of preferred shares and different classes of shares with varying rights, so as to meet the various financial objectives of different segments of the investment market.

Amid recent signs of sputtering growth and declining foreign investment, China's leaders have realized that the ailing SOE sector must be fundamentally reformed in order for growth to continue. The golden share is an idea that may help to sustain China's economic miracle. ■