Critical Issues Confronting China:  
The State Strikes Back: The End of Economic Reform in China?  
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Since the publication of his 2014 book *Markets Over Mao: The Rise of Private Business in China*, Nicholas R. Lardy, the Anthony M. Solomon Senior Fellow at the Peterson Institute for International Economics, has detected from China’s official data a trend reversal: the state seems to have returned and private enterprises have been squeezed. Through copious data and analysis, he painted a woeful picture of vast misallocation of resources in recent years, leading him to question whether this new trend points to the end of economic reform in China—hence the title of his talk.

Lardy first explained the basis for his previous book thesis. The dramatic rise of Chinese private business during the first three decades of China’s economic reform is demonstrated by the price reform of the 1980s; the affirmation of the legal status of private firms, which culminated in President Jiang Zemin’s induction of private entrepreneurs into the Communist Party in 2001; the increased flow of bank credits into private firms, the increased share of total investment by private firms; and their increased displacement of state firms in industrial production and in total exports.

But data from the last six to seven years in the same measurement matrix indicates a rollback of China’s market reforms. Data from the last couple of years is especially worrisome. Credits from the formal banking system to private companies shrank from 57 percent in 2013 to 11 percent in 2016, while those to the state sector grew from 35 percent to 83 percent. Deprived of bank credits, private companies had to turn to informal financial channels for loans, such as P2P (person-to-person) lending facilities, which gave rise to a booming “shadow banking” sector. By 2016, the central government had realized the perilous credit risk built up through shadow banking because of the sheer size of private debt to GDP. The government then began to rein in the growth of credit through informal channels.

Thus, the spread of micro-level financial institutions peaked in 2016. As business credits slow down, small and medium-sized enterprises (SMEs) are the first casualties of this credit contraction. Private Chinese companies generally have had a difficult time in the last couple of years: on the one hand, on the one hand, the government has encouraged the formal banking system to serve the needs of SMEs; on the other hand, it has regulated the shadow banking
sector. Many of the SMEs did not survive this difficult time. Taking their place in the economy is the expanding state sector. From 2012 to 2015, the pace of private investment growth slowed down markedly, to only 1.3 times that of state investments, and in 2016, it fell well below that of state investments.

At the same time, the State-owned Assets Supervision and Administration Commission of the State Council (SASAC), established during 2003-2004, orchestrated mergers of already large state-owned conglomerates in a top-down approach, and created behemoths in certain industries, deemed crucial by the state. These industrial champions defied China’s respectable anti-trust laws, and became de-facto national monopolies. The number of SOEs under the SASAC’s supervision, already oligopolistic in nature, has been reduced from 196 to less than 100. Lardy predicted that the anti-competitive effect of these mega-mergers would make SOEs even less efficient, less innovative, and less nimble in reacting to market conditions. He further pointed out that these mergers were conducted in an opaque fashion among related parties, which became a natural breeding ground for large-scale corruption.

While the ratio of liabilities to total assets for SOEs expanded from 56 percent in 2005 to 66 percent in 2017, their productivity declined sharply from the early 2000s. At that time, China enjoyed the remaining benefits of Premier Zhu Rongji’s radical SOE reform of the 1990s and the boon of lower tariffs on Chinese exports as a result of China’s WTO accession in 2001. The SOEs’ return on assets dropped from about six percent in 2007 to 2.6 percent in 2017. Lardy attributed this drastic drop to the SOEs’ growing inefficiencies and expanding debt, either through bank loans or issuing more corporate bonds. The state sector has been taking more and more productive resources and generating inferior returns than private companies would have on average.

In the end, Lardy referred to a 2014 cross-country study by Lawrence Summers and Lant Pritchett. He disagreed with these two Harvard economists’ conclusion that, although China had grown faster and for a longer period of time than many other developing countries, its growth rate would have to come down significantly and align with other countries’ experiences—as the statistical concept, “regression to the mean,” would predict.

Lardy rebuffed this view because China’s starting point of economic catch-up in the late 1970s was much lower than that of the “four Asian tigers” in their similar development stage. Even now, China’s income per capita is still only one quarter of that of the U.S. China still has a long way to go. Furthermore, the technology and know-how information to fill this large gap are available to China. The only question is whether China will adopt the right economic policies to exploit this late comer’s advantage. Lardy believed that China has the potential to keep growing at six percent or even a much higher rate for decades to come, but the current policies that
produced the trend he delineated above will not help China fulfil its potential.