The State Strikes Back: The End of Economic Reform in China?
Nicholas R. Lardy
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The fast-paced, uncertain relationship between the United States and China makes it difficult for anyone to write a book depicting how that relationship will evolve, even in the short run. In 2014, Nicholas Lardy, one of America's top experts on China's economic liberalization since 1978, was optimistic about the rise of China's private sector; today he is less so.

In his 2014 book, *Markets over Mao: The Rise of Private Business in China*, Lardy saw a vibrant private sector gaining on a largely stagnant state sector, especially in terms of returns on capital. The market, not the state, was on the rise. Consequently, private-sector firms accounted for nearly 70 percent of GDP by 2012.

That picture changed dramatically after Xi Jinping took power in late 2012 as head of the Chinese Communist Party (CCP) and became president in 2013. While preaching reform, Xi has consolidated his authority by being crowned "president for life," promoted industrial policies under the banner of "Made in China 2025," and energized the CCP in the task of "building socialism with Chinese characteristics." This drift away from economic liberalization is reflected in the title of Lardy's new book, *The State Strikes Back: The End of Economic Reform in China?*

No one knows the Chinese economic data better than Lardy. So when he concludes that, "absent significant further economic reform . . . China's growth is likely to slow, casting a shadow over its future prospects," one should take his prediction seriously.

The book is divided into five chapters, each filled with extensive data to support the author's arguments. Chapter 1 explores the reasons for China's slowing economic growth since the 2008–09 global financial crisis. One key reason, as Lardy explains, is that President Xi failed to implement the pro-market reform agenda introduced in the Third Plenum of the 18th CCP Congress, which was held in the fall of 2013. As such, market-led development has given way to state-led development, economic life has become more politicized and state-owned enterprises (SOEs) more protected, while resource allocation has become less efficient. Indeed, Lardy notes that, "beginning in 2012, [state-owned] banks directed a larger share of credit to state firms, essentially crowding out private investment," which was "a stark reversal of the earlier trend" Lardy had lauded in *Markets over Mao*.

Chapter 2 focuses on the potential for convergence between SOEs with low returns on capital and private firms with much higher returns. Lardy argues that, if SOEs and state-owned banks could become more market-oriented, their performance would improve and spur economic growth. However, the soft budget constraints that face socialist enterprises and banks, along with their lack of any credible bankruptcy threat thanks to state-ownership, make them ripe for corruption. "Too big to fail" is endemic in China, as loss-making SOEs turn to state-owned banks for support, and banks favor SOEs in the allocation of credit under pressure from both central and local officials. Because SOEs are seen as less risky than private firms due to their government backstop, they have access to cheaper credit—even though they are much less efficient than private firms.

In competitive capital markets, with private enterprises and effective bankruptcy laws, rates of return tend to converge as capital is put to its highest-valued uses. China's basic problem is a lack of strong private property rights protected by a genuine rule of law and an independent judiciary. To realize the convergence potential that Lardy desires, China will have to undergo a major transformation from "building socialism with Chinese characteristics" to safeguarding property rights and allowing the free flow of both capital and information. Yet, under Xi Jinping, China is moving in the opposite direction, dimming its chances for realizing the potential gains from all-around privatization.

The assets of nonfinancial firms in the state sector increased nearly fourfold between 2008 and 2016, according to Lardy, while their rates of return declined. In particular, the return on assets of state industrial firms reached 1.9 percent in 2015, while the return for private firms stood at 10.6 percent. By failing to reform SOEs, China lost the opportunity to greatly increase the value that a more efficient allocation of resources would have produced.

Chapter 3 tells the story of China's failed strategy to reform SOEs. Corporatization (i.e., turning SOEs into limited liability entities with the state as the majority owner), top-down mergers (directed by the state, not the market), mixed ownership, debt-to-equity swaps, governance reforms, and financial window dressing all count as half-hearted attempts at reform. As such, they have not been sufficient to end state control of enterprises. There are still too many "zombie" SOEs cluttering the economic landscape and sucking up resources that the private sector could have used to increase the wealth of the nation. The idea that SOEs can be made viable and act like private firms—without a hard budget constraint and well-defined private property rights—is an illusion.

In Chapter 4, Lardy makes the case for returning to market-oriented economic reform and away from state-led development. The reforms Lardy prescribes include reducing barriers to entry, promoting mergers and acquisitions, ending "too big to fail" by enacting effective bankruptcy laws, opening the financial sector to competitive pressure, and improving corporate governance. If China were to return to a market-led development strategy, argues Lardy, economic growth would likely increase "from the recent range of 6 to 7 percent to an average of 8 percent or possibly slightly more," and be sustained. However, that's a big "if"—and many experts predict much lower growth rates. For example, the IMF predicts China's economic growth rate will decline to 5.5 percent by 2023. Moreover, Chinese growth statistics are often suspect and might overestimate actual growth rates.

Finally, in Chapter 5, Lardy considers the prospects for further economic reform. Although he examines the obstacles standing in the way of SOE reform, he also lists reasons to be optimistic. If Lardy were writing this chapter today, however, I believe he would be much less optimistic, given the rising tensions between the United States and China (especially evidenced by the current "trade war" and the U.S. Treasury's decision to label China a "currency manipulator"). Just because Xi Jinping touts free trade, and espouses the goal of realizing the "Chinese Dream of national rejuvenation," doesn't mean he will embark on the path to a freer market and respect human rights. Indeed, his crackdown on dissent is incompatible with a free market for ideas, which is essential for meaningful reform.

Listing reforms is the easy part; getting them implemented will require a new way of thinking about the relationship between the state and the market—that is, between the individual and the state. As long as the CCP retains its monopoly on power and President Xi does not tolerate criticism, there is little likelihood of China adopting limited government and a genuine rule of law, which are necessary conditions for an efficient free-market system. Hence, the potential for convergence and the benefits to be gained are unlikely to be realized. As Lardy concludes, "China cannot credibly advocate for further globalization, which depends on free and open markets, when its domestic policies continue to move in the opposite direction."

In sum, Lardy recognizes that the main impediment to reform is Xi's "view of himself as the commander in chief of the Chinese economic state," but hopes that Xi will bow to pressure to reform in order to restore more rapid growth and avoid social instability. That possibility, however, is fading as Beijing relies on a repressive legal regime—rather than turning to markets and a genuine rule of law—to bring about social and economic harmony.

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