

## BOOK REVIEWS

### **Markets over Mao: The Rise of Private Business in China**

Nicholas R. Lardy

Washington: Peterson Institute for International Economics, 2014, 185 pp.

China's rise as an economic powerhouse since 1978 has been characterized by an expanding scope for markets and prices, and a diminishing role for the state. That is the main message that Nicholas R. Lardy, one of the world's foremost scholars on the Chinese economy, conveys in *Markets over Mao*.

Lardy is the Anthony M. Solomon Senior Fellow at the Peterson Institute and former director of the Henry M. Jackson School of International Studies at the University of Washington. He is the author of numerous books including *Sustaining China's Economic Growth after the Global Financial Crisis* (2012), *Integrating China into the Global Economy* (2002), and *China's Unfinished Economic Revolution* (1998). His trademark is a detailed understanding of China's institutions along with a rigorous examination of a wide variety of data to substantiate his arguments. That trademark is firmly imbedded in his new book.

This is a relatively short book with only four chapters, in which Lardy explores state vs. market capitalism, reform of state-owned enterprises (SOEs), the rise of the private sector, and the reform agenda. Each chapter is packed with important facts regarding China's institutional development and economic reforms as the private sector evolved out of Mao's nightmarish state. Lardy makes a

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strong case that price liberalization and ownership reform, in which Beijing has given greater recognition to the private sector, have transformed the economic landscape so dramatically that China's economy can no longer be viewed as a form of state or authoritarian capitalism.

Of course, Lardy does not consider China a full-fledged market economy; he recognizes that parts of China's economy are still dominated by SOEs. However, he argues those flaws should not detract from the advances made over more than three decades. It is instructive that in 1978 China had virtually no market-determined prices, private firms were illegal, and foreign trade was restricted to a few state enterprises. Today, China is the world's largest trading nation, the second-largest economy, and SOEs account for only about one-third of GDP.

The private sector has been the main engine for economic development and job creation. Economic freedom has advanced giving individuals more choices and improving their living standards. China's real GDP has increased 25-fold since reforms began in 1978, and the reduction in absolute poverty is unprecedented. Hundreds of millions of people have lifted themselves out of poverty as Maoist policies and central planning gave way to freer markets, private ownership, and competition. That is the story Lardy tells so effectively.

Some critics argue that Lardy is too sanguine about the advance of the private sector. They contend that while the nonstate sector has been the engine of China's long-term growth, the decade-long administration of President Hu Jintao and Premier Wen Jiabao (2003–13) delivered a heavy blow to private firms while favoring SOEs. The State Asset Supervision and Administrative Commission was set up in 2003 to make "national champions" out of the largest SOEs, the National Development and Reform Commission was made responsible for major investment decisions, and greater emphasis was placed on industrial policies to support large SOEs. Critics also contend that state-owned banks discriminate against private firms. James McGregor, a long-time China watcher, argues that China's economic system is best described as "authoritarian capitalism."

Lardy finds most of this criticism "misleading." He reexamines the data and argues that "the access of private firms to bank credit has improved so much that on average new bank lending to private firms in 2010–12 was two-thirds more than to state firms." He also

contends that “China’s stimulus . . . was much less state-centric than is commonly charged.”

The difficulty in finding the truth in this debate is that Chinese data are often suspect and definitions elastic. The division of ownership between state and private, for instance, is complex in China’s opaque legal system. Lardy, however, is a master craftsman and uses clear language, has an in-depth understanding of Chinese institutions, and carefully analyzes his data to reach his conclusions. Nevertheless, his critics have some solid ground to walk on.

The state sector is still dominant in many areas and owns or controls a large share of assets—even if SOEs account for one-third of GDP. In 2012, SOEs held nearly 50 percent of loans made by financial institutions to enterprises. China’s leaders pay lip service to the rule of law, but the Chinese Communist Party (CCP) still holds a monopoly on power and favors market socialism over market liberalism.

Those in power seek to maintain it. Chinese reformers mostly sought to revitalize SOEs, not privatize them. Premier Li Keqiang now wants to accelerate SOE reform by allowing private firms to take an ownership interest in large SOEs and create a “mixed-ownership economy.” That is a step in the right direction.

Lardy’s strong case is that private firms did acquire 36 percent of all loans from financial institutions in 2012 compared to 26 percent in 2009; so they were not crowded out by SOEs as contended by the critics. As Lardy notes, “Private firms now enjoy better access to credit than in any previous period in the reform era.” Moreover, on average, SOEs are much less efficient than private firms as measured by the return on assets, and private firms continue to gain ground on that front. In particular, average profits of SOEs are falling and below those of private firms. The lesson is that ownership and incentives matter. Hence, if financial markets do open more to competition and interest rates are liberalized, the share of bank credit going to the private sector should improve.

The CCP’s Third Plenum in November 2013 laid out the groundwork for further price liberalization and the relaxation of barriers to entry for private firms wanting to compete with SOEs in service-related industries (e.g., finance, banking, transportation, telecommunications, and energy). Lardy is hopeful that under the leadership of President Xi Jinping and Premier Li Keqiang China will move ahead with economic reform. He understands the

tension between economic and political reform, and recognizes the dangers special interests pose to meaningful change. “Enhancing the role of the market,” writes Lardy, “will require important changes in China’s institutional arrangements, especially in the role of the state in the economy.”

The heart of this book lies in chapter three, “The Rise of the Private Sector.” Not only have private firms been the engine behind China’s export growth, they have become the dominant player in manufacturing, mining, construction, and wholesale and retail trade. They are, notes Lardy, “responsible for virtually all of the growth of employment in urban China since the reform began” and “consistently make more productive use of capital” than SOEs. By 2012, the return on assets of registered private firms in the industrial sector exceeded the average return for SOEs by about three to one.

There is no doubt that the incentives inherent in private ownership have compelled managers to economize on scarce capital and efficiently allocate funds to productive investments. A further expansion of the private sector would thus increase the prospect for future economy-wide growth. That is why Lardy is encouraged by the Third Plenum’s reform programs, especially the loosening of controls on interest rates, energy prices, and the exchange rate, as well as the promise of greater capital freedom (i.e., the liberalization of capital controls). With more market-oriented prices, resources will be more efficiently allocated and growth will improve along the lines recommended by President Xi—namely, acceleration of market-led growth relative to state-led growth.

The problem is that China remains a one-party state without effective constitutional safeguards for persons and property. Even though enterprise reform has occurred, state ownership is still a strong force, especially in the financial and other service industries. The casino nature of China’s stock markets—and state intervention to prop them up by restricting the sale of shares and other tactics—increases uncertainty and makes it more difficult to attract capital. If the right of a private owner to sell stock is restricted, the desire to buy is weakened, and property rights are less valuable.

The sanctity of private property rights must be respected if China is to become a global financial hub like Hong Kong. Those rights include the free flow of ideas, as Ronald Coase and Ning Wang so elegantly expounded on in *How China Became Capitalist* (Palgrave 2012).

One of China's top reformers, Zhang Weiyong (the architect of China's dual-price system, which helped China make the transition to market pricing), writes in *The Logic of the Market: An Insider's View of Chinese Economic Reform* (Cato Institute, 2015): "The progress of humanity has been a continuous transition to the logic of the market," which is the logic of freedom. Lardy would no doubt agree. Like the late Peter Bauer, a pioneer in development economics, Lardy sees state ownership as a "drag on development."

The spontaneous nature of many of China's key reforms, which were later sanctioned by the state, illustrate that if the government gets out of the way and allows experimentation with market-friendly institutions that reward productive activity, then there will be a cumulative movement to expand those reforms. Lardy shows how small steps in the direction of the market led to deeper reforms in product and factor markets, and in enterprise ownership. Yet, entrenched interests continue to impede the path of free enterprise and cling to the commanding heights of state capitalism.

The CCP's Organization Department still appoints the directors of the largest SOEs, including state-owned banks. Such political control is inconsistent with what Milton Friedman called "free private markets." Until China's leaders respect the rule of law, private property, and freedom of expression, markets will not be fully released from Mao's grip.

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### **The Future of Violence: Robots and Germs, Hackers and Drones—Confronting a New Age of Threat**

Benjamin Wittes and Gabriella Blum  
New York: Basic Books, 2015, 336 pp.

On Memorial Day this year, link-aggregator *The Drudge Report* displayed a shocking banner headline: "Drone Hits 2 People during Parade." Playing on readers' expectations of some titillating new horror disrupting a beloved American holiday, the site linked to a story about a small, remotely piloted aircraft flown over a parade in the New England town of Marblehead, Massachusetts. Its owner had lost control and run the drone into a building. On its descent, the drone hit a man on the head and nicked his neck, then caromed off