

## Books

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# The Irresistible Advance Of The Private Sector

By Joe Studwell

*Markets over Mao: The Rise of Private Business in China*  
by Nicholas R. Lardy  
(Peterson Institute for International Economics, 2014)

For four decades Nicholas Lardy has defined the key research themes for those wanting to understand the development of China's economy. In previous books, beginning in the early 1980s, he tackled agriculture, the rise of the export economy, the financial sector strains engendered by an unreformed state industrial base, and the impact of accession to the World Trade Organization following premier Zhu Rongji's reforms to the state sector. With *Markets Over Mao* he tackles the *zeitgeist* issue of the 2010s: whether China can achieve escape velocity in its effort to truly marketize a socialist economy.

The core of *Markets Over Mao* is an impressive push-back against the most pervasive negative argument about China's economy in recent years: that as the economy deleverages following its 2009-12 debt-fest, and as the investment rate falls as a corollary, the rate of GDP growth must fall precipitously too. Lardy is too academic to prognosticate in his book, but he states clearly in an interview that he believes that relatively rapid growth can continue for another decade or more. The reason is that the current period of structural economic adjustment under the Xi Jinping government will unlock productivity gains that offset growth lost to deleveraging. In *Markets Over Mao* he writes: "There is a substantial misallocation of capital which, if corrected, would allow China to sustain relatively rapid economic growth with a smaller share of resources devoted to investment."

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The first support to Lardy's argument is data demonstrating the steady increase in the private sector's share of credit flows—disproving the common but false generalization that “private companies can't get bank loans.” He relies in part on relatively new figures from the China Banking Society, whose yearbook in 2011 began to publish breakdowns of bank loans by the controlling equity ownership of the recipient. By adding this new series to two others on credit flows to the private sector, Lardy is able to show that private firms' share of credit in China is higher than almost anyone thought (including, he says, Chinese interlocutors).

More surprisingly, Lardy finds that in the wake of the global financial crisis it was the private sector share of credit that increased fastest. This contradicts the widespread belief (labeled in China as *guojin mintui* or “state advances, private sector retreats”) that the debt-financed economic stimulus from 2009 onward resulted mainly in a huge increase in borrowing by state owned enterprises (SOEs) and local governments. Lardy believes the true story is *minjin guotui*: the private sector advanced, while the state sector retreated.

The transformation in credit flows is striking. In 2009, the stock of loans in the formal banking system was distributed 56% to the state sector and 26% to the private sector, with the balance in the hands of collectives and foreigners. In the three years 2010-12, some 52% of new loans went to the private sector, and only 32% to the state sector. Thus by the end of 2012 the private sector share of bank credit outstanding had increased by 10 per-

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In 2010-12, more than half of new loans went to the private sector

centage points, to 36%. Add in some small-scale credit, particularly in rural areas, that is not normally counted, and Lardy reckons the private sector share of credit was actually 44% at the end of 2012. This is less than the private sector contribution to the economy, but the situation is hardly one of credit starvation, and it is changing in the private sector's further favor.

An obvious objection is that even if formal bank credit is flowing ever more heavily to the private sector, so-called “shadow banking” money may still be propping up state enterprises and local government investment vehicles. But Lardy mines data for bankers' acceptances, entrusted loans, trust loans, microfinance loans and corporate bond and equity issues to show that the only measurable area of shadow bank lending where SOEs enjoy real dominance is in corporate bond issuance. Across the whole of shadow finance, the most striking trend appears to be that a lot of money is going to small- and medium-size private firms. Such firms have little

choice but to accept higher borrowing rates, and they are a better credit risk than the state sector.

### **State firms suck**

The second part of Lardy's argument is that the return on assets in SOEs, which improved markedly in the decade after Zhu Rongji's state-sector reforms of the late 1990s, has wilted since 2007 and now sits far below the return generated by private firms. The average return on assets for SOEs in China's broadly-defined "industrial" sector fell from its peak of 6.8% in 2007 to 4.9% in 2012—well below the 6-8% interest rates typical on one-year bank loans. Since 2007, private sector industrial firms' return on assets continued to rise and, at 13.2% in 2012, is now more than double the average for SOEs. Moreover, despite the fact that the return on assets of China's largest SOEs—the ones centrally overseen by the State-owned Assets Supervision and Administration Commission (Sasac)—is flattered by monopoly earnings from a handful of businesses with real pricing power, in tobacco, telecommunications and oil, *as a group* they are doing even worse than the SOE average. Lardy uses Sasac's own numbers to show that its firms' return on assets—across industry *and* services—fell to 3.7% in 2013.

*Markets Over Mao* combines the data on credit flows and return on assets to make a simple case. China's private sector uses capital much more efficiently than the state sector. This means the private sector has proportionately higher retained earnings than the state sector, and in the era before the global financial crisis this allowed it to grow fast despite constrained access to formal bank lending; retained earnings accounted for a remarkable 71% of investment by non-financial firms of all ownership types in 2000-08.

Today, when Chinese banks are carrying a lot of non-performing loans as a result of over-lending to SOEs and local government investment companies, they have little choice but to extend more credit to the private sector because it is a better risk. The data show clearly that this is happening. The Chinese Communist Party (CCP) may not be entirely comfortable with the expansion of the private sector at the expense of the state, but as Lardy's taxonomy of the 30-year evolution of national policy treatment of private firms shows, pragmatism has always won through so far. So long as credit continues to flow in ever-greater proportion to the private sector, and Xi Jinping delivers structural reforms, relatively high economic growth can be sustained by a continuous improvement in capital allocation.

*Markets Over Mao* has a good story to tell, and one that meets Lardy's benchmark of finding things that are widely misunderstood. To continue this game, one has to highlight where Lardy himself might have done bet-

ter. There are two obvious lacunae in this book: international contextualization of China's reform story; and thoughts about how and why China's economic development might eventually come unstuck.

### **Does destiny converge?**

The first point is that Lardy got himself—by his own admission—hung up on the distinctly fuzzy debate over “state capitalism” when researching this book. He is keen to show that China's story has been one not of a grand state plan, but instead of a gradual retreat from a level of state planning that included, in 1978, quotas for things like gunny sacks. He is right, but in hammering this theme he invites less historically literate economists to return to their familiar trope, that the market is the solution to all things.

China needed to reduce the role of government because it started with an overweening level of industrial *dirigisme*. But other successful countries in East Asia took very different approaches. Take South Korea. In 1961, Park

Chung Hee seized power in a politically dysfunctional, oligarch-dominated economy in the mold of southeast Asia, Russia, or Latin America. He increased government power by nationalizing banks, creating an Economic Planning Board and Ministry

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of Trade and Industry, instituting five-year plans and so on. South Korea's economic success owes much to these policies. Given the decades-long track record of Western advice wreaking havoc in the developing world with its one-size-fits-all interventions, Lardy should have provided a brief international contextualization of the Chinese case.

The second hole is small, but worth mentioning. *Markets Over Mao* has nothing to say about the role of the three policy banks set up under Zhu Rongji in the 1990s—China Development Bank, Export-Import Bank and Agricultural Development Bank—which together account for roughly 15% of Chinese bank loans. This is a shame because Lardy could have included the available data sets about lending to the private and state sectors from these institutions. My anecdotal impression from visits to Chinese firms in recent years is that changes to the lending pattern of the policy banks have kept pace with, if not led, the switch in favor of the private sector that Lardy demonstrates in the aggregate bank data. The hypothesis that China Development Bank, the dominant policy bank, has played a signaling role in cutting credit to SOEs could usefully be tested.

Finally, Lardy's optimistic long-run view of China's prospects rests heavily, as he said in an interview, on his belief in the power of "convergence." The claim that better capital allocation can sustain high growth rates depends in part on the assumption that there are still a lot of high-return opportunities for capital. This is plausible: with Chinese GNI per capita at just 12% of the US level (US\$6,560 in 2013 versus US\$53,670), China seems to have a huge amount of catch-up potential left.

Yet there are reasons to be less sanguine about the power of convergence. In essence, this is to do with *institutions*. Anyone who has lived in a "post-economic-miracle" society—like Taiwan or Japan in Asia, or Italy in Europe—knows that countries with the right basic economic development policies can go a very long way in spite of rather poor political and civil institutions. To what extent are China's prospects constrained by its relatively much worse institutions? Consider a few obvious examples. In a world of "big data" and unprecedented global information flows, how much will China's efforts to censor and manage the internet cost it in potential growth? The recent Fourth Plenum was dedicated to the theme of "socialist rule of law," indicating that the CCP has at least some sensibility to China's institutional backwardness. But few people expect that China will develop efficient and transparent legal mechanisms by the time they become critical to a more open economy's progress.

In Lardy's analysis, everything is decided by trends in aggregate data. Yet even as the private sector forces its way in to more areas of the economy at the firm level, the government shows no signs of opening up political control of national resources. The electricity grid, telecommunications bandwidth, aviation landing rights, navigation rights, land use and, of course, political office are still "gifts" to be apportioned from on high, not obtained through meritocratic competition. Meanwhile, China's demographic trajectory in the next 20 years—a major determinant of growth potential—looks pretty ugly for a country only of its income level. China may yet find itself institutionally more constrained than its earlier fast-growth peers.

Lardy's thoughts on this aspect of the Chinese development puzzle would have been welcome. But in the end he is a macro-economist, one with unsurpassed knowledge of the Chinese data sources and a track record of reticence when it comes to prognostication. If he did make more predictions, there would at least be a chance that he might occasionally be wrong. For now, with *Markets Over Mao*, Lardy has once more hit the ball out of the park. If you work on China, there is no case not to own this book.