CHAPTER 6

Prospects for Economic Reform and Medium-Term Growth in China

Nicholas R. Lardy

China has grown faster for longer than any other country on record as a result of gradual economic reform over 40 years. Nonetheless, both commentators and serious economists have predicted at various times that China would have a hard landing soon, which would reduce China's growth to the low single digits. To date these predictions have not been borne out. Even though China's growth rate has declined since the global financial crisis, it has continued to make a disproportionately large contribution to the pace of global expansion.

This paper explains in broad terms why China has grown so fast for so long and argues that its growth rate has slowed since the global financial crisis because of a decline in the pace of exports from the earlier boom years; an expansion of state-owned enterprises, which perform less well that private enterprises; and a slowdown in private investment. China's current growth rate is below potential and likely to remain so in the absence of further market reforms.

WHY SO FAST FOR SO LONG?

I continue to believe that China's long-term growth record has been stellar primarily because market forces have increased in importance since reforms began in the late 1970s. The long-term rise of market forces has been very gradual and not without some setbacks, most of which eventually proved temporary. But there is no denying that the state has continued to attempt to shape the pattern of China's growth. Some of these attempts, however, have not contributed to China's economic success, which has come despite these attempts.

The critical importance of market forces is clearly reflected in their increasing role in price formation and in the growing contribution of private business to GDP and employment. On the eve of reform in 1978, the State Price Commission fixed the prices of all important goods—farmgate prices, consumer goods prices, producer goods prices, and prices for most services as well. After the reform began, the state's control of agricultural and consumer goods prices eroded most rapidly, with about half of the transactions

Nicholas R. Lardy is Anthony M. Solomon Senior Fellow at the Peterson Institute for International Economics.

in these goods taking place at market prices by the mid-1980s. The state gave up control of producer goods prices more slowly; market prices did not dominate transactions in these goods until the 1990s. By 2001 the government fixed prices of only 13 commodities, 9 services, and 5 types of public utilities, so 95 percent of all transactions involving both consumer and agricultural products and 87 percent of all transactions in producer goods were at market-determined prices (Lardy 2014, 14).

On the eve of reform in 1978 state-owned enterprises and collective firms, the latter closely affiliated with local governments, dominated the economy. Along with agricultural collectives they produced close to 100 percent of output and employed all but 150,000 members of the labor force. Thirty-five years later private agriculture and private firms in industry, construction, and services accounted for about 70 percent of GDP (Lardy 2014, 94). Private firms were equally important in generating employment: By 2011 privately controlled firms employed an estimated 253 million workers, or 70 percent of the urban labor force, up from 0.2 percent in 1978, meaning that private firms accounted for about 95 percent of the growth in urban employment over that period (Lardy 2014, 83-85).

WHY HAS CHINA'S GROWTH SLOWED SINCE THE GLOBAL FINANCIAL CRISIS?

Perhaps the most frequently heard explanation of China's slowdown is that it is the natural result of the maturing of an economy that has experienced super-rapid economic growth for an unprecedented period and one should expect further slowing in the years ahead—more in line with the median global historical rate of 2 percent per capita, according to Pritchett and Summers (2014). But this explanation is not convincing. China has already expanded at a super-rapid pace for longer than any other country, and the empirical analysis on which this explanation is based cannot say when and, more importantly, why a slowdown to 2 percent per capita might occur.

Moderating Global Trade Surplus

China's economic slowdown since the global financial crisis does not appear to be the inevitable result of the maturing of an economy that had already enjoyed three decades of super-rapid economic growth by the time of the crisis. An almost always overlooked factor contributing to China's slowdown is the role of foreign trade. In the years before the global financial crisis, between 2005 and 2008, China's currency was undervalued and its global goods and services trade surplus rose rapidly, reaching a peak of 8.7 percent in 2007, an all-time record for any large trading economy (State Administration of Foreign Exchange Balance of Payments Small Group 2008, 9). This growing trade surplus added an average of 1.3 percentage points to China's economic growth (National Bureau of Statistics 2017, 79). But this surplus distorted China's domestic economic growth in favor of tradables and led to substantial friction with China's trading partners. As early as mid-2005 China gradually allowed its currency to appreciate. By year-end 2016 the cumulative appreciation, on a real effective basis, exceeded 45 percent.[1] As a result the goods and services trade surplus declined to only 2.2 percent of GDP by 2016 (State Administration of Foreign Exchange Balance of Payments Small Group 2017, 17). The shrinking surplus reduced China's economic growth by an average of 0.8 percentage points in 2009–16 (National Bureau of Statistics of China 2017, 79).

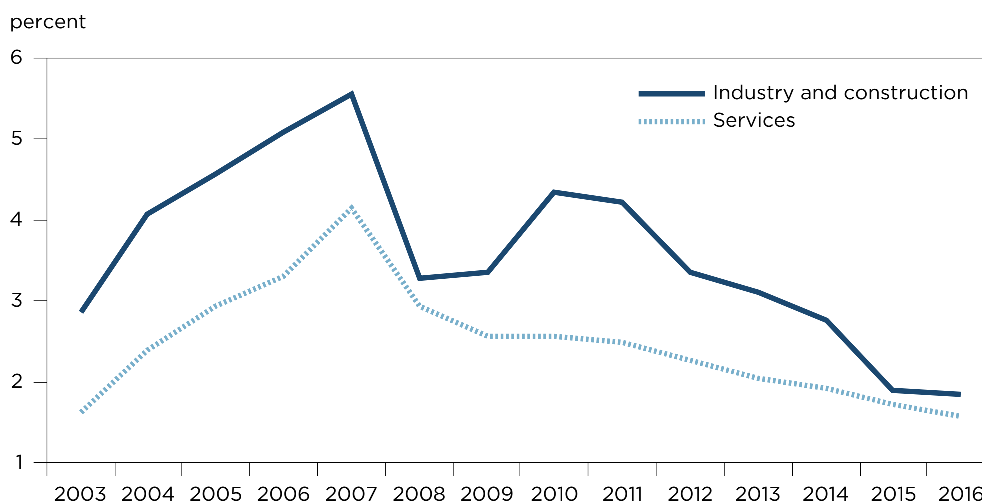
1. The Bank for International Settlements (BIS) real effective exchange rate index (2010 = 100) rose from 83.5 in June 2007 to 122.9 in December 2016, a cumulative appreciation of 47 percent. Available at www.bis.org/statistics/eer.htm (accessed on March 29, 2018).

China's economy expanded by an average of 8.2 percent in 2009–16, compared with 12 percent in 2005–08. Thus, a bit more than half the slowdown of 3.8 percentage points between the two periods arose because rapidly rising, but ultimately unsustainable, surpluses in its trade in goods and services with the rest of the world pushed economic growth in the years before the global financial crisis substantially above potential. The shrinkage of its trade surplus to a much more modest, sustainable level since the global financial crisis is the single most important cause of China's slowing growth. But this negative factor has run its course, suggesting that, other things being equal, China's growth might pick up slightly in coming years.

Deteriorating Performance of State-Owned Enterprises

The second most important factor dragging down China's growth since the global financial crisis is the deteriorating financial performance of China's state-owned firms. The financial losses of money-losing state firms more than quadrupled, from RMB378 billion in 2007 to RMB1,950 billion in 2016 (Ministry of Finance 2017, 369). Over this decade 45 to 50 percent of state-owned firms consistently did not earn enough to fully cover interest and principal payments on their bank loans. More importantly, as reflected in figure 1, the return on assets of all state-owned enterprises in industry (including construction) and services fell by two-thirds and two-fifths, respectively, between 2007 and 2016. In industry alone, returns of state-owned companies were only 3.0 percent in 2016, less than half the 6.8 percent returns these firms earned in 2007, just prior to the global financial crisis. In 2016 private industrial firms' returns were 10.6 percent, slightly

Figure 1 Return on assets of state-owned enterprises by sector, 2003–2016



Sources: Ministry of Finance (2017, 379, 383); Wind Information.

higher than the 9.5 percent level of 2007 and an astounding three-and-a-half times the returns of state-owned industrial firms in 2016 (National Bureau of Statistics of China 2008, 496–99, 506–09; National Bureau of Statistics of China 2017, 420–23, 426–29).

Although the contribution of state firms to China's GDP has fallen dramatically since 1978, these firms still control a massive amount of underperforming assets. In a reversal of the trend in earlier years, starting gradually in 2012 bank lending to nonfinancial corporations went increasingly to state-owned firms, while

Table 1 Financial preformance of central SASAC enterprises, 2005–17

Year	Profits (billions of renminbi)	Assets (billions of renminbi)	Return on assets (percent)
2005	641	10,630	6.0
2006	765	12,192	6.3
2007	997	14,927	6.7
2008	696	17,629	3.9
2009	815	21,058	3.9
2010	1,143	24,427	4.7
2011	1,266	28,036	4.5
2012	1,300	31,457	4.1
2013	1,300	35,078	3.7
2014	1,400	38,964	3.6
2015	1,167	47,647	2.4
2016	1,233	50,500	2.4
2017	1,423	54,500	2.6

Source: State-Owned Assets Supervision and Administration Commission, sasac.gov.cn (accessed on March 14, 2018).

private firms were crowded out. In earlier years, private firms accounted for an increasing share of bank loans. According to data published by the People's Bank of China, between 2011 and 2015 the share of loans to nonfinancial corporations that went to private firms fell from 54 to 19 percent, while the share flowing to state firms rose from 28 to 69 percent (China Banking Society 2012, 369; China Banking Society 2016, 357–58).[2] Over roughly the same period state firms raised an increasing share of funds on domestic stock markets through initial public offerings and secondary offerings.[3]

The expanded claim of state companies on China's financial resources, despite their deteriorating financial performance, is demonstrated most clearly in table 1, which shows the financial results of very large state-owned group companies administered at the central level by the State-Owned Assets Supervision and Administration Commission (SASAC). These firms and their numerous subsidiaries account for about one-fifth of all state-owned nonfinancial enterprises. The return on assets of these firms fell from 6–7 percent in the years before the global financial crisis to a low of 2.4 percent in both 2015 and 2016, before recovering slightly to 2.6 percent in 2017. Despite this rapid deterioration in the financial performance of these firms, they accessed increasing bank loans and proceeds from stock issuance, which allowed them to more than quintuple their assets between 2005 and 2017. The increase in their assets was RMB45 trillion, four times the cumulative after-tax profits of these firms over this period.[4]

2. The increase in the share of loans to state companies in only four years is so large that one wonders whether there has been some change in the coverage of the data. However, the source table with data on lending by ownership contains no explanatory notes.

3. Private firms in very recent years have accounted for a large share of the funds raised through initial public offerings (IPOs). In 2017, for example, private firms received about three-quarters of IPO proceeds. However, state firms dominate secondary offerings, which account for a large share of funds raised on China's domestic stock markets. Taking these factors into account, the share of total equity fundraising flowing to state firms increased from 35 percent in 2011 to 44 percent in 2017. Calculated based on data from Wind Information.

4. Cumulative after-tax profits calculated assuming that these firms paid the standard 25 percent corporate income tax on the pre-tax profits shown in the table. No allowance is made for dividend payments made by some listed subsidiaries of SASAC group companies, so the calculation overstates the share of assets that could have been acquired with after-tax profits.

Slowing Private Investment

The third factor contributing to China's slowdown since the global financial crisis is the slowing pace of private relative to state investment in recent years. From 2006 through 2011 the pace of private investment was 2.6 times that of state investment; from 2012 through 2015 the pace moderated to 1.3 times; and in 2016, and apparently in 2017 also, private investment collapsed, growing only at about a fifth the pace of state investment. If sustained, this trend will further drag down China's economic growth.

The much faster pace of investment by more productive private firms had previously boosted China's growth. But the resumption of state-led investment, in which a growing share of resources is flowing into relatively less productive state firms, is contributing to China's growth slowdown.

In addition to crowding out private investment, the resurgence of the state, starting in 2015, appears to have chilled the enthusiasm of private entrepreneurs to invest. The seriousness of abuses of the property rights of private businessmen was underscored in a document issued jointly by the Chinese Communist Party Central Committee and the State Council (2016), which specifically acknowledged that the state had illegally seized and frozen the assets of private enterprises. The issue also received considerable attention at the 13th National People's Congress in the spring of 2018. The report of the National Development and Reform Commission (2018) contains a long paragraph pledging "to ensure equal protection of the property rights of economic entities under all forms of ownership in accordance with the law." These efforts, the report goes on, "will help to ensure private enterprises can develop in a supportive and positive atmosphere." The difficulty the regime faces in guaranteeing property rights also was reflected in the response of Premier Li Keqiang to a query on the slowing pace of private investment at his press conference marking the closing of the National People's Congress in March 2018. He acknowledged that private investment was weak and explained it was due to "weak protection of property rights and some other factors."[5]

WHY MIGHT CHINA CONTINUE TO OUTPERFORM?

Despite the challenges outlined above, China's medium-term potential growth is higher than the 6 to 7 percent pace recorded in 2015–17. This judgment rests on two simple observations. First, from an international perspective China is an extreme outlier in terms of the magnitude of state-owned nonfinancial assets relative to GDP, primarily because of the large assets of state-owned nonfinancial firms (IMF 2013). In 2016 the value of assets of state nonfinancial companies alone (i.e., excluding the value of state-owned land and other assets) was about RMB155 trillion, or twice the GDP in the same year and 4.5 times the value in 2007, the year before the global financial crisis erupted. Assets of state industrial firms in 2016 were RMB40 trillion (Ministry of Finance 2017, 366).

Second, the returns on these state assets have fallen dramatically, as reflected in figure 1, and are now a fraction of the returns of private companies. If state industrial firms had been able to achieve the same returns as private industrial firms, value-added in 2016 would have been RMB3.04 trillion more than was achieved, boosting GDP growth in 2016 from the reported 6.7 percent to 8.2 percent. State service sector assets at RMB103.6 trillion are even larger, but without an average productivity figure for private service firms, the boost to economic growth from the convergence of state service firms to the level of productivity of private service firms can only be roughly estimated. If state service firms had closed an estimated

5. "Premier Li Keqiang meets the media after the NPC's annual session closes," *China Daily*, March 21, 2018, p. 6.

4-percentage-point gap in return on assets with private service firms, GDP growth in 2016 would have been boosted to 11.7 percent. The combined effect of the postulated convergence of the returns of state companies to those of private firms in both industry and services would have boosted GDP growth in 2016 to more than 13 percent, roughly twice the pace actually recorded.

Obviously, the productivity gap between state and private firms can't be closed in a year, but the right mix of economic reforms could reduce the gap substantially over a period of years, significantly boosting China's GDP growth. The required reform package to capture the gains from convergence involves some combination of policies that would (1) raise the productivity of the assets already in the hands of state companies, (2) transfer underperforming state assets to more productive private firms, and (3) more efficiently allocate bank loans and bond and equity issuance.

Policies to achieve the first aim include those that would increase competition. The state should reduce barriers to entry by private firms, which are particularly high in many service industries as well as in upstream oil and gas and in utilities. Competition from private firms would increase pressure on underperforming state companies.

To achieve the second aim, the government should adopt policies that would facilitate increased market-driven merger and acquisition activity, i.e., bottom up activity initiated by more efficient individual firms bidding to acquire some or all of the underperforming assets controlled by other firms.

In addition, the state should adopt policies that would enable bankruptcy and exit of firms that are persistently unprofitable, so-called zombie firms. The liquidation of these bankrupt firms would provide another opportunity, in addition to merger and acquisition activity, for more productive firms to acquire underperforming state assets. What we observe instead is a sclerotic bankruptcy system in which only 3,602 cases were adjudicated in 2016, when well over 100,000 state firms were unprofitable, a large subset of which had been losing money for years.

Finally, the government should promote additional reforms in the financial sector to more efficiently allocate capital by banks and capital markets. In the current environment, massive quantities of funds are flowing to underperforming state-owned companies.

In comparison to the program just outlined, China's reform program for state-owned firms falls short. The first component of the reform program is corporatization, in which traditional state-owned companies are converted to limited liability companies or joint stock companies. But corporatization of state companies has been an ongoing program since the Company Law took effect in 1995. By 2007, on the eve of the global financial crisis, corporatized firms accounted for about half of all state-owned industrial firms. Nine years later this share had risen to almost 90 percent. A renewed push for corporatization was approved at the Central Economic Work Conference in December 2016 and confirmed by Premier Li Keqiang (2017) in his March speech to the National People's Congress. This was followed shortly, in July 2017, by a formal State Council (2017) notice calling for the completion of corporatization of all central state firms, except those in the finance and cultural sectors, by the end of 2017.

There is no reason to expect that further corporatization of state firms will be transformative. The financial performance of state industrial companies continued to decline even as they switched to the corporate form of ownership after 2007. So corporatizing the relatively small number of noncorporatized state-owned firms is not likely to make any difference.

Similarly, China's merger program, the government's second policy initiative to improve the performance of state firms, falls short. Almost all mergers and acquisitions in the last decade have been top-down, state-orchestrated activities organized by SASAC. SASAC began with about 200 group companies and carried out a sustained merger program that reduced the number of companies to under 100 by the summer of 2017. As shown in table 1, the total assets of SASAC firms have more than quintupled, with average assets controlled by each of these group companies increasing about ten-fold since 2005, reaching RMB5.5 trillion. SASAC's program of top-down mergers has not improved corporate governance but created new monopolies. It has led to a precipitous decline in the return on assets of these firms, and the resulting reduction in competition has predictably decreased innovation and productivity in this universe of firms. There is little reason to expect that more mergers will change this pattern.

The third component of the program of state enterprise reform is mixed ownership, which seeks to introduce collective or nonpublic capital into state firms. This program too is not new but was initially promoted by Party General Secretary Jiang Zemin (1997) in a speech to the 15th Party Congress in September 1997. The Central Committee of the Chinese Communist Party further endorsed mixed ownership in 2013. And the State Council (2015) reiterated its support for mixed ownership reform two years later. By mid-2017 over two-thirds of all central state firms and over half of their subsidiaries had introduced mixed ownership.[6] Again, the financial performance of state firms has continued to decline markedly since 2007 despite widespread adoption of mixed ownership.

It is not clear why the authorities expect that introducing mixed ownership in additional state firms will be transformative. An example helps to explain the limits of the campaign to promote mixed ownership. In mid-2017 four large private technology companies—Alibaba, Tencent, Baidu, and JD.com—invested in China United Network Communications Company, the Shanghai-listed subsidiary of the China Unicom Group, China's second largest telecom company. The Chinese press hailed the transaction as a "milestone in SOE reform," but little seems to have changed. The listed company was a mixed ownership company even prior to the transaction, leading some to characterize the mixed ownership campaign as simply a way of forcing private companies to invest in underperforming state firms.

It is not surprising that the government's corporatization, mergers, and mixed ownership programs have thus far failed to improve the performance of state-owned companies. All three programs appear to involve more form than substance. Many of the state firms that are corporatized and adopt mixed ownership and most of the firms that are merged under SASAC guidance remain 100 percent state-owned and the vast majority remains state-controlled, meaning that the state continues to be the majority or at least the dominant controlling shareholder. The Organization Department of the Chinese Communist Party in many cases continues to appoint the top management; the Party Committee within each firm retains a central role in major corporate decisions; and there is little or no increase in transparency.

Corporatized state-owned firms that are listed on the Shanghai or Shenzhen Stock Exchanges have become slightly more transparent since they are subject to stricter disclosure requirements. But, it is important to keep in mind that this group of firms is a tiny subset of corporatized state firms. For example, of

---

6. "Reform of State-Owned Enterprises Has Achieved Great Success Since the 18th Party Congress," July 27, 2017. Available at www.sasac.gov.cn (accessed on July 28, 2017).

the almost 120,000 corporatized state-owned firms in 2012 only 980 were listed on either the Shanghai or Shenzhen Stock Exchange.[7]

While the State Council (2017) advises strengthening the role of the board of directors in state companies converting to corporate ownership, these boards appear to be largely window dressing. In market economies, the key function of any corporate board is the selection and removal of top management, decisions that are only nominally controlled by the boards in Chinese state companies. Technically the Party's Organization Department nominates and the boards confirm candidates to the top three management positions in the largest state companies. But there are no known cases where a board of a state-controlled company has failed to confirm the nominees chosen by the Organization Department.

CONCLUSION

The central conclusion is that China's growth is currently below potential. The prospects for bringing growth closer to potential are uncertain. China's current reform program for state-owned firms consists primarily of elements dating back a decade or more, a period in which the performance of these firms has deteriorated persistently. There is little or no reason to expect that continuing to pursue these policies will miraculously turn around the performance of state-owned firms. The speech of Premier Li Keqiang (2018) at the National People's Congress in the spring of 2018 does not suggest that the trajectory of reform of state firms will change in the short run. He referred briefly to the need to strengthen work on the liquidation and reorganization of zombie enterprises but offered no specifics on how this would be achieved. Similarly, Premier Li used familiar language on the need to support the development of private enterprise but did not outline specific policies that might reverse the recent erosion of the earlier substantial contribution of private firms to China's growth. Absent a more far-reaching reform of state-owned firms China is likely to struggle to maintain growth in the 6 to 7 percent range.

REFERENCES

China Banking Society. 2012. *Almanac of China's Finance and Banking 2012*. Beijing: China Financial Publishing House.

China Banking Society. 2016. *Almanac of China's Finance and Banking 2016*. Beijing: China Financial Publishing House.

Chinese Communist Party Central Committee. 2013. "Resolution concerning Some Major Issues in Comprehensively Deepening Reform," November 15. Available at http://chinacopyrightandmedia.wordpress.com (accessed on November 18, 2013).

Chinese Communist Party Central Committee and State Council. 2016. "Opinion on Improving Property Rights Protection; Protecting Property Rights According to the Law," November 27. Available at www.gov.cn (accessed on March 5, 2018).

IMF (International Monetary Fund). 2013. *Another Look at Governments' Balance Sheets: The Role of Nonfinancial Assets*. Working Paper 13/95 (May). Washington. Available at www.imf.org (accessed on January 13, 2017).

Jiang Zemin. 1997. "Report to the Chinese Communist Party 's Fifteenth National Congress," September 12. Available at http://cpc.people.com.cn (accessed on July 31, 2017).

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

Li Keqiang. 2017. *2017 Government Work Report* (March 5). Available at http://english.gov.cn (accessed on March 13, 2017).

7. Data from Wind Information.

Li Keqiang. 2018. *2018 Government Work Report* (March 5). Available at http://english.gov.cn (accessed on March 5, 2018).

Ministry of Finance. 2017. *Finance Yearbook of China 2017*. Beijing: China Financial Magazine Publishing House.

National Bureau of Statistics of China. 2008. *China Statistical Yearbook 2008*. Beijing: China Statistics Press.

National Bureau of Statistics of China. 2017. *China Statistical Yearbook 2017*. Beijing: China Statistics Press.

National Development and Reform Commission. 2018. Report on the Implementation of the 2017 Plan for National Economic and Social Development and on the 2018 Draft Plan for National Economic and Social Development, March 5, 2018.

Pritchett, Lant, and Lawrence H. Summers. 2014. *Asiaphoria Meets Regression to the Mean*. National Bureau of Economic Research Working Paper 20573 (October). Available at www.nber.org/papers/w20573 (accessed on May 15, 2016).

State Administration of Foreign Exchange Balance of Payments Small Group. 2017. Report on China's International Balance of Payments in 2016, March 30. Available at www.safe.gov.cn (accessed on March 30, 2017).

State Administration of Foreign Exchange Balance of Payments Small Group. 2008. Report on China's International Balance of Payments in 2007, June 5. Available at www.safe.gov.cn (accessed on June 9, 2008).

State Council. 2015. *Opinion on the Development of the Mixed Ownership Economy by State Enterprises*, September 23. Available at www.gov.cn (accessed on July 31, 2017).

State Council. 2017. *Guiding Opinions on Further Perfecting the Legal Governing Structure of State-Owned Enterprises*." April 24. Available at www.gov.cn (accessed on June 16, 2017).