China Leadership Monitor interviews Nicholas Lardy on his latest book, *The State Strikes Back*: The End of Economic Reform in China? (Peterson Institute for International Economics, 2019)

You argue in the book that China's long-term growth potential is actually quite healthy. This contradicts many pessimistic forecasts about the coming decades. Can you briefly spell out your argument?

China's current level of per capita income, measured at international prices, is only about one-quarter of the level of the United States. This is roughly where South Korea, Japan, and Taiwan stood vis-à-vis the United States when their periods of rapid growth began. After two decades of rapid growth, per capita GDP in Taiwan and South Korea was about one-half of the level in the United States at that time and per capita GDP in Japan was some two-thirds of the U.S. level. After four decades of rapid growth, China's level of per capita income is roughly at the starting point of the successful East Asian modernizers. What this indicates is that China's 1978 starting point of rapid growth began at an extraordinarily low level, only about 5 percent of the US level. Thus, China still has enormous potential to move further in the direction of the level of per capita income in the United States.

What needs to happen for China to realize its growth potential?

To realize this potential convergence, China will have to return to more market-oriented economic policies. In recent years, policy has favored state companies at the expense of private companies, particularly in terms of the allocation of credits. Previously, a sharply increasing share of investment was being undertaken by private firms. The return on assets of state companies had fallen by about two-thirds compared to what it was just prior to the global financial crisis. Thus, as the allocation of credit tilted sharply toward state firms, increasingly more investment was undertaken by far less-productive firms. Predictably, this state-driven approach has resulted in a move to far below China's growth potential.

Your book focuses almost exclusively on the inefficiency of the state sector and its drag on growth. It does not consider the external environment, in particular the dramatic geopolitical changes during the last two years. How will the advent of great power rivalry in general, and the strategic competition or "cold war" between the U.S. and China in particular affect China's growth potential?

China has already decisively moved away from export-driven growth. Last year, for example, its current account surplus fell from almost 9 percent of GDP in 2007 to less than one-half of 1 percent. Thus, China is far less dependent on trade to serve as an engine of growth. It has begun to rely much more on its large domestic market; in recent years, increases in private consumption have become the dominant source of growth. Even if those in the United States who see the economic rise of China as an existential threat will be able to put in place policies that will lead to a decoupling of the Chinese economy from the United States, the likely effect on China's growth over the medium term will not be large. This is primarily because Europe and Japan and other East Asian economies are unlikely to follow extreme decoupling policies with respect to China. As a result, China's trade and investment relations would refocus toward these economies, meaning the United States would be most deeply affected by the costs of an economic decoupling.

How inefficient are Chinese state-owned enterprises (SOEs)? What are the principal causes?

In the industrial sector, where we have the best data, the return on assets of state companies is now about one-third that of private companies. This is an enormous change compared to the situation prior to the global financial crisis when the return on assets of state companies was about four-fifths that of private companies. Two important factors may explain this widening gap over the past decade. First, there was a huge increase in competition in the Chinese economy during the second half of the 1990s that led state companies to step up their performance. Competition increased because China had to cut its tariffs and eliminate its import quotas and licenses as a condition for its entry into the World Trade Organization in 2001. Imports became much more widely available at lower prices, forcing domestic firms to improve their productivity to compete with foreign goods. Another factor was Premier Zhu Rongji's reforms that led to the closing down of the inefficient state firms. But the gains from these two sources of increased competition were largely exhausted by the mid-2000s. A second factor was the merger of more than one hundred of the largest state conglomerates beginning in about 2005. These mergers were in specific industries, meaning that competition was reduced. As a result, the incentives for innovation and cost controls were eroded. The productivity of these firms, as measured by returns on assets, fell to an average of 2.5 percent in 2015–2017, compared to 6-7 percent prior to the global financial crisis.

Why have most of the previous reforms failed to make SOEs more efficient? What kind of reforms will be required?

The reforms have touted corporatization, mixed ownership, and mergers of state companies. But as such reforms were rolled out over the last decade, the productivity of state firms steadily declined. Even though the state is still promoting these policies, for example pledging to complete the corporatization program during the next several years, there is little evidence that this will make any difference. For example, years ago most state companies adopted a corporate form of ownership, but this coincided with a decline in productivity. What is required is market allocation of financial resources, meaning at a minimum the ending of the implicit state guarantee of borrowing by state companies; the elimination of obstacles to merger and acquisition activities, which would place the underperforming state assets in the hands of the better-managed companies; the facilitation of bankruptcy for chronically money-losing companies, and the liberalization of access of private firms to the services industries.

Are the required reforms politically feasible in China? What types of conditions are necessary for Chinese leaders to embrace fundamental SOE reforms?

In the fall of 2013 the regime endorsed a far-reaching economic-reform program that included many of the above-mentioned factors, so apparently the Chinese leadership judged them to be feasible at that time. But little of the program was implemented, perhaps due to a misjudgment on the part of the leadership. My view, however, is that Xi Jinping came to the view that party control is paramount and a large state sector is a necessary element to maintain control. In short, Xi appears to be willing to pay a price in terms of slower economic growth in order to enhance political control. Two things might cause this situation to change. First, if growth continues to slow down, President Xi might have no choice but to alter this policy. The legitimacy of the party depends to a considerable extent on raising living standards, improving the social safety net, reducing pollution, elevating food safety and drug standards, and so forth. A slowdown in growth will endanger the achievement of these objectives. Second, it is possible that at some point a new leadership might assign a higher priority to growth and adopt increasingly market-friendly economic policies.

Absent the required SOE reforms, what is your forecast about China's economic growth in the coming decade?

Absent a serious economic reform program, I would expect that China's growth will continue to slow down. However, a return to more market-oriented reform policies over time might allow China's growth to reach 8 percent for at least another decade.