Unedited Transcript

Book Release Meeting

Markets over Mao: The Rise of Private Business in China

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Adam Posen: Good afternoon, ladies and gentlemen. Please don’t let me disturb your lunch. But in honor of our online friends around the world who are tuning in for the world premiere of Markets over Mao, Nicholas R. Lardy’s new volume, I’d like to get the session going.

My name is Adam Posen. I am President of the Peterson Institute for International Economics. And I’d like to welcome our many distinguished friends who are with us in person today and who are our core audience to the first event of sort of our fall season. And like the Metropolitan Opera starting off with Pavarotti back in the day or the NFL’s first game being Seattle and Green Bay, we are starting off the season with Nick Lardy’s new book on China. Why not go with your best and most exciting and get things going?

Joking aside, I can say on behalf of the institute we have treasured having Nick with us as the definitive best Western-based assessor of the Chinese economy, as a fabulous colleague. He’s written a whole series of books for us since joining the institute in March 2003. Many of you know he was previously at Brookings and Yale. He was director of the Henry M. Jackson School of International Studies in the University of Washington. But we are delighted to have him in the full flower of his insights with us for the last 11 years.

Nick is going to present Markets over Mao: The Rise of Private Business in China. You will notice that this book has blurbs from such minor luminaries as Larry Summers, Robert Zoellick, Bob Rubin, Steve Roach, and Dwight Perkins. This is not an accident. This is a groundbreaking book. And it’s groundbreaking both in what it concludes, but most importantly it’s groundbreaking in the quality and depth of its research insight. And I will leave Nick to make the case and explain what the book is about. But I will give you, as is my prerogative, the bumper sticker.

The more China has grown private and market-oriented, the more it has grown. The parts of China that have grown are the parts that were private
and market-oriented. The model that people talk about of alternative capitalism in China is something that China grows despite not because of. That to me is the bumper sticker summary of Nick Lardy’s groundbreaking book. He’ll give it to you in much more detail. And it is, of course, the substance of the argument that matters.

We’re delighted to have with us today two distinguished discussants to give us a completely different outside perspective on the book. I’m going to introduce them now so that I will call them up after Nick would not break the flow.

We have with us Jin-Yong Cai who is, of course, Executive Vice-President CFO of the International Finance Corporation, member of the World Bank Group. He’s a Chinese national who’s been at the IFC since October 2012. He, of course, was one of the leaders in the financial services industry in Asia for two decades, including 12 years with Goldman Sachs, where he was its top executive in China and previously had worked in Morgan Stanley. He has a PhD in economics from BU and a Bachelor of Science from Peking University.

Dr. Cai has kindly consented to give us, not by any means a World Bank or certainly not a Chinese government view, but the view of someone who knows both Western economics and China extremely well and will give us an independent take.

Our second discussant is a distinguished journalist writer, author, the man who’s going to help us sell a few thousand copies of Nick Lardy’s book, Richard McGregor. As many of you know, he was the former Bureau Chief in Beijing for the Financial Times. He wrote the well-cited, including by Nick in this volume book, The Party: The Secret World of China’s Communist Rulers. He has worked previously for The Australian, the International Herald Tribune, the BBC, and The Far Eastern Economic Review.

He is, of course, the Financial Times Bureau Chief. And we at the institute are delighted to work with his whole team here in Washington on many occasions. But on this subject Richard has the combination of political and real-world insights that we think will be a perfect foil to Nick’s top down analytical work.

So on that note, please allow me to call my friend, my colleague, the Anthony Solomon Senior Fellow here at the Peterson Institute, Dr. Nicholas Lardy.

Nicholas Lardy: Thank you very much, Adam, for that very generous introduction. I too would like to join in thanking Jin-Yong Cai and Richard McGregor for
coming to discuss this work with us today. And I also need to begin by
acknowledging that two very important people have worked with me
closely on this book, Nick Borst and Ryan Rutkowski and this book
couldn’t have been done without their unstinting support for a long period
of time.

As Adam has already said, the key theme really of this book is that in
virtually every dimension of China’s economic success over the last three
decades plus can be attributed to the rise of markets and private
businesses. Now, I do acknowledge that during the Hu Jintao-Wen Jiabao
period that is roughly 2003 to 2013, that fundamental economic reforms
slowed down dramatically. The state made a major effort to push
industrial policies as I will describe. And a lot of people concluded from
that that the government in China no longer saw market capitalism as the
model to follow, that they could rely on state firms as a sustainable model
economic growth.

The argument in the book is that these attempts to produce a model of
state capitalism have actually failed. I think it’s one of the best kept secrets
in China. And the book argues that industrial policies favoring state firms
have failed. These state firms continue to drag down China’s economic
growth.

So I’m going to start by talking about some of the fundamental reforms
that marketization was based on. Then I’m going to talk about some of
what I see as misconceptions about the economy. And then at the end I
will tie it into the reforms that were announced at the Third Plenum and
argue if they follow through on them that China has the prospect for
sustaining rapid economic growth for quite an additional period of time.

But to begin with the basics, the foundation for the market economy, of
course, is prices set in markets. When reform began in China all important
prices were set by the State Price Commission without any regard for
relative scarcity, but this very, very rapidly changed.

As you can see in the figure, the share of prices and transactions at state
fixed price has diminished very gradually, but by the time we get to the
late 1990s, virtually all prices are being set in the market based on supply
and demand. There are few exceptions that I discuss in the book. Some of
them are important. Pharmaceuticals, they’re still price controlled, a few
things like that. But this was the foundation to move towards a market
economy that the state was giving up its control of prices.

One of the important things in understanding this is that there’s not a high
degree of concentration in China’s industrial structure. If you look at this
OECD study, the share of industrial subsectors that were judged to be
highly concentrated was relatively low, only about 15% in 1998. It fell by half over the ensuing decade. The share of sectors judged to be not concentrated in 1998 is almost exactly the same as the United States, 72-73%. So there isn’t evidence at least at first glance of a lot of market power that would allow prices being determined in a distortive way.

The final fundamental thing, before I go into the misconceptions, is to point out that most investment in China is financed from retained earnings today. This was not true at the beginning. At the beginning of the reform process, firms had to send all their profits to the Ministry of Finance. The State Planning Commission decided how the money should be allocated and retained earnings were not a significant factor. This system was phased out in the 80s and by the early 90s, it was basically gone.

You can see in most of the 2000s, about 70% of all investment by non-financial corporations was financed from retained earnings. And even in the last few years, where we’ve had a huge increase in bank credit, that it’s still over 50% of all investment is financed from retained earnings.

Now that sets the stage for the basic explanation of why the private sector has grown so fast, particularly in industry. All of the data we have for as far back as we can go shows that private firms have a much higher return on assets than state-owned companies. And the Zhu Rongji reforms I think narrowed it a little bit in the second half of the 90s, but as you can see over the last seven or eight years, the gap has widened and today, it’s almost three to one.

So private firms have a return on assets that’s almost three times those of state companies. They have much higher retained earnings. They can invest more. And they grow more rapidly. I think there's a very important fundamental factor that I tried to explain in considerable detail in the book. So it’s the efficiency of the markets and retained earnings that has generated the growth. And most of it has been in the private sector.

So now I want to turn to four or five misconceptions that get a lot of play in various circles. One is that the economy is still dominated by state firms. This was the basic theme of the special issue that The Economist ran a couple of years ago about state capitalism, that China's dominated by state firms. And I do certainly acknowledge in the book that state firms are dominant in some subsectors and I’ll come to that later.

But this idea that overall the state is dominating in the economy, I think, is a misconception. And I’ll start out by looking at industry, which is very important. Industry accounted for 40% of GDP when reform began in 1978. And you can see here on the red line that state firms accounted for about 80% of the output. And if you include local state firms that had a lot
of influence, these so-called collective firms, the number would be closer to 100%. There was no private industry in China when reform began.

Today the share of state companies is down to about a quarter. And if you disaggregate industry into its three components, you can see that the state still is completely dominant in utilities. Electric power generation and distribution, of course, is an entirely state-run operation. Upstream oil and gas, which is a big component of the mining sector, is very heavily state-dominated. If we just look at manufacturing, which has been the most opened up to competition, the share of state firms is now down to only 20% of output.

So the state has dramatically faded away, particularly in manufacturing. And this is not, as you would have to conclude going from 80% to 20%, this is very, very widespread. China breaks down its industrial structure into 40 subsectors. This is showing you at the top the ones that state still dominates. They are utilities, upstream oil and gas, somewhat in petroleum refining, the average there is 26%, as I showed you in the last diagram. Then you see it falls off very, very rapidly.

And the bottom-line is showing you that there are 24 sectors that I couldn’t squeeze onto this one page where the state share is less than 15% of output. These are things like subsectors like apparel and furniture where state companies today produce less than 2% of the output. And for those 24 subsectors as a whole, the state share is only 6-1/2%. So in the manufacturing sector, the state has retreated and I believe will continue to retreat.

Another dimension of this, of course, is to look at investment. How much are state firms in the manufacturing sector investing? The data don’t go very far back. But the takeaway here is that state firms may be responsible for 20% of output. But they’re only doing about 10% of investment private firms, and these are indigenous private firms, account for more than 70% of investment.

Most foreign-invested firms, I believe, also should be considered to be private and if you added those in that the share of investment by private companies in manufacturing would be something approaching something actually slightly over 90%.

One additional dimension of the fading away of the state is in the export sector. If you go back to the mid-90s, state companies were producing about 70% of China’s exports. That faded away over the course of the second half of the 90s and into the 2000s. And foreign-funded firms basically supplanted and took the place of state companies. Their share rose to a little over 50%.
But what most people have not noticed is that the share of China’s exports being produced by foreign firms has peaked in 2005. It’s gradually been coming down. And the private sector is now the dominant source of China’s exports. They’re only at 40%, but they are rising and foreign firms are falling. So if you look at the last few years of data, the increase in exports coming out of private firms in China exceeds that of foreign firms and obviously is light years ahead of state companies, which are basically completely fading away in the export sector. So I think the evidence suggests that this is not a state-dominated economy.

Now the next misconception is about how big and powerful the Chinese bureaucracy is. This is a favorite theme where you can read about it in many studies. I began to search in the secondary literature to try to find out how big is the Chinese bureaucracy. And I even called up some well-known people like Ambassador Roy there to see if he could point me to the right source of information. He’s been studying China longer than I have. There’s no data on this in any major study that I looked at.

Table 4.2 in the book has, I believe, the only time series data in any English language publication about the number of people employed in the Chinese bureaucracy. And it not only includes the government, people that you might consider to be the narrow civil service, it also includes teachers and researchers and the healthcare sector. And it also includes all those people employed in paid party positions.

And the number adds up to about 40 million, which of course, at first glance seems fairly big. But if we follow the approach of the ILO, the International Labor Organization, and look at how big the Chinese government bureaucracy is relative to the population, it’s about 30 people per thousand residents. The champion, of course, is France with three times that number. The US is more than twice. And the US number, I believe, is under counted because all those contract workers are not counted. And as we all know, the Defense Department has more civilian contractors than civilian employees.

If you look at other countries that are comparable to China and roughly comparable or closer to China in terms of per capita income, China kind of looks like Mexico or South Africa. And I haven’t heard people describing the Mexican bureaucracy as the most powerful in the world in terms of its employment.

What about going to SOEs? We looked at the government sector, the other big chunk of employment by the state, is those people that are working for state-owned enterprises. And here the trend obviously the black bar is showing you the trend that the absolute number has been steadily
declining over the last decade or so and the share of urban employment in almost all state enterprises are located in urban areas. So I'm going to look at their employment as a share of urban employment. State companies are employing about 13% of the urban workforce today.

I don’t have a diagram. But if you put these two together, the government employees plus the enterprise employees, the number for France is still in the lead at 24, the US at 15, Germany at 14, and China at 11. So I think that the government is not as powerful in terms of employment as some people have argued.

In terms of finance, its control of financial resources, it’s not a surprise to see that China’s fiscal revenues as a share of GDP are much lower than advanced industrial economies. But I think most people will be surprised to see that China is below the average of emerging markets in terms of the general government revenues as a share of GDP. These data, of course, all come from the IMF.

So I don’t think this idea that the state is all powerful in terms of employment income. In the book I also go into its regulatory powers and certain other aspects of state power that I don’t have time to go into here.

The third misconception is that these big state companies are all powerful, that they are generating huge amounts of profit, astronomical according to one person. And *The Economist* is telling us that, yes, maybe state companies are fewer in number than they were when reform began, but they are more powerful than ever.

Well, I was thinking about this. I thought, well of course, this argument is buttressed by all the industrial policies that emerged in the Hu Jintao-Wen Jiabao era. This is at the very beginning they established State Asset Administration and Supervision Commission or is it the other way around? SASAC, we all call it. They enhanced the role of the State Development Planning Commission and renamed it the National Development and Reform Commission. They put out a number of industrial policies that were widely decried in the west. The NDRC became even more powerful later.

And so the view was that the state companies were taking over. This as the resurgence of the state idea under Hu Jintao and Wen Jiabao. Well so I thought, well, let’s look at the data. What did the data show us? The first thing I looked at is what are the profit margins of state companies, those are shown in red, compared to private companies?

If you can quickly average and you have your magnifying glass handy, you will see that state companies have profitability over the whole period
that is two-tenths of 1% higher than private companies. And in the last few years, it’s fairly obvious the profitability is basically identical. So I don’t see much evidence here that state companies are so powerful that they’re making so much money that they have high profitability, that they have market power or that they can charge higher prices than firms with different forms of ownership.

So the next thing to look at is, well let’s look at the crown jewels, the now 113 companies that are under SASAC, this agency that was created back in 2003. What about their profits? Well if you look at the black bars you do see their profits quadrupled between 2003 and 2013. But what most people fail to recognize is that everything in China is going up rapidly. And the red line shows us that their profits by 2013 were less as a share of total profits than they were in 2003. So their profitability rose but not as rapidly as the rest of the economy.

And to me the final nail in the coffin is to look at how well these companies, these SASAC companies, are doing in terms of their underlying efficiency, return on assets. Well they barely had a return on— they had a return on assets that barely covered their cost of capital, that’s the red line, in the middle part of the last decade. But in the last six years, they have earned substantially less than their cost of capital. And the gap between their return on assets and the cost of capital is actually widening. I think this is the best evidence that this effort to create national champions has failed in China.

Misconception number four has to do with credit. One of the most widely cited things, and here I have to mention the Financial Times 2014, saying that the vibrant private sectors starved of cash while state-owned enterprises enjoy easy access to loans.

The problem is most of the people writing this are repeating it, because they read it somewhere else, have never looked at the data or if they’ve looked at the data, they’ve misinterpreted it, misunderstood it. I’ll start out by showing you the stock of loans outstanding to enterprises with all different forms of ownership. These data only start in 2009. And you can see well, it looks like the state has a very large share of 56%, but as we go up to 2011, the state share is coming down, and the private sector has expanded.

Now, these are the stocks. But in 2009 the stock of credit outstanding in China was already 120% of GDP. So to get the stock going to the private sector to change by 10 percentage points on a flow basis you have to have a very different picture and that’s what we see in the data for the last three years that are available. On average private companies receive about 52% of the loans going to enterprises while state companies were only getting
about 32%. So this is certainly not consistent with the conventional wisdom that private companies get no credit and everything is going to SOEs. And the famous line of one of the critics, the line is Chinese state-owned banks service ATMs for the SOEs.

Now, it is still true that private sector is still relatively under-served because it’s producing two-thirds of GDP, probably maybe even a little bit more by now. So I would say it’s under-served. I do agree with that part of the argument. But the idea that they’re only getting a teeny bit of credit, *The New York Times* last year said they were getting 2 percent of all the credit.

Why are banks lending so much to private firms? Well, I’ve already basically told you the answer. They have a return on assets that’s much higher. If we look at this a different way, what’s their interest coverage ratio? What are their earnings relative to their interest payments? You can see that the credit worthiness of private firms has almost always been higher than state firms and in recent years the gap has expanded significantly. So I can’t quite read this on my piece of paper here. But I think it’s a little bit more than two to one. So private firms, if you don’t know anything else about a firm other than its ownership and you were a bank, you’d probably want to lend to a private firm.

Now the last one I want to take up more specifically, is this idea that there was the resurgence of the state in Hu Jintao-Wen Jiabao era. Well I’ve already basically told you that’s not true. SASAC firms did not improve their return on assets. They did not increase their share of profits. And here I want to look at it just from the point of view of output in the industrial sector.

If you look at the two right-hand parts of this diagram and look at the red, that’s the rate of growth, the annual average rate of growth of private enterprises, and then on the right hand side, state enterprises. And if you’d take the period, the five years before the global financial crisis, private firms were growing twice as fast. If you take the five years since the beginning of the global crisis in 2008, private firms are still growing twice as fast as state firms. So as measured by output, we don’t see much evidence of state resurgence.

Let me turn finally, to the reforms going forward and what needs to be done in China and what that might accomplish. To me the key things that they talked about at the Third Plenum last November were that the market should play a decisive role in the allocation of resources and that everything except natural monopoly should be eliminated. And if those things are carried out I believe and I argue in the last chapter of the book, it would be very positive for China’s economic growth.
If you’ve been following me carefully, you’ll notice that most of the evidence that I’ve pointed to deals with manufacturing in the broader industrial sector. I’ve not said so much about services. And this is the area where the role of the state is still substantially larger. Here, the number—we don’t have good output data by ownership for the sector as a whole, so I’m looking at investment data here. And the key takeaways here are several.

The state invests more in services than private firms do. The share of investment undertaken by the state is 4 times—that’s 40 something percent is four times larger than their share of investment in manufacturing. And thirdly, there’s not much of a trend here. The state share is not going down very significantly and the private share is not rising very much.

This is very important for a couple of reasons. The available evidence that we have shows that the productivity of private service providers is twice that of the state. We don’t have the good time series data like I showed you for industry but the data that we do have shows a two to one differential. So the state is investing a lot more in enterprises that are quite inefficient.

The second reason, this is very important, is when you look at the overall sectoral distribution of investment in China, over half of all investment in China these days is going into the service sector. It’s about 55%. So this is a big, big chunk of investment and potentially a significant of misallocation.

Well you might say, well the state dominates because they have education and health and so forth and that is part of the answer. But it is also the case that in modern business services things like finance, information, software, information technology, state firms dominate. As you can see from this diagram, state firms and modern business services account for almost half of all investment and private companies only about a third.

So if China follows through on its commitment and these are things like financial services where the state banks are completely dominant, the state insurance companies are completely dominant, the state asset management companies are completely dominant, et cetera, et cetera. The telecom sector where are three monopoly state-owned basic service providers, these are the sectors where the state is dominant and productivity is relatively low.

And so if the regulatory barriers to entry are eased, I think we will see a substantial expansion of private firms in this sector. This ties into financial reforms as well. Financial reforms will support the growth of the private
services firms because I think they will result in a greater flow of credit to private companies.

Despite all the reforms China has had it still, as I’ve been arguing for years, characterized by a fairly high degree of financial repression. You can see it in the deposit rate structure average deposit rates in the last ten years have been negative and down 320 basis points from what they were in the earlier period as a result of the caps that the Central Bank imposes on the commercial banks.

Most of this cheap cost of funding has been passed on to borrowers. Lending rates have come down by about 300 basis points. So the banks have held on to some of this cheap source of funding in the form of higher profits but a lot of it has gone to borrowers.

And some people say, well, these lending rates aren’t really so low. But if you start looking at the data, China looks like an outlier, average real lending rate over the last seven or eight years of under 2%. You can compare it with the countries that are shown on the diagram. This is certainly one of the reasons that China has had a skyrocketing investment share of GDP. Lots of projects look profitable when you’re going to borrow at under 2%.

So savers are getting taxed. And if rates were liberalized banks would have to pay more. The best evidence for that is to look at wealth management products, which is an unregulated form of saving that’s being offered by various types of financial institutions. And the spread is quite substantial. We’re looking at roughly 200 basis points or more if you put your money into a wealth management product as opposed to putting it in the bank.

So I think if the caps were eliminated rates would go up. If banks have to pay more on their liabilities they will certainly want to earn more on their assets. So I think lending rates would go up. And I think the result is fairly predictable, since state companies have very low return on assets. When lending rates go up they will be even less attractive borrowers than they already are and more credit will flow to the private sector.

But let me just run you through the conclusions quickly before I stop. The growth of the Chinese economy largely reflects market forces and the growth of private business. China has not developed a successful model of state capitalism in my view. There was no resurgence of state companies in the Hu Jintao-Wen Jiabao era when they tried to use industrial policy to support state companies. The banking system in my management does a much better job of lending to the private sector than the critics of Chinese banking suggest.
The state only accounts for 11% of employment today. That’s government bureaucracy plus all the people working for state-owned companies. Its footprint is very small. And I think China can support future growth by demonopolizing upstream oil and gas and the modern business services where entry of private firms is still highly restricted. Thank you.

Adam Posen: That was terrific. As I said, I don’t want to break the intellectual flow. So if Dr. Cai is willing to come up, that would be great.

Jin-Yong Cai: Good afternoon. I’m honored to be invited here to offer some comments. It’s a wonderful book. And for me, let me just reflect my career a little bit, so I can offer, not as rigorous academic research. I have to say, Nick, this is really how I have felt for a long time, but you put it in a very rigorous methodology. I think really the data and the methodology really powerful.

I started my career in the World Bank, but I left World Bank in 1994. And the interesting thing is reading the conclusion kind of reminded me of the time when the Chinese government decided to move the economy from state domination, as you pointed earlier, particularly in the earlier days that all the prices were controlled by the government to a much more market economy.

I think there’s a general perception that Chinese has a super smart bureaucracy planning commission that makes all the decisions [inaudible 32:20]. And they know what they’re doing. But I can give you a couple of examples which reflect what Nick has concluded. But I would offer a different take in a sense.

It’s not planned. It’s very much trying to solve the problem today. And this thing keeps moving. At the beginning those problems actually they were easier to handle vis-à-vis today. The reason for that is the understanding of market economy was weaker and that there were fewer number of special interest in blocking the reform.

But as China continued to move into a much more, I will say robust and private economy, all these special interest groups, all the state-owned companies, they become very much—at the beginning of the reform, they were the advocate. Once they moved into a powerful position, they become more a block for the reform.

And so, let me just explain what I’m saying. Okay. I remember—Nick mentioned a lot of example in the book about telecom industry and the oil industry. And if you reflect at 1997—actually I went back to China in 1995 and was involved in this investment bank called the China International Capital Corporation. It was very much behind a lot of ideas.
in trying to reform the state sector. And Wang Xianzhang was State Chairman and we didn't know what we were doing. Frankly, we were sitting in our room trying to figure out what to do.

This firm was two shareholders, Morgan Stanley and the China Construction Bank. When we go there to talk to a client, we say, “We have great shareholders, Morgan Stanley and China Construction Bank.” And then the client says, “What do you do?” We have nothing to say. I remember in some of the dinner table, Wang Xianzhang was saying, “Look, you got to figure out a way where you can add value.” The reason I said this is very much the earlier reform was driven by some individuals, particularly Wang Xianzhang and a few others, they believe something has to be done.

And then there are a couple of interesting developments for Asia financial crisis were critical. China Telecom, initially called China Telecom but right now China Mobile which was explained in the book, it was created not because they have a plan. It's [inaudible 34:40] was basically saying I need foreign exchange. In 1997, China didn’t have enough foreign exchange. There was a real worry that foreign exchange will become an issue.

And then there was another event. Hong Kong was about to return to China. And at the time there was a transaction. British Telecom was trying to acquire Cable & Wireless. Cable & Wireless’, the crown jewel of that company is Hong Kong Telecom, represents 75% of value. So when that transaction was about to happen, certainly Chinese was battling with UK on how to handle Hong Kong transfer.

So in China particularly [inaudible 35:18] there are always more conspiracy theories, saying okay. This is another attempt by UK to undermine this, what they call security of data.” So this whole China Telecom transaction was driven by two events. One is this merger. The Chinese felt they have to do something. The second is there’s no foreign exchange reserve.

So I remember during restructuring, we selected the least controversial assets at the time, which was a mobile operation. At the time fixed line was the core. Mobile, who cares, it really is considered marginal assets. We select two provinces and put them in China. Certainly when Goldman Sachs came in, it was very smart trying to figure out how to position this equity story.

The share was listed on the Hong Kong exchange when the Asia financial crisis happened on that same day and at least $4.2 billion. It doesn’t sound
a lot now, but at that time it was just astronomical. I mean [inaudible 36:16] would not believe the money would arrive into the bank account.

So I remember Wang Xianzhang was making a speech trying to say this is great if we get it down. And then he got a call and said, “I got to go Beijing.” The moment he landed, he was taken to the [inaudible 36:32] was asking had that money arrived because everyone was worried. Okay.

This is one of many examples. All these state-owned companies were created either because of accidental event or because of desperation. In 1997, after the China Telecom IPO, we started to work on the restructuring of oil sector, the same piece of losing money everywhere. There was no possibility because the crude was controlled. Everything was in bad shape.

At the time the only thing the government was thinking, how can I find the money to rescue this failing state-owned enterprises, rather than coming from my own resources? So the idea of creating all this so-called super national champions was in my view very much accidental inadvertently kind of result—inadvertent result because at the time the government was trying to solve some problems.

This has implication on how we see the future because I don’t believe—I’ll agree with you. By the way, the Hu and Wen era, there was a perception they’re trying to create a national champion. In my view, it’s not necessarily their policy. It’s very much once you become a leading company like Zhou Jiping was leading PetroChina and Sinopec, all these companies become public companies. So they talk to the investors, the investors demand growth. The investors want them to use whatever. They are advantaged to continue to grow their business. So they use us as a mean to lobby the government agencies to become much more kind of powerful. It’s not because, in my view, the government at the top, at least at the Hu and Wen level, have a grand plan of let’s create a national champion.

It’s very interesting that the people who are talking about we want to become the national champion are more the companies than the regulator. And what happened was there are a couple of events I think somehow created this impression Hu and Wen were trying to create this national champion. Number one, the Olympics. That was the time China was really excited. And everything was focused on trying to make sure things are stable with the Olympics. And then the financial crisis came.

So all those events, I mean, you think with the financial crisis the [inaudible 38:50] R&B stimulus. They used the state-owned companies to quickly deploy that money. So these over—I would say ten years’ time,
maybe less than ten years—eight years’ time under Hu-Wen, it was pretty much because of those special events, rather than there’s a grand plan in creating national champion really that people would really advocate the national champion. Very much I would say I was partially guilty in the sense as an investment banker you try to create the next deal. You spur your company. You lobby. You do this and that.

So in a way I’ll agree with your conclusions. It’s very much happened in that way that the state-owned sector after they take advantage of the good days they have run out of their stream. Actually, a lot of investments, bad investment, the return has gone down. And also partially because during the financial crisis the government made sure there’s no instability. You got to take on a lot of things you need to take. And there’s a mutual dependence between the government trying to stimulate the economy and also the company trying to get bigger and bigger.

To be honest, I think the state sector reform from 1997, the China Telecom IPO was the beginning until 2005. They finally cleaned up the banks. I think that was the most interesting time in reform in China. But after that there was kind of a relief. So finally the state sector is not as problematic as before. So the eyes were off the ball. So that’s why the state sector really, in terms of form of return, is getting worse and worse.

So looking forward, I think I’ll agree with you the next phase if [inaudible 40:36] and another person in involved, if three can really deliver what they promised, I think there will be continued growth potential in China. But nowadays, making those reforms is much more challenging than before. And because you do have all these companies become very powerful, not quite internationally experienced in terms of how they advocate their interest in this overall debate between the regulator vis-à-vis the companies. And particularly at the top between the companies and regulator is not that clear.

So I think, if you think if Chinese economy going forward, we are at a cusp of decisive moment. And if over the next few years the state sector reform cannot be implemented and we’re going to have a lot more problems because when you look at your banking assets, that distribution, if the economy is not growing fast enough people in the past talked about, “Oh you’re going to have unemployment problems.” That’s only one of the problems.

Another problem is a lot of assets on the bank’s book will be in bad shape. All the money spent on recapitalizing the bank during the period of 2003 and 2006 will really have to be redone. And how do you deal with that when you still have an aging society, all these other demands coming in?
So I think the book is a wonderful book, really using very rigorous methodology to prove a lot of things people feel, but you give a very good explanation. And really I congratulate you to make this great research. Thank you very much.

Adam Posen: Thank you so much, Dr. Cai, to bring in the personal experience on just how brilliant bureaucrats can be.

I’d now like to turn to Mr. McGregor.

Richard McGregor: Thanks very much, Adam. Thanks very much, Nick. As somebody who reported on the economy in China, I was always grateful for Nick’s help and guidance.

I certainly may have been one of those journalists at one time who described China as a model of state capitalism. But I’m going to exempt myself from all the personal criticism in Nick’s book because by the time I stopped writing about the issue I don’t think the paradigm that he is describing was quite as fully evident or certainly as closely measured. I was actually also going to Google Nick Lardy and state capitalism to see if Nick used to do it as well, but I didn’t do that.

In any case, there’s no doubt that Nick’s written an utterly iconoclastic book here, which will change the way that many people think about the Chinese economy. And if not change the way that people think, it’s going to force them to test their assumptions. And you don’t get to write a book like this unless you, like Nick, have had years of experience in the trenches in China and you’ve gone through the books with the sort of meticulousness that he’s done.

I mean just look, for example, if you read the book, Nick has to walk us through the byzantine definitional problems of what is public and private in China. That’s a real challenge. It’s always been a big challenge. In fact, it may have been the biggest challenge, I think, in tackling a topic like this head on with any credibility.

Now, I think it’s pretty well known that the private sector for many years in China has been the overwhelming driver of job creation, new job creation, but still some of the figures that Nick dug up really made me sit up and take notice. One of them for example, that the number of employees of state and collective firms now is in fact slightly less than 1978, which was just astounding to me.

Now I think Nick wisely does not assert that the rise of the private sector necessarily spells the end of the Communist Party. In fact, the truth is that the private sector might have saved the Communist Party.
Now the book briefly notes how the party decided officially in 2001, I think it was, to allow entrepreneurs to officially become party members. That I think is the sort of decision which tells you that senior leaders or many of them, have recognized for decades that the state capitalism as a dominant force in the economy was not sustainable.

To cite a line that used to be used in an advertisement for a bank when I was growing up, the party decided to get with the strength. That is the private sector. And they did that slowly, and by their standards, I think with a minimal rhetorical flourish. And in doing so they really managed to make the credibility as the most powerful surviving Communist Party dependent on a vibrant private sector. That’s quite a feat, I think.

Now how do they do that? I think they effectively, in a political sense, the party has managed to colonize the business sector and ensure that they don’t emerge as a rival center of power, which after all is the most important thing, I think, for the Communist Party, that you don’t have independent centers of political power developing. The entrepreneurs in return, of course, get access to the most powerful network in the world or in the phrase that the Chinese love to use, it’s ‘win-win’, and quite an achievement along the way.

But since I’m a discussant here today, I do wonder whether the headline message of Nick’s book, that the private sector dominates China, may be misleading or in a way underestimate the power of the state in China? The state sector, after all, is designed to achieve much more than just financial ratios.

Now Nick notes, for example, that there are 561,000 officials working directly for party organizations. You could easily site another figure, that the party now has about 80 million members. In other words, you don’t have to be employed by the state to have deep ties to the state in China.

Nick doubts the regulatory power of the central government, except he says when it’s aligned with the incentives of the provincial and local governments. And certainly, it’s been hard and he gives this example, for the central government to implement plans for a reform of the auto industry. I think there was 110 firms or something like that and they’ve struggled to cut any of them over the years, largely because there’s lots of money to be made in them and when that happens, the central government struggles to get its way.

But I think the power of regulators in China remains powerful in many big sectors in different ways, like the finance and the internet. And I don’t
think you’ll find many foreign investors in China, big foreign investors, who think that Chinese regulators and the state are weak in any way.

Now, one reason why there are still definitional problems about what is private and what is public in China, is that many entrepreneurs still like to don what they call a red hat now and again, because they know there’s safety in cuddling up to the state.

If you take one firm, for example, Vanke, which is undoubtedly a private firm, one of China’s biggest real estate companies. The head of the company or at least the founder of the company, Wang Shi, is quite rightly a famous entrepreneur. His biggest shareholder, for example, last time I looked was the state firm China Resources. And Wang Shi is still periodically quoted in the press as calling his company state-owned and that’s telling, I think.

It’s certainly true as Nick writes that an aggregate terms the private sector is now much larger than the state sector. But I think it’s also true that it’s highly fragmented in many ways whereas much of the state sector is highly concentrated. Moreover, if you look at the economy sector by sector, you’ll find a large number of sectors, with the exception of the internet and high tech and some but not all manufacturing sectors, where the biggest firms are still state firms.

And I wonder whether this is really where the next frontier on this topic. And this is alluded to by Nick at the end of his speech, about the outcome of the Third Plenum of the Communist Party last year, which talks about a much more decisive role for the market. In other words, laying the groundwork for the private sector with a backing of the government to go into areas which hereto have been basically reserved for the state. Now, obviously that won’t happen quickly, but the direction as always in China is all important.

Nick’s book is not about the foreign private sector, but it’s interesting to just tie his thesis to the foreign private sector in some ways. Now, as we all know, I think China has never had to develop a model that you’ve seen in Japan and South Korea, which was much more protectionist, much more autarchic if you like.

China from the start for its own practical reasons was very open to foreign investment. And they used to actively court foreign investment, I think, like few other countries. It wasn’t until the Hu-Wen administration came in that foreign multinational CEOs suddenly realized that they would come into China and couldn’t get to see the premium. For many of them that was a shock.
But when we talked about local champions, as Dr. Cai talked about, we used to talk about state firms, whether that was an improvised policy or not. With the growth of the domestic Chinese private sector, I wonder whether the policy now will now focus more on them as China’s champions? And in fact, the corollary of that that may add in some respects to the chill that many foreign companies are feeling in China right now.

One other final point, China, like just about every other country around the world feels the chill winds of globalization. And in China, like elsewhere, that’s very much associated with privatization. I think if you talked to a lot of ordinary Chinese, you’ll find that there are many losers and many of those people want more, not less, involvement by the state sector. And they want a bigger state to tackle all sorts of problems that China faces, inequality, overpopulation, pollution, and so on.

Now, this is obviously a highly political issue in China. It’s been one of the big themes of the so-called New Left, which has been driving the New Left, the neo-Maos, for many years. And I think we’ve got some distinguished Chinese journalists here today and I’ll be very interested to see if they report the contents of this book in a fully-fledged, full-blooded fashion back to China. I think it would alarm a lot of people there. The next question might be in China, not is the state too big, but if the state is too small? Thank you.

Adam Posen: Richard, thank you so much. That was great. Can I ask Nick to take the hot seat in the middle and our two discussants to flank him?

Those were extremely substantive remarks. And as I hoped and Nick hoped, they gave us, both Richard and Dr. Cai, gave us some of the political realities and context for how these economic patterns that Nick uncovered will play out in terms of reform.

Unless, Nick, you have something specific you wish to respond to, we have an excellent audience no one quite as good as our discussants, but we have some very distinguished people and substantive people and even some distinguished substantive people, in the audience. I’d like to encourage you to ask a question or make a comment in the form of a question.

As is our wont, Jessica has a traveling mic upfront or people towards the back can go to the standing mic. I’ll recognize you. Please identify yourself when asking a question. This is going out live over the web and will be preserved forever on our website. Who would like to be first? Yes, please. We’ll bring you the mic. One second.
Arturo Porzecanski: Arturo Porzecanski from American University. I look forward to reading the book. Thank you for the introduction.

The state, any state, has many ways to meddle with the private sector. And I was wondering if you had time in the book or here perhaps, to reflect on the ways to which the state, for instance, tells companies to lower prices, to transfer more technology, et cetera, et cetera? Because I wouldn’t want to walk away thinking that there is such a sharp divide between where the state ends and the private sector begins. Thank you.

Adam Posen: Thank you. Nick.

Nicholas Lardy: Well, I do talk about state regulatory powers in some parts of the book. And as Richard pointed out, I think the state frequently doesn’t get very far when its interests are not aligned with local government. And one example is enforcement of environmental regulations. And local environmental authorities have very, very few resources. And I cite the example of a man that’s in charge of going to visit all of the industrial firms in his region once a quarter so that he can visually see whether or not they’re complying with the laws on emissions and other things. He said he can’t do it. They won’t give him a car. So he has no way to get to all of these places. So he can’t carry out his job. So, certainly there are some areas where state regulatory power is quite weak.

In other areas, it’s obviously quite strong. I mentioned at the outset they have complete control of pharmaceutical prices. They obviously have the anti-monopoly laws that they can enforce in a possibly discriminatory fashion as we’ve seen in recent weeks.

On the other hand, I point out in the book that the World Bank says, that I think they’re ranked 160 something out of 190 countries in the ease of getting a building permit.

Jin-Yong Cai: 96—96 to be precise.

Nicholas Lardy: Well, over this period, the new starts on construction have gone from 200 million square meters per year to 4 billion square meters per year. It can’t be that hard to get a construction permit. I think the World Bank has it completely wrong when they’re doing their assessment of the regulatory powers of the state.

Adam Posen: Nick, unless one of our colleagues wants to come in, could I just follow up on something you said? I mean, there are a lot of reports about you gave the development, that the NRDC is a much bigger organization than it once was. There’s a lot of reports about these very aggressive and what are
called anti-trust actions of late, say in the auto industry, which could be interpreted in different ways.

One thing which you make a lot of in the book is the distinction between private and state within China. But could you say a few words on the distinction between domestic private and foreign private in China and how much that sort of favoritism or those kinds of barriers you think are still going to be in play?

Nicholas Lardy: Well, this book discusses and mentions foreign-invested firms at a number of places. And in a few places—I do think they should be regarded as part of the private sector. When I showed you the figure that private investment accounts for 73% of investment of manufacturing that I mentioned that if you include foreign firms that’s probably closer to 90% or even a little bit more.

But I didn’t want the book to be about foreign firms. And I think my view is that when they opened up the manufacturing sector in the 1980s to private firms, they also opened it up to foreign companies. Foreign companies today produce 25% of manufacturing output. I don’t know of any other, maybe in Singapore or some teeny place like that, there’s a high number, but I don’t know of any other large economy where foreign firms are responsible for 25% of output.

So my view is if they open up the service sector, which is still monopolized by state companies, it’s likely that that not only indigenous private firms will have an opportunity to participate but foreign firms as well. But I didn’t want to make the book an argument for improving the access of foreign firms to the financial services sector et cetera, et cetera, because there are millions of people engaged in that effort, including in our government and so I wanted to focus it on the domestic part of the economy.

Adam Posen: Oh no, quite sensible. I just want you to clarify that for people. Justin.

Justin Wolfers: Justin Wolfers of the Peterson Institute. The bumper sticker here is everything I’ve read about China is wrong. It sort of raises the meta-question; why? Who’s out there misinforming me and one of the deeper forces that are behind that?

Adam Posen: Nick did not spare naming a few of them in the slides, but I think Justin wants something a little deeper than that.

Richard McGregor: By the way, it is James McGregor, not Richard McGregor that was-
Nicholas Lardy: I think that’s a very important question, a very difficult question to answer. But I think the starting point is to recognize that a lot of the reporting on China is influenced very heavily by foreign firms. And when foreign firms think they’re getting a bad deal, it will be on the front page of The Wall Street Journal the next day.

But when do you read about foreign manufacturing firms having a very hard time in China? Caterpillar has 34 plants making various kinds of construction equipment, excavators, and so forth. They seem to be doing very well. That CEO is not going over to see Mr. Froman twice a week to complain about how he can’t do business in China.

But if you’re in financial services or you’re trying to get in telecom, as I admit in the book, the door is closed. And so, the people that are coming to the US government are complaining to the US press or using the US Chamber or using the US China-Business Council to make their case, they are vocal advocates for their firms and that determines the dominant story. So I think that’s at least the beginning of an answer.

Adam Posen: I was just going to say. Could you speak on this, Richard?

Richard McGregor: Another aspect of that question is do you think what you’ve written is news to the Chinese? And in fact, I mean, it’s a labor of love but a labor nonetheless if you go through these stats for years and work out the classifications with the Chinese and the like, but much easy to do there. Has the same story been written there?

Nicholas Lardy: I’m not aware that the same story has been written there. There are certainly people in China who understand many of the dimensions of the story. But there are many more who don’t because they don’t look at these kinds of kind of macro-data. They are extrapolating from what they’ve seen from direct personal knowledge or where they’ve been trying to do business or not doing business. So I think that quite a bit of the data in this book will be unfamiliar to many in China.

Adam Posen: Jin-Yong.

Jin-Yong Cai: Around this, I think part of the reason, to answer your question, is over the last few years, you see a lot of the Chinese companies making acquisitions internationally, many of whom happened to be state-owned. And there’s a general kind of bow kind of type of feel and partially because the sectors they’re in predominantly energy and minerals. And these are the sectors still, as in the book, Nick has identified in the oil sector, there are only three players and the telecom and other sector. Because they are aggressively either making acquisitions or building a lot of things because the state gave them, what do you call, encouragement. China asking bank
as China Developmental Bank building lots of things in Africa, this creates the impression that’s also true in domestic market.

To answer your question, actually I was [inaudible 01:00:48]. I just visited him a few days ago. I said, “Have you read the book by Nick?” He said, “Well, what did he write?” I gave him the thesis. “Well, only American scholar would do that type of work. I already know this a long time ago.” So this is really a great compliment to what Nick has done. This is very rigorous, really based on evidence, not just feel. Most of the Chinese in the economic struggle, they have a feel. They don’t spend the labor of love to do this study.

Adam Posen: And again, just to repeat something Nick said earlier, we had two fantastic young researchers working for Nick, Nicholas Borst and Ryan and Rutkowski, and they deserve all the credit; under Nick’s guidance, of course. Richard.

Richard McGregor: I just want to say it’s not just sort of silly foreign journalist who are the cat’s paws of foreign companies propagating this view. I mean, this is a theme that runs through a lot of the commentary of Chinese economist, liberal and otherwise. It runs through a lot of what Chinese leaders have been saying, I think. The success of the Chinese stimulus in 2008-2009 was [inaudible 01:01:52] as an example of the Chinese model. That was money through the state banks. It wasn’t quick get entrepreneurs out there, which is more credit to you for your book.

But I don’t think it’s simply the narrow funnel of foreign perceptions. It’s a much wider view than that, which is why your work should have an impact in China.

Nicholas Lardy: Just to follow up, I agree with that. And I think I mean the phrase that Chinese economists that were in favor of reform over the Hu Jintao-Wen Jiabao period, they were talking about guo jin min tui. That is the state is advancing and the private sector is retreating because they weren’t seeing the kind of reform that had occurred under the Zhu Rongji-Jiang Zemin period. So they were also saying that this was that the state was advancing. They were using that as a critique of what they saw as a substantial slowdown in basic economic reform. And so I think you’re absolutely right. There is a widespread view, even among Chinese economists, that the state was advancing during this period.

Adam Posen: The love that dare not speak its name. John here and could I suggest the gentleman there go to the back mic perhaps?

John: Thanks. John Epski, from SAIS, Johns Hopkins, SAIS.
One of the highest profile reform initiatives of the new administration has been the anti-corruption campaign. It has two aspects. On the one hand, it suggests that perhaps not all the influence of the state on the economy is captured through formal structures, and secondly, that there is an important high-level initiative to make changes in that relationship. How would you position this policy initiative within your interpretation of developments in the Chinese economy?

Nicholas Lardy: Well, I think and many people told me and I told myself I should write something about corruption in the book. But I decided that I did not have a comparative advantage on this topic, so the word corruption does not appear.

But in this audience I can tell you what my opinion is. And that is I think the anti-corruption campaign is very reinforcing of the kind of basic underlying economic reforms that Xi Jinping and Li Keqiang want to push through, at least as reflected in the documents expressing the intentions, because clearly most of the targets of this anti-corruption—most of the corruption is in the state sector. The targets of the anti-corruption campaign are predominantly people that have had lengthy careers, like in oil and gas or electric power or they’ve been regulator power or they’ve been the regulators in the NDRC who are giving out the licenses or approvals for one sort of project or another.

And I think the taking down of so many of these people will reduce the kind of strong vested interest that Dr. Cai was talking about, that are very significant impediment to reform. So I’m on favor of this campaign and I think it will help to overcome the vested interests that are the biggest obstacle to undertaking the kinds of reforms that have been outlined.

Adam Posen: Dr. Cai, Mr. McGregor, anything you want to add to that?

Richard McGregor: Well, I guess that’s true up to a point. But the anti-corruption campaign so far, thus far, is taking part we should remember outside of the legal system. It’s within the party and outside of the legal system. I’m not necessarily saying it’s capricious or entirely driven by a factional considerations, but there’s an element of the power struggle in it as well.

I think, so basically what they’re doing to a lot of officials and I think why a lot of the officials don’t like Xi Jinping, because they’re all scared to death. And that’s the way the anti-corruptions work. Now whether this goes, say I think Wang Qishan probably has another three years, whether this goes on from there into broader legal reform and this is obviously long term, into something more concrete institutional. And I think that would be much more of a success than simply taking a few bad guys off the playing field.
Jin-Yong Cai:  I think in a month, I think October, there will be the Fourth Plenary Session and that the big slogan for—the agenda for this on rule the country by law. So there are certainly—I think they heard the complaint that the anti-corruption had been down through a pretty extraordinary means.

And to answer your question, I think this has shaken the whole state-owned sector. Some of the most powerful people in the state-owned sector have been taken down. So really, I think in pushing forward the reform as a message with this move will become easier.

But again, there are always unexpected and I agree with Nick with what he said. It wasn’t financial crisis in 2007, I remember, at that time, the NCDRC, that literally the government demanded them in month develop ten sectors rehabilitation program. They quickly deployed the money. So that gave the government such kind of excitement saying, “Look, because of the state sector so we can do those stimuli so much easier.” So that strengthens their position. But the anti-corruption move, I think is going to pave the way for the potential reform to come.

Adam Posen:  Great. Gentleman, back mic, and this will be our last question.

Mark:  Mark Hew, John Deere. China has often put forth as the leader of state capitalism, this so-called Third Way. I’m thinking of Justin Lin, the World Bank, and conversations directed in that direction. I’m wondering if you would suggest we infer from your thesis that this has been overblown? And I’m curious if your opinion about how substantial this Third Way truly is?

Nicholas Lardy:  Well, I don’t share many of Justin’s views about the current state of the Chinese economy. He continues to think that it’s just fine to invest 50% of GDP, that it supports innovation and so forth, and technical change. He doesn’t see any stresses in the financial sector as a result of this huge increase in credit relative to GDP. And he basically thinks the current model, including the continued significant role for state companies in some sectors, he thinks that’s fine.

I basically have a different point of view. I think we need to raise the cost of capital. We need to lower the rate of investment. We need to have faster growth of the service sector, which will generate more jobs, will increase the wage share of GDP, which will increase consumption, which will help to offset a moderation in the growth of credit and investment. This is an economy which I think is far too investment driven.
And so I’m basically a little bit skeptical about Justin’s views about the current situation. I mean, I’ve talked about it with him a number of times. We just see things differently.

Adam Posen: Sorry. Did you have something quick?

Richard McGregor: Oh very quickly. I think it’s a little overblown for three quick reasons. I think a lot of the China model promotion is often anti-US. In other words, it’s Geo-politically inspired. I think the China model itself, with the Communist Party and all its powers, the personnel, et cetera, is not exportable easily. But I think many parts of China used the Chinese reform lesson in the way they’ve experimented with things and rolled various reform out. I think other countries have a huge amount to learn in that respect but not by importing a whole system.

Adam Posen: If I could just wrap this up. I think one of the things that by no means is a trope among us, but which various independent studies by various of IIE or PIIE scholars have done through the years, is turn the country’s, be it Japan, be it China, be it Germany and said this great mythos builds up, but actually much of the same economic recommendations much of the same economic analysis applies.

And in a sense that’s what underlay the Washington Consensus work that John Williamson did here many years ago. That’s not to say that one size fits all. And I think all three of our commentators today showed you their sophistication and depth of knowledge on China. But I think it is a sort of hopeful message that we can take away, that A, economists and economic research really do know something. Getting prices out of the state’s hands actually does work. And B, that there is therefore a basis for common understanding, be it across the Pacific or across the Atlantic when dealing with these issues.

And I think Nick’s Markets over Mao is going to be a huge contribution to that. And I’m very grateful to Dr. Cai and Mr. McGregor for joining us today and helping us amplify exactly that contribution. Thank you all very much.