Introduction

The world has never seen anything like the rise of China from an impoverished and politically unsteady country in 1978 to a confident and ambitious economic superpower 40 years later. Its economy has grown faster for longer than any other country on record, persistently defying widespread warnings of a drastic slowdown that was supposedly to occur at any moment. To date these predictions have not been borne out. China's growth rate has been declining since its peak on the eve of the global financial crisis, but it has continued to make an outsized contribution to powering worldwide economic expansion. The world has become so dependent on Chinese economic growth and stability that analysts around the world carefully analyze even mild fluctuations in its domestic economy, concerned that these could contribute to a recurrence of global financial instability. When China's domestic stock market melted down in 2015 and again in 2018, many experts fretted that the government would once again resort to exchange rate manipulation to lower the value of Chinese currency to drive more exports. More recently international concern also has focused on the unusually large increase in the ratio of domestic credit to GDP, and the supposed attendant financial risks that could flow from a debt crisis. Many experts fear that a resulting domestic financial crisis would spread turmoil in international markets.

China's stellar growth since 1978 has been driven by market-oriented economic reform. In the era before Deng Xiaoping's introduction of market reforms, the state fixed prices for virtually all commodities and products. That regime gave way to prices determined by supply and demand in the market.

The marketplace for factors of production—such as labor and capital—was substantially reformed. The system of job placement run by state agencies yielded to a robust labor market in which workers were able to move from rural to urban areas or within cities and wages were determined by supply and demand—rather than rigidly fixed by the state. Investment, once largely determined by the State Planning Commission and its various successor agencies and financed almost entirely through the state budget, has also been transformed. By 2012 almost half of all investment was undertaken by profit-oriented private firms with financing provided by retained earnings and ever growing access to credit provided by the state-owned banking system. Because of this transformation, by 2012 private firms contributed an estimated 70 percent of China's GDP (Lardy 2014, 94).

Since 2012, however, this picture of private, market-driven growth has given way to a resurgence of the role of the state in resource allocation and a shrinking role for the market and private firms. Increasingly ambitious state industrial policies carried out by bureaucrats and party officials have been directing investment decisions, most notably in the program proclaimed by President Xi Jinping known as "Made in China 2025." This drive has been financed by many government-guided funds, of which the National Integrated Circuit Investment Fund, created in 2014, is perhaps the best known. In 2015, 297 new government-guided funds were created with more than RMB1.5 trillion in capital (Kozul-Wright and Poon 2017). President Xi assumed the office of the General Secretary of the Chinese Communist Party in late 2012. Since then he has consistently championed the role of state companies, arguing these firms "should be supported and not abandoned" (Economy 2018, 118). Local political leaders have been only too happy to follow his lead by leaning on local financial institutions, such as city commercial banks, to prop up underperforming state companies, most of which are administered at the local rather than central level.

This book mobilizes a wealth of data to evaluate this resurgence in the role of the state, applying an analysis of China's medium-term growth potential and the implications of this growth for the global economy.[1] Its core conclusion is that absent significant further economic reform returning China to a path of allowing market forces to allocate resources, China's growth is likely to slow, casting a shadow over its future prospects. Of major importance for the rest of the world newly dependent on China's economic ups and downs, the goal of reducing financial risks, which have accumulated in the years since the

1. Potential growth is the rate of growth of output consistent with stable inflation.

global financial crisis, will be far more difficult. Alternatively, a well-designed economic reform program can rescue the world's most populous country from that dubious fate. Such a program would largely eliminate remaining domestic economic distortions foisted on the economy by the state, raising the average returns on the massive quantity of assets still held by state companies toward the average returns earned by private firms. Expanded reform would likely boost China's growth from the recent range of 6 to 7 percent to an average of 8 percent or possibly slightly more. Moreover, the evidence suggests that this higher growth could well be sustained for a couple of decades. This perspective on China's potential economic growth departs from the forecasts of major international financial institutions. The World Bank (2018b), for example, forecasts that China's growth will slow to 6.3 and 6.2 percent in 2019 and 2020, respectively. Similarly, the International Monetary Fund (IMF) forecasts that China's growth will slow from 6.9 percent in 2017 to 6.4 and 6.3 percent in 2019 and 2020, respectively, and then fall to 5.5 percent by 2023 (IMF 2018).

China's growth slowdown since the global financial crisis has puzzled and confounded many analysts. Accordingly, this book opens with an evaluation in chapter 1 of the causes of China's relatively sluggish growth compared to the hyperperformance of the economy that ended in the global financial crisis of 2008–09. Many analysts (e.g., Carl Minzner 2018) argue that China's slowdown is the result of the natural maturing of an economy and that we should now expect permanently lower growth. These economic experts have predicted further slowing in the years ahead. But these prognosticators are looking at the wrong data. In fact, transitory factors—some of which have largely dissipated—account for a large part of the slowdown. The implication of those factors is important: the evidence suggests that further slowing is far from inevitable—and in fact would be unlikely if China resumed the market-oriented reform strategy evident before President Xi came to power. For example, the single most important cause of China's slowing growth is the evolution of its trade balance with the rest of the world, driven by its capacity as an export superpower. Prior to the global financial crisis, China's growth was driven to an above potential rate by rapidly rising, but ultimately unsustainable, external surpluses powered by phenomenal export performance.

Since the global financial crisis, China's trade has declined as a contributor to its growth for two reasons. First, global trade in general has slowed dramatically compared to earlier decades. Second, domestic developments, notably a substantial appreciation of the renminbi and a reduction in China's saving-investment imbalance has reduced the country's trade surpluses to a much more modest, sustainable level. These two developments have pulled China's growth down to a pace below potential. However, this negative factor now has run its courses suggesting, other things being equal, that China's growth might pick up slightly in coming years.

The second most important contributor to China's slowing economic growth, this book argues, is the slowing pace of domestic economic reform and the resurgence of the role of the state in resource allocation. These trends stifled the competitive forces that had previously powered the Chinese economy, placing more investment in poorly performing and indeed deteriorating state-owned enterprises. Pumping resources into these ailing entities has slowed investment by more productive private firms. Over the entire reform era beginning in 1978 the contribution of state firms to China's growth has shrunk as the private sector has expanded. But since the global financial crisis state firms nonetheless have dragged China's growth down. These ailing enterprises have weakened China's overall economic performance and crowded out investment by far more productive private firms. Chapter 1 cites several other potential contributors to China's slowing growth, ranging from demographics to an inability to move away from an investment and export-driven pattern of growth toward one more reliant on consumption and services. But these other factors are much less important in slowing China's growth than the inhibiting dominance of the state in the economy.

Chapter 2 assesses China's economic growth potential in light of the convergence hypothesis. While China has had extraordinarily rapid growth for more than three decades, by 2014 it was only at about one-quarter of the level of per capita development relative to the frontier, i.e., the level of per capita economic development of the United States as measured by purchasing power parity (i.e., using a "basket of goods" approach to comparing economic performance between countries). This is the same level of economic development recorded vis-à-vis the United States by Japan in 1951, Singapore in 1967, Taiwan in 1975, and South Korea in 1977. Each of these economies subsequently grew rapidly for 20 years or more, in the process strongly converging toward levels of economic development in the United States. Thus, China now falls well short of the relative level of development achieved by these four Asian economies at the end of their two-decade periods of rapid growth. Moreover, the huge disparities in the performance of state firms compared with that of private firms also suggests that there is potential for further convergence in China. These disparities are evident in large and growing differentials between state and private firms in the extent of loss making, the reliance on subsidies, the return on assets, the ratio of debt to equity (the leverage ratio), and the burden of interest payments relative to earnings before taxes and interest.

The chapter rejects the argument of some Chinese officials and economists that state firms are just as efficient as private firms but that they face different constraints that lead to predictably weaker economic performance as measured, for example, by return on assets. The chapter ends with an analysis of the large magnitude of assets controlled by state companies. The evidence demonstrates that if the return on assets of these companies, instead of falling after the global financial crisis, by 2015 had converged to the level of private companies, real GDP in 2015 would have been 13 to 15 percent larger. Achieving this hypothetical endpoint would have required annual growth between 2007 and 2015 to have been as much as 2 percentage points more than the recorded pace of 8.6 percent. This opportunity still exists. Going forward, if the performance of state firms over time approaches that of private firms and/or the underperforming assets of state firms are acquired by more productive private firms, China's growth would gain substantially. In addition, borrowing by state firms to cover their financial losses would moderate, and risks in the financial system would be systematically reduced. In short, on the assumption that the rising trade frictions between China and the United States are relatively short-lived, China's potential growth for a considerable period into the future is more rapid than the 6 to 7 percent rate observed in recent years.

Chapter 3 analyzes the current efforts to reform underperforming state-owned firms. Elements of this approach include corporatization, the conversion of traditional state-owned companies into limited liability companies; top-down mergers of the largest state companies overseen by state bureaucrats and party functionaries rather than business-oriented managers; mixed ownership, the introduction of private capital into state companies; debt-to-equity swaps that would salvage state companies by reducing their indebtedness; and governance reforms that would make most state companies responsible for their profits and losses. But the state has pursued the first three reform components for a decade or more, the period in which the return on state assets has plummeted. And the latter two components have not gotten off the ground. A new approach is needed.

What specific reforms must China undertake to capture the higher potential growth analyzed in chapter 2? Chapter 4 focuses on reducing the barriers to entry for more productive private firms, particularly in services such as banking and logistics. China should also encourage more bottom-up, market-oriented merger and acquisition activity allowing private firms to take over underperforming state assets. Reform must force into bankruptcy more long-lived zombie firms (僵尸企业), mostly state-owned, that now survive by borrowing ever increasing amounts from state-owned banks. The takeover of failing Dongbei Steel by China's most successful private steel entrepreneur is a good, but unfortunately isolated, precedent.

Another important reform discussed in this chapter would take place in the financial sector, by encouraging a more efficient and market-oriented allocation of funds by banks and capital markets. China also needs to upgrade the use of financial metrics in evaluating the performance of state companies.

The concluding chapter notes the various political economy constraints to adopting a more far-reaching reform program and the implications for the global economy. At the most fundamental level, President Xi fears that downsizing state enterprises could slow economic growth. More important, he and his allies in the leadership councils of China no doubt fear that reforms could trigger social unrest, unemployment, financial instability, and loss of support among crucial vested interests—particularly local party and government officials and top managers in China's state-owned enterprises. Pursuing a more reform-oriented course faces undeniable challenges. But perhaps the main one relates to President Xi's own view of himself as the commander in chief of the Chinese economic state. On the other hand, President Xi may recognize that his desire to raise living standards and promote further globalization will probably depend on a more ambitious domestic economic reform program. Which course he chooses will powerfully affect the future not only of the Chinese economy but also of the global economy.