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# Preface

The range of views expressed on the likely future pace of China’s economic growth is stunningly wide. Some contend that in terms of common prices China’s GDP already exceeds that of the United States and project that it will soon overtake the United States even measured at market prices. Others are equally confident that China’s growth over the next decade or two will slow to an average rate of only two to three percent, a pace not much above the likely trajectory of the United States. Both camps, and many in between, treat their projections as predetermined by great forces—whether the oft-mentioned but dubious “middle-income trap” pushing the trend relentlessly down, or the sheer size and nature of China’s global presence keeping the growth rate up high.

Rightly and powerfully, Nicholas Lardy argues that China’s economic trajectory is far from predestined. Instead, the Chinese state’s policy choices will be the major determinant of its future growth. The slowdown of recent years is not primarily the natural slowing of what is now a more mature, upper middle-income country. It reflects the increasing drag of state companies on economic growth and the burgeoning misallocation of resources by China’s financial sector. If China’s leadership continues to opt for state-led growth in pursuit of greater economic and political control, China’s growth trend would slow further. Alternatively, if China’s leadership goes back to a market-oriented reform program, that would boost China’s trend growth to well above the pace of recent years. In this study, Lardy not only demonstrates the economic costs to China—and to the world—of the state having struck back

since 2011 but he also outlines a path that would sustainably raise China's growth rate. The economic benefits to China and the world would be enormous, but it would require the reduction of some control reimposed by the Chinese state over the economy.

Any longer-term projection must be based on a deep understanding of the contingent factors and policy choices that account for the recent slowdown in China's growth, from the double-digit pace in the decade through 2011 to the 6 to 7 percent range since that time. Lardy's analysis shows that a main driving factor was the turn away from the market orientation that guided economic reform for more than three decades starting in 1978. Market-oriented reform based on private firms was wildly successful. By 2012 these firms accounted for 70 percent of China's output, up from almost nothing in 1978. But a visible change in strategy, in favor of state led growth, accelerated under the leadership of party Chairman Xi Jinping starting in 2012.

Xi came into office endorsing wide-ranging market-oriented economic reform but he quickly abandoned this design in favor of a more statist approach. This was evident in more aggressive, detailed industrial policies that directed a growing flow of resources to priorities identified by the state; mergers of already large state companies to form even larger conglomerates that reduced competition in many critical sectors; a redirection of credit away from far more productive private firms to underperforming state companies; and an undermining of private property rights that further reduced private investment. But state-led growth clearly has failed in economic terms. The productivity of state firms in industry and services is now two-thirds and two-fifths lower, respectively, than a decade ago, while the productivity of private firms has continued to increase.

Another important contributor to China's economic slowdown is the shift towards sustainable domestic-driven growth. Unlike the return to heavy state intervention, the move to focus on internal growth drivers was both necessary and beneficial. Much of China's growth in the first decade of this century was held above potential by a rapidly expanding trade surplus. This overheating was itself largely driven by an increasingly undervalued exchange rate that significantly inflated aggregate demand. This policy not only garnered substantial international opprobrium making it costly to maintain—it distorted domestic resource allocation contrary to China's own well-being. This policy was gradually but decisively abandoned. Export-driven growth has faded away. At a time when China's international economic impact remains under sharp external criticism, only some of it justified, Lardy contributes a healthy reality-check on excessive claims about the importance of export-led

growth to China's past growth and future prospects. While specific trade and investment issues merit serious attention, continued strong Chinese growth is sustainable both internally and externally. What it takes is deliberate domestic economic reform to restore the ascendance of markets over Mao.

*The State Strikes Back* is Lardy's fourth book for the Peterson Institute. *China in the World Economy* (1994) provided one of the first assessments of China's emergence as a major force in the global economy. *Sustaining China's Economic Growth after the Global Financial Crisis* (2012) not only analyzed China's strong response to the global crisis, which increased its importance as a source of global economic growth, but also examined the policies that would be necessary to sustain that growth. His third book, *Markets over Mao: The Rise of Private Business* (2014) provided a sweeping analysis of the critical role that the market and private firms played in China's rapid growth after 1978. *The State Strikes Back* continues Lardy's pathbreaking work pursuing his independent analysis of Chinese economic development to wherever the research leads, even when the conclusions are at odds with popular simplistic stories.

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