Markets Over Mao: The Rise of Private Business in China

Dr. Nicholas R. Lardy, Anthony M. Solomon Senior Fellow, Peterson Institute for International Economics

Critical Issues Confronting China Seminar Series

Wednesday, October 8, 2014

China's economic growth in the recent decade continues its previous impressive record - albeit at a slightly slower rate than double digit - surpassing Japan in 2010 and becoming the second largest economy in the world. Is this a result of China's extensive use of industrial policies and state-led capitalism, as portrayed by American popular media and characterized by some Chinese scholars as "advance of the state and retreat of private enterprises" (国进民退) during the "Hu Jintao-Wen Jiabao era'? The answer of Senior Fellow at Peterson Institute for International Economics, Nicholas Lardy, is a resounding No. Instead the opposite is true. It is another piece of evidence of market triumph over state control and central planning.

Lardy illustrates this thesis from several angles with copious data and charts. First, the Chinese market has become highly liberalized and generally competitive over the past three decades. The share of transactions at prices fixed by state has come down so dramatically that by the end of the 1990s, most of transaction prices had become market determined. Market concentration rates in some selected industrial sectors have become comparable to those of the U.S. Retained earnings of non-financial corporations as a percentage of corporation investment have been very high in the recent decade. Even after China's enormous 2009 stimulus package of 4 trillion RMB, this ratio is still over 50%, indicating company self-generated cash is the main source of funding for future growth.

Second, China's private sector has operated much more efficiently than the state sector with average return on assets twice as much as that of the state sector (13.2% vs. 4.9% in 2012). This important fact points to a very vibrant future for the private economy, thereby the Chinese economy at large, if unabated by policies to curtail the natural growth trajectory of the private sector.

Third, the relative importance of the state sector in China's economy has significantly shrunk. The state's share of industrial output is down to a quarter, while the private sector (including private foreign firms) takes up three quarters. The state's share of fixed asset investment in the entire economy is down to 34% in 2012, while the private sector's share (domestic firms only) is 48%. In particular, the state's share of fixed investment in manufacturing is 11%, less than 1/6th of the size of private (domestic firms only) investment (73%). Lardy attributes state's shrinkage to private sector's displacement rather than privatization of the state sector since private enterprises operate much more efficiently as explained above.
Fourth, in China’s exports composition, the state no longer plays a dominant role. The state’s share of China’s total exports has dropped from about two thirds in 1995 to only 11% in 2013, while exports from Chinese private enterprises took off from the ground level to a substantial 39%.

Lardy dispels a few popular misconceptions about the Chinese economy. First, the Chinese government is generally perceived too big. In fact, given the size of China’s population, the Chinese government is not big. China’s state and the public sector employs only 11% of the total labor force, whereas the French government employs 24% of the labor force. Only 30 people for every thousand Chinese population work for the government, while 74 people for every thousand Americans work for the American government.

Second, state owned enterprises (SOEs) are perceived to extract profits at the expense of the private sector through industrial policies. Lardy examines the policies of the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) over the last decade, and finds that whenever the state attempted to give favorite policies to SOEs and to create national champions, it invariably failed. Return on assets for central SASAC non-financial firms has dropped from 6.7% in 2007 to 3.7% in 2013, less than the average interest rate of bank loans. This means that SASAC has created black holes that drain resources that could have been used more productively somewhere else. Furthermore, profits of SOEs are not disproportionately high. Data show that the average profit margin of SOEs is essentially identical to that of private companies.

Third, SOEs are generally perceived to be able to obtain bank loans much more readily than private companies. Data show that the proportion of total bank loans outstanding to enterprises that has gone to SOEs has decreased from 56% in 2009 to 48% in 2012, while the proportion to private companies has substantially increased from 26% to 36% during the same period. Lardy points out that this trend has been underappreciated by the general public. An increasing proportion of bank loans to private companies makes sense as private companies have proved to be on average twice as profitable as SOEs, with interest coverage ratio (the ratio of operating income over interest expense) 9.6 vs. 4.3 for SOEs. This implies that SOEs on the whole burn cash and that state owned banks should further reduce loans to them.

To be sure, the Chinese state still plays a dominant role in some sectors such as oil and gas and utilities, and what Lardy calls "modern business services" such as telecommunications and financial intermediation. Most SOEs in these sectors have much lower returns on assets than their international peers. To improve their operating efficiencies and to reduce mis-allocation of resources at a macro level, Lardy sees no alternative but to lower entry barriers and allow private entry into these fields down the road.