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China's Challenge: Growing the Market, Limiting the State

Freeing interest rates and better protecting property rights would tell investors the government is serious about changing its institutions and economy

By James A. Dorn
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In his new book *Markets over Mao: The Rise of Private Business in China*, Nicholas R. Lardy, one of the world's leading China experts and a senior fellow at the Peterson Institute for International Economics, makes a strong case that the market, not the state, has been the key factor in the country's remarkable rise. In 1978, Beijing began to loosen its grip on economic life and paramount leader Deng Xiaoping recognized the failure of central planning as a development model. Today China is the world's second-largest economy, and the range of choices open to consumers has greatly expanded under economic liberalization and trade.

Nevertheless, the state-controlled sectors of the economy still exert a strong influence, especially in services, and Beijing continues to suppress interest rates, peg the exchange rate, impose capital controls and underprice energy – thereby distorting factor prices and misallocating resources. The banking system is dominated by state-owned banks that funnel funds to inefficient state-owned enterprises (SOEs). The huge infusion of funds to counter the 2008 financial crisis has left a large debt overhang. Meanwhile, the shadow banking system has grown rapidly to help serve small and medium-sized enterprises in the nonstate sector.

To address these and related problems, the third plenum of the 18th Central Committee, held in November 2013, provided a blueprint for further liberalization. Premier Li Keqiang has promised to rebalance the economy by moving from an investment- and export-led growth model to one based on "all-round" development and a focus on quality, not just quantity, of output. By lifting restrictions on bank deposit rates, allowing more freedom in making bank loans, moving energy prices toward market-clearing levels, allowing greater flexibility of the exchange rate and increasing the role of the private sector, China's leaders hope to encourage domestic consumption and reduce overdependence on exports and fixed-asset investment.

The country's challenge is to grow the market and limit the state. That will not be easy given the lack of a genuine rule of law, special interests that support state cronyism in the form of cheap credit from state-owned banks, a managed exchange rate that favors export-led development, subsidies giving life support to inefficient enterprises, anti-monopoly laws protecting "pillar" industries, and the politicization of investment decisions, which are heavily influenced by local Communist Party officials.

Even though Li has advocated a more market-oriented allocation of resources, he has called the GDP growth target "legally binding" – which is more an echo of central planning than market liberalism. Industrial output growth in August slowed to 6.9 percent from a year ago, below the official target of 7.5 percent, and the slowest growth since 2008. If year-end growth falls below the target, which is highly likely, it will be the first time since 1998.

The pampering of SOEs whose large investments and low returns hamper efficient growth needs to be ended. Expanding the nonstate sector and allowing more competition would redirect scarce capital and increase overall wealth.

What really needs rebalancing in China is the relation between the state and the market. Hong Kong's mantra of "big market, small state" is one that should be voiced – and implemented – on the mainland. Economic prosperity is best understood in terms of economic freedom. Regulations and laws that block entry and limit competition (both domestic and foreign) diminish opportunities for mutually advantageous exchanges and slow the advance of widespread prosperity.

When vast amounts of resources are allotted to building a Chinese Wall Street in Yujiapu on the outskirts of Tianjin, one can marvel at the enormity of the project but overlook the reality that China lacks the institutional infrastructure to support a real capital market. The Tao of the market is first to establish the institutions that anchor a free market – namely, private property rights, freedom of contract, an independent judiciary and the rule of law – and then let investors determine the optimal size and location of the physical structures.

China has made substantial progress in moving toward a market system, but much remains to be done in building its institutional infrastructure. When the third plenum called for greater reliance on "market principles, market prices and market competition," market liberals cheered. Private/nonstate enterprises have been far more productive than SOEs, both in the industrial and service sectors. As Lardy points out, "state firms drag down growth."

When market prices guide economic activity and direct resources, consumers benefit and GDP statistics tell a more truthful story about the range of choices open to people. The coastal areas where the private sector and markets predominate have flourished and millions of jobs have been created. That lesson has not been lost, as seen in the plenum's "Decision on Major Issues Concerning Comprehensively Deepening Reforms."

However, it is one thing for the Central Committee to pen such a document and another to implement it. The slowdown in growth is an opportunity to deepen reforms but it is also a temptation for greater state intervention. Thus far that temptation has been largely resisted, but the People's Bank of China is beginning to open its credit spigot to satisfy local officials' growth mania. Gearing up the monetary printing press may give some short-run relief to the lagging growth rate but risks igniting inflation and further misallocating investment funds.

Moreover, China should have learned from the U.S. experience that propping up the housing market and engaging in off-balance sheet lending can be very disruptive when deleveraging breeds a balance-sheet crisis.

Administrative controls and credit allocation are palliatives. China needs real reform. Liberalizing interest rates and improving the legal protection of property rights would give investors a strong signal that China is serious about rebalancing its institutions as well as its economy.

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