INTERVIEW

Nicholas Lardy

Good plan; can PRC do it?

Nicholas Lardy is a Senior Fellow at the Peterson Institute for International Economics. His most recent book on China (2012) is: *Sustaining China's Economic Growth after the Global Financial Crisis*.

TOE: On a scale of 0 to 10, how would you rate the Third Plenum reforms?
Lardy: The plan itself is a ten. It's hard to imagine it could be any stronger given the constraints that exist.

As to how much it's going to be implemented, I am relatively agnostic. You can point to the vested interests and say that other people have tried to do some of these things and they haven't succeeded.

But there are several things that may be different this time. First, Xi Jinping has consolidated his power much more rapidly than others have done in previous transitions. Secondly, he has taken complete ownership of the economic issue and put his personal prestige behind it. And thirdly, much more than [Communist Party chief] Hu Jintao and [Prime Minister] Wen Jiabao [both 2002-12], Xi recognizes that, if he doesn't get some significant economic reform underway, growth could slow dramatically. Over recent years, Xi has talked a lot about the shortcomings of the growth process and its unsustainable character.

It's only four years until the majority of the Standing Committee of the Politburo [China's highest ruling body] rotates. If Xi hasn't demonstrated an ability to improve the economic situation, his chances of getting people who share his views on a broad range of issues will be substantially impaired.

TOE: Do you think most Party leaders accept that, without reform, they're going to have a tough time growing?
Lardy: I don't know if it's generally accepted within the Party leadership. I certainly think it's a view that Xi and [Prime Minister] Li Keqiang have. Certainly, quite a number of senior people in the leadership and most of the people in charge of all the various economic bureaucracies believe that.

TOE: How much of a difference will reform make in Chinese growth rates?
Lardy: If they don't implement anything, the growth rate is going to slow down dramatically over the next two to three years. Instead of 7.5% or so, it could be 5.5% or so. If they can implement most of this reform package, then after a couple years of slower growth during the transition, they have the potential to grow 8-9% for a decade.

TOE: Would 5% create social unrest? Is that the political driver?
Lardy: The regime is not going to fall from a year or two of very slow growth. But Xi's leadership will be under substantial stress.

TOE: The reform document seems contradictory. On the one hand, the document says the market is going to be decisive. On the other hand, it says that the public sector will continue to dominate the economy.
Lardy: The phrase "the public sector will continue to dominate the economy" has been in Plenum documents repeatedly. Still, role of the state has shrunk dramatically—as a share of output, access to bank loans, etc. Employment in the state-owned enterprises (SOEs) has been flat, which means a declining share of total employment. I regard that statement as a sop to those who think the public sector should be primary.

On the other hand, the phrase that the market is going to be decisive in resource allocation has never before appeared in any Party document. This is fundamentally different. It's certainly the single most important thing—and not only because of its substance, but because the phase was repeated three times in the communiqué.

TOE: Derek Scissors (see interview, pg. 8) says that, while official state-owned enterprises (SOEs) have declined, there are large ostensibly non-state Limited Liability Corporations (LLCs), like PetroChina, that are subsidiaries of SOEs.
Lardy: All the measures that I use for measuring the state sector include all of the LLCs where the state is the majority owner.

TOE: Is the decline of the state sector the sine qua non of reform?
Lardy: It's a very good metric. The key thing is that, in industry, the return on assets (ROA) of SOEs is now under 5%. That's less than the cost of bank loans. In the private sector, the ROA is 13%.

The ROA gap began to be closed during the reforms of the 1990s. But, after 2007, it widened again. The SOEs are not very sensitive to cost of capital. They just keep borrowing. They grow their assets faster than they can grow their output. SOEs can continue existing even if they're losing money.

Since, private firms don't have unlimited access to capital, if they keep losing money, they go out of business. But the rate of creation of new private firms is extraordinarily high. It's a very dynamic sector.

TOE: Have Chinese officials talked about the difference in the rate of return?
Lardy: I don't think I've ever seen that explicitly. They talk about efficiency.

TOE: Does the state sector play a political role in the sense of making sure there's full employment even if it's inefficient?
Lardy: No, that's a myth. They are very capital-intensive. All of the employment creation is coming in the private sector.

TOE: The Plenum talked about the liberalization of interest rates. Yet, state banks still dominate banking. Can interest rates really becoming freer, and private firms really have access to the bank capital that they need to grow even more?
Lardy: State banks are dominant, but most of the money that they're lending to firms these days is going to private companies. You can read everywhere that state companies are still getting 95% of the credit. It's not true. In recent years, only 35% has gone to SOEs or state-dominated LLCs.

Lending rates have already been completely freed up. The new liberalization is on the deposit side. And that is going to raise

the cost of capital. That will have a very profound effect on resource allocation.

TOE: What about the international flow of capital in and out, and the floating of the currency rate?
Lardy: This is an area where I thought the decisions were a little bit cautious. I was glad to see that, since I'm not a big fan of overnight capital account liberalization. The phrase they used was to "raise the extent of convertibility of cross-border capital." That is nothing more than they've been doing for some time. It's not as clear a call for capital flow opening as we've heard in the past. This is an area where they may have pulled back a bit.

TOE: After the 1997-98 Asian financial crisis, Barry Bosworth wrote a paper saying that you have to do the right things in the right order. It's asking for trouble to free up international capital flows before you have a sound domestic financial system. Do you agree?
Lardy: Yes, I do.

TOE: Some people believe that globalization, including operations of foreign firms, is a very key driver for internal liberalization.
Lardy: I don't see any connection with the presence of foreign firms. Over the past 35 years, the state sector has been shrinking, shrinking, shrinking. Yet, during this period, there are times when foreign firms have a tougher time, and others when they have an easier time.

TOE: What about globalization in the broader sense, including trade as a high share of China's GDP?
Lardy: In the past, there's been a fairly close relationship between reforms on the domestic and the foreign fronts. But we're in a different world now. And, it's likely that the linkage is not quite as tight.

TOE: What are the main obstacles to real reform?
Lardy: There are a lot of sectors, regions and so forth, that have benefited from the distortions of the past decade. The whole manufacturing sector has benefited from an undervalued currency, cheap energy, and cheap capital. That's why the manufacturing sector has grown so strongly over the past ten years, and the service sector has languished. Those benefits are going away if this plan is implemented.

TOE: Critics say that one big problem is that lots of individuals at the top levels of the Party are involved in these inefficient enterprises that would be hurt by reform.
Lardy: There are certainly people in the Party that benefit from the current system. Opponents also include some owners of capital. Under the current system, the labor share of GDP has been going down while the capital share has been going up.

TOE: In the last decade, Prime Minister Wen Jiabao talked a lot about rebalancing the economy, i.e. to raise level of consumption relative to investment and the trade surplus. While the trade surplus has come down—perhaps because of the appreciation of the Chinese currency—the investment share has leveled off at a very high level. Yet, many analysts, including yourself, see this rebalancing as critical to growth.
Lardy: The consumption share of GDP has actually gone up in the last two years. It's not dramatic yet, but it's the beginning of a change. The consumption share of GDP bottomed out in 2010, at 34.9%. In 2011, it was 35.7%. Last year it was 36%. Now, that's not much of a change. But, if you take the previous decade between 1999 and 2009, the consumption share of GDP declined by 11 percentage points, roughly one percentage point per year. So now, it's gone up by half a point per year. The increase looks rather modest. But compared to the trend of the previous ten years, the change is much more dramatic.

TOE: Is continuing that trend something that the Plenum discussed a lot?
Lardy: Yes. The document has all kinds of things that will change that situation. For example, if you liberalize interest rates on deposits, bank lending rates will go up. As a result, the investment as a share of GDP will come down. The services sector will do better. Employment growth will be improved compared to the trajectory that we're on now. The wage share of GDP will go up, and so consumption will go up.

So, if they actually do what they say they're going to do, within a period of two to three years, we should see some slight acceleration of this rebalancing. It's going to take ten years to get the consumption share back to where it was in 1999. If they can get back to a gain of one percentage point per year in the consumption share, that that will be a substantial accomplishment.

Regarding the goods and services trade surplus, it peaked in 2007 at 8.8% of GDP. By 2010, it was down to 3.7%, and now it's 2.8%.

Investment is still very elevated. It's only declined by three tenths of a percentage point since 2010. I don't want to say that they've hit the bottom on that. But the picture is a lot more positive than some people are giving them credit for.

TOE: What things should we look at over the next two or three years to judge how implementation is going?
Lardy: For deposit rate liberalization, the key indicator is how soon they get in place a deposit insurance scheme. That's because they think it's too risky to liberalize deposit rates if they don't have deposit insurance. And by the way, they're now talking openly about letting financial companies go bankrupt, and letting owners losing their equity. This is something that's never been in print before.

Perhaps the most important test is how they handle the reform of prices. They have given a whole long list of prices that they're going to reform: water, electricity, gas, etc. Some of this has already been going on in a very preliminary way. Energy is significantly underpriced. In 2012 the ROA in oil refining was zero. In electric power supply, it was 0.4%. And in thermal power production, it was 3.2%. This is even lower than the SOE average of 4.9%.

They have not talked about ending price control. The government pricing scope is mainly limited to important public utilities, public interest-type services, network-type natural monopolies. So, the government is still going to be in charge of freight rates on the railroad, and airline ticket prices, and probably the price of water, and others.

Other measures are harder to identify. They've talked repeatedly about open, competitive, orderly markets; fair competition; eliminating monopolies; etc. Well, what are they going to do about that? I think we'll know when it's underway, but it's not like price reform, where all of a sudden they announce the price of water is going up by a certain amount. But that leads me to believe that some of these areas where the SOEs have had monopolies are going to be under pressure. And they're going to be opened up to foreign capital and, private domestic capital. So, I track that indicator very closely.