The Economist

The economics of reform

Stoking the furnace

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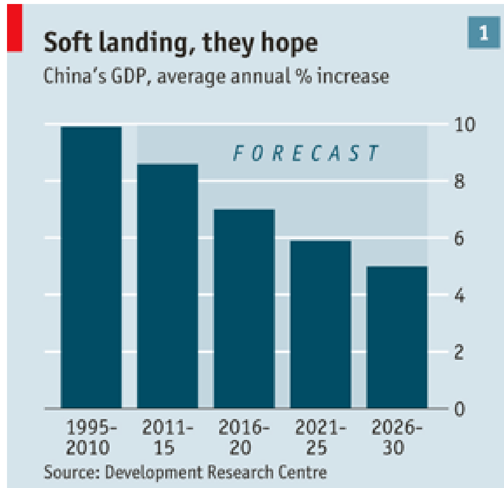
IN 1985 a Chinese steamship, the *Bashan*, chugged down the Yangzi river, carrying an unusual cargo: ten foreign economists, including one Nobel prize-winner, and almost twice as many Chinese counterparts from the government and academia. They spent the weeklong voyage swapping ideas on how to steer China's unruly economy between the plan and the market.

This "steamship conference", organised by the World Bank at the request of a government commission, has become legendary (although a bank report published the same year was probably more influential). This week the bank unveiled the results of another collaboration it hopes will make a similar splash: the "China 2030" study, examining how China can fulfil its ambition to become a high-income country over the next two decades, at ease with itself, its neighbours and its environment.

On the steamship, the foreign advisers had the undivided attention of their hosts. Getting noticed in China is much harder now. China remains a big deal for the bank, but the bank is not a big deal for China. It still finances projects ranging from road-building in Ningxia to restoring the historic architecture of Confucius's hometown. But the bank's outstanding loans (worth $20.6 billion) are equivalent to only 0.6% of China's foreign-exchange reserves.

The China 2030 report was, however, jointly produced with a government think-tank, the Development Research Centre, which advises China's cabinet. The bank's involvement may have given the

DRC cover to say what needs to be said. And the DRC's participation may have given the bank the clout it needs if it is to be heard.

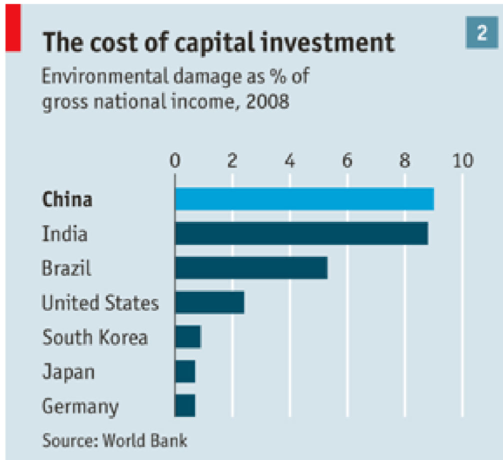


The report's contributors were urged to think big and push hard. They did not hold back. The report sprawls like one of the land-hungry Chinese cities it criticises. The authors project a gentle slowdown of growth, which will average 7% in the second half of this decade and 5% from 2026-30 (see chart 1). That would be enough to make China the world's biggest economy and a high-income country, by the bank's definition, with an income per head of about $16,000. But China will not fulfil this benign destiny unless it undertakes a bewildering array of reforms.

The report urges China's government to stop meddling in the market for inputs, such as capital (where interest rates are set by administrative fiat, not competitive forces); labour (where rural migrants cannot settle easily in cities); and land (where local officials routinely expropriate rural plots for urban development). The government must also promote entry and competition in output markets now dominated by state-owned enterprises. The state should instead concentrate on setting rules that allow markets to function, and provide public goods the market cannot furnish. This is a hugely ambitious manifesto. But the report counts it all as only one of six areas of reform, each of which is deemed a priority.

Such laundry lists are not usually very helpful to policymakers, who need clearer guidance on what to tackle first. But the report may sprawl because many of China's problems do: one distortion or skewed incentive invites another.

Take, for example, the criteria used in promoting local officials. The usual benchmark—growth—encourages local bureaucracies to offer investors cheap land, underpriced electricity and low taxes, anything to bring factories to their county or province. That is one reason why China's growth has relied so heavily on investment. Capital-intensive



growth has in turn taken a toll on the environment. The depletion of China's natural resources combined with the damage to health from water pollution, soot and other particulates, cost China the equivalent of 9% of its national income (see chart 2) in 2008, the report estimates. Both fiscal reform and greener growth are therefore among the report's six priorities. And it cites with approval Guangdong province's experiments with using a broad "happiness" index to judge local progress and reward the bureaucrats responsible.

The capital-intensity of China's growth has also left workers with a relatively small slice of the national cake. That has prevented China's consumption growing as quickly as the economy as a whole. The things it does not buy itself it sells to foreigners, resulting in a troublesome trade surplus. That surplus jeopardises the friendly international relations that the report identifies as another of China's six priorities. One problem leads to another.

Nonetheless, since the government cannot do everything at once, it has to start somewhere. The sequence of reform, the report acknowledges, may be dictated by politics as much as anything else. Nowhere is the politics of reform more ticklish than in the case of state-owned enterprises. The report envisages a more arm's-length relationship between the state and the powerful conglomerates it still owns. These companies enjoy the benefits of state ownership with few of the obligations. They transfer 15% or less of their profits to the budget, for example. If dividends were increased to 50% of profits, a rate more in line with rich countries, budgetary revenues would jump by about 3% of GDP, the report says, money that could help fund the public services that are another of the report's priorities. But state enterprises firmly oppose such a change.

So the report urges China to continue its long tradition of local experimentation, because "successful reforms at the local level tend to grow their own champions". It also recommends starting with measures that face the least resistance as a way to build momentum for tougher reforms later on.

Trojan redback

One institution that may be following such a strategy is China's central bank, the People's Bank of China (PBOC). Its research and statistics division last week released a potential timetable for easing China's extensive capital controls over the next ten years. The China 2030 report also foresees an eventual opening of the capital account, but not until a long list of prerequisites is fulfilled, including liberalising the exchange rate, freeing interest rates, improving the supervision of China's banks, and deepening its financial markets.

Such preconditions are not, however, absolute, according to Sheng Songcheng, head of the central bank's research department and the lead author of its new study (he is also a candidate for assistant governor). If you wait for the exchange rate and interest rates to be fully liberalised, he says, you may wait forever.

So the central bank may be hoping for a different sequence, dictated by politics as much as economics. Further easing of capital controls would certainly hasten the liberalisation of currency and interest rates. China's banks would have to offer a market rate on deposits if savers had more liberty to seek higher returns elsewhere. And if capital found it easier to come and go, the central bank would have to ease its grip on the exchange rate (unless it were willing to give up monetary control at home). Capital flows might provide the external pressure the central bank needs to overcome domestic opposition. Eswar Prasad of the Brookings Institution, a Washington think-tank, calls it a "Trojan horse" strategy.

To make the horse look more attractive, reformers are touting some side-benefits of opening up. It would allow Chinese investors to snap up foreign companies at a time when Western investors are in retreat and prices are cheap. It would also permit the yuan to fulfil its destiny as an international currency.

A global currency is a mixed blessing. As the report points out, international demand for the dollar strengthens America's currency and blunts the competitiveness of its exports. But many Chinese officials probably believe the world's second-biggest economy deserves a currency of similar stature. A global yuan may not greatly benefit China, but it certainly befits it.

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