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Reform by stealth is reason for optimism about China

By Eswar Prasad

China pessimists are claiming vindication as growth slows in the world's second-largest economy. Optimists point out that Beijing has fiscal room to respond but there are risks to any short-term policy measures. A surge in bank-financed investment, for example, could boost growth but it is also likely to increase the stock of non-performing loans in the banking system and set back the goal of rebalancing growth by promoting private consumption. An ageing population and a rocky leadership transition strengthen the bears' case.

However, there are grounds for hope. Recent political turmoil, including the Bo Xilai affair, put reactionary forces in the Communist Party of China on the defensive. Meanwhile, reform-minded officials pushed through some modest but significant financial market reforms.

The government has long recognised that reforming the financial sector is needed to improve the balance and sustainability of growth. Why has it not acted more forcefully before? The present system works well – for some. State-owned banks provide cheap financing for state enterprises, which are key fiefdoms of political patronage. Banks also provide financing to powerful provincial officials through shell corporations that bankroll pet investment projects. This is financed by paying Chinese households low or negative inflation-adjusted returns on their voluminous bank deposits.

All of this needs fixing, but the best of intentions can backfire. In an economy with many policy problems, getting rid of one or two can have unintended consequences. In

2008, asking banks to limit credit growth and avoid new non-performing loans were sensible moves. But banks had a lot of outstanding loans to weak state enterprises – starving them of credit would have turned those loans into non-performing loans in short order. So banks continued lending to state enterprises and shut off lending to the private sector, meeting the government's conditions but thwarting its intentions.

Recent moves indicate that the government has learnt its lesson. It increased the flexibility of the exchange rate (in principle) when the renminbi was not under pressure to appreciate, relaxed the cap on interest rates paid on deposits, increased foreign investors' access to capital markets and encouraged certain informal financial companies to become part of the formal banking system. Each of these moves has broader significance.

For example, giving informal financial companies the opportunity to join the formal banking system serves multiple ends. It brings them under the ambit of the banking regulator and reduces the risks they pose to financial stability. Moreover, they now provide more overt competition for established banks.

The need for interest rate liberalisation is widely recognised inside and outside China. Freeing up deposit rates and abandoning the fixed spread between deposit and loan rates would result in better returns for depositors and encourage banks to sharpen their lending practices. The big banks have resisted this fiercely as it would cut into profits. So the government cleverly took a small step when it cut rates recently – freeing up banks to offer deposit rates marginally higher than the base rate, arguing that this would make the rate cut more palatable to depositors.

A one-shot approach to breaking up big banks or freeing interest rates risks a backlash and concerted opposition that could block changes altogether. Reform-minded officials are taking a more subtle approach – using a megaphone to draw attention to the problems and introducing small but tangible changes.

One can make a strong case that, with its economy growing more complex and market-oriented, China needs to move beyond this cautious approach. The 12th five-year plan issued last year laid bare the range of problems, including corruption and dismal corporate governance among Chinese enterprises, and deficiencies in the policy making process. Given the severe political constraints China's leaders face, however, modest reforms by stealth are better than no reforms at all.

This strategy may slowly turn China in the direction it needs to go. Whether this will be

enough to outrun the many demons China faces remains the big question.

The writer is a professor of economics at Cornell University, a senior fellow at the Brookings Institution and a former head of IMF's China division

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