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Beijing's caution on reforms makes sense – for now

By Eswar Prasad

But China does not have the luxury of deferring all changes until conditions suit, says Eswar Prasad


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Cataloguing China's economic risks has become a popular parlour game. In the past decade, a steady drumbeat of warnings has predicted imminent collapse. Rising state and local government debt, a weak financial system and multiplying inefficiencies in the economy certainly pose big risks. The reforms needed to maintain growth and improve its quality have been painfully slow.

Despite these problems, the size of China's economy and the per capita income of its citizens have quadrupled in the past 15 years, pulling millions out of poverty. Still, the country cannot outrun its problems forever. Unbalanced growth has led to widening inequality and environmental degradation.

China's leaders often talk of the need for broad reforms but their actions are, critics say, plodding and hypercautious. This issue is in the spotlight as expectation builds that next month's party plenum in Beijing will yield a range of reforms. Some warn, however, that such hopes will be disappointed.

Yet, for all the criticism, certain aspects of China's cautious approach to economic reforms, which is likely to continue, might actually prove an object lesson to other countries.

Consider the proposal to eliminate the ceiling on interest rates paid on bank deposits. The ceiling has stifled competition among lenders, resulting in households receiving minuscule real returns on their deposits for much of the past decade.

Removing the ceiling would have its dangers. Weaker, poorly regulated banks might offer higher rates to compete for deposits, make riskier loans and set themselves up for failure. An explicit deposit insurance system, rather than the implicit state guarantee that now covers all deposits, would impose market discipline.

Since such a system would take time to put in place, the government has chipped away at the ceiling by allowing the proliferation of other saving products with higher returns. This approach has its own risks but helps catalyse interest rate reforms.

Small, indirect changes, even if inefficient, elicit less opposition, pose fewer risks and make course corrections easier. A big-bang approach might harm the cause of reform in the long term by inviting stronger opposition from those keen to maintain the status quo.

Many countries have undertaken big changes when they face a crisis; reforms are harder without such pressure as they invariably involve disruption and risks. The rhetoric surrounding proposed measures then turns out to be crucial in determining their political fate. In the US, the benefits of the Affordable Care Act have been subverted by the false narrative that it would socialise healthcare and destroy jobs.

In emerging markets, the notion that reforms benefit the economic and political elite is a powerful obstacle. Foreign investment in India's retail sector has been stymied by the narrative that it profits global corporations, destroying small retailers' livelihoods. In reality, it would help the poor by improving food distribution channels, reducing waste and keeping costs down.

Beijing has proved effective at creating narratives that build broad support and provide a framework for communicating the logic and desirability of individual reforms.

Given its under-developed financial markets, capital account liberalisation would be premature. But this objective highlights areas where reforms would be in China's own interest: broader and better regulated financial markets, as well as a more flexible exchange rate.

This year, Beijing announced a plan to reduce inequality. This would be a dubious policy goal if it emphasised redistributive policies. In fact, the proposals are exactly the reforms needed – financial market liberalisation, reform of state-owned enterprises and freer labour mobility. All are worthy in themselves but the narrative helped emphasise that the benefits would be widespread rather than accruing to the select few.

Narratives must be translated into action. China does not have the luxury to postpone all reforms until the conditions are ripe. Its leadership may have to take greater risks to advance much-needed steps. But critics should appreciate that Beijing's approach might reflect its economic and political savviness rather than a lack of commitment.

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