China’s economy has been the leading contributor to global growth since 2009 and became the second largest in the world in 2010. Small wonder that fears of a growth slowdown in China are causing trepidation around the world.

The fears are palpable given that virtually all indicators of economic activity are pointing down. Growth in gross domestic product, industrial production and retail sales have all slowed markedly. Alternative indicators like electricity consumption suggest an even sharper slowdown. Foreign trade has not helped, with export and import growth falling sharply as well.

Then there are the longer-term concerns that a rapidly aging population is going to limit the economy’s growth potential, snaring China in the “middle-income trap.” With fear in the air, foreign capital is no longer pouring into China and some domestic investors are even taking capital out.

Inflation has eased to 2 percent and some of the froth has come off the property market, but these are seen by many as signs of deeper malaise rather than as positive developments. All told, it appears to be the season for China bears, who are exulting as their views appear — finally — to be validated.

The burden of pulling along world growth while the major advanced economies — the United States, Europe and Japan — continue to post anemic growth and remain in a state of policy paralysis has clearly taken its toll on the Chinese economy. Moreover, many emerging markets and even some advanced economies that rely on commodity exports have been riding on China’s coattails during a difficult period in the world economy. Thus, China’s growth is seen as a bellwether of an even rockier period ahead for a global economy whose recovery has stalled.

For all the angst about China’s growth, the government does have room to stimulate the economy through fiscal and monetary policies. This is in contrast to many advanced economies, which seem to have exhausted their policy options. With a leadership transition looming, the Chinese government appears to be holding some of its fire to be able to
respond strongly to external shocks.

Attaining this year’s growth target of 7.5 percent is likely to be difficult but not insurmountable. The real challenge Chinese policy makers face is how to sustain growth in the short run without creating more risks over the longer term.

A bank-financed investment surge lifted economic growth during the global financial crisis. The temptation to use this policy tool again is strong. But another wave of bank-financed investment would also create big risks, including excess capacity in many industries and more bad loans in the banking system.

The mix of policies also has implications for making growth more balanced. Until recently, the Chinese economy was beset by two imbalances — an external one, reflected in a high trade surplus, and an internal imbalance, reflected in a low and falling ratio of private consumption to G.D.P.

The external imbalance has dissipated, at least temporarily. China’s trade surplus has fallen steadily from its recent peak of 7.6 percent in 2007 to 2.1 percent in 2011, and below 2 percent in the first half of this year. Part of this decline is because China has been growing far more strongly than its trading partners. Another factor is that the currency, the renminbi, has appreciated in value against the currencies of China’s major trading partners, reducing export competitiveness.

By contrast, domestic growth remains unbalanced, with investment still accounting for a major share of G.D.P. growth. The share of private consumption in G.D.P., which is only about one-third — already much lower than in virtually every other economy — continues to decline.

There was a spark of hope in the first quarter of 2012, when private consumption accounted for the major share of G.D.P. growth. But this proved fleeting, and investment has once again taken over as the main driver of growth. Investment-led growth of the sort China has experienced is not entirely a plus — it does not lift employment growth by much, has deleterious environmental consequences and limits the benefits that the average household gets from fast growth.

What is to be done? Fiscal policy, if well targeted, would be a better tool to stoke demand in the short run without creating too many long-term risks. For instance, a better safety net would help spread the benefits of China’s strong economic performance more evenly and reduce the incentives for households to “self-insure” against risks of unemployment by
saving more. Raising social expenditures on health and education would not only give households more incentive to spend rather than save but also help improve the productivity of labor.

For the longer term, the main priority for the government is to improve productivity rather than rely on high investment or an expanding labor force. This will also require a better financial system and more effective policy tools.

The financial system needs to improve its efficiency in allocating capital to more productive uses, including providing capital for small and midsize enterprises that could generate more employment, and providing savers with a higher return on their deposits. A better monetary policy would help in this objective and that, in turn, requires a greater freeing up of the exchange rate over time so that the central bank can use interest rates to guide credit allocation.

The economy faces other enormous challenges, including corruption and dismal corporate governance at Chinese enterprises. The twelfth five-year plan, issued last year, laid bare these problems and deficiencies in the policy-making process. An authoritarian government can certainly do what would be infeasible in a democracy, where such an admission would be politically fatal. But it is difficult to think of another government, democratic or not, that so bluntly acknowledges major problems and areas where its policies have failed to deliver much progress. In the midst of the gloom, that allows a glimmer of hope that Chinese policy makers will continue to embrace an agenda of much-needed reforms.

Despite the difficult economic environment and a looming, rockier-than-anticipated political transition, there has been progress. This includes modest but significant steps taken in recent months toward greater flexibility of the renminbi’s exchange rate, liberalization of domestic interest rates, and freeing up of restrictions on capital inflows and outflows.

This opportunistic and gradual approach to economic overhauls is one way to make progress given the significant constraints, both political and institutional, that the government faces. But China’s leaders may not have the luxury of time or a benign environment, either domestic or global, to limit themselves to such a slow, even if steady, pace.

The country’s policy makers have proven adept at managing a high-wire balancing act for a number of years, keeping growth strong even while managing the many problems the
growth process has created. Gusting winds from abroad have now exposed many of these tensions and threaten to bring the act crashing down.

A more aggressive push for reforms is needed to help secure short-term growth while improving future prospects and reducing risks. Not moving forward on these reforms may be the biggest risk of all.

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