OPINION

China's Balancing Act

By Eswar Prasad

The recent slowdown in China's growth is apparent validation of a number of theories de jour. First, China is getting mired in a middle-income trap. Second, China's long period of high growth is already a statistical anomaly that cannot possibly last much longer. Third, China's growth has been built on shaky foundations of a debt-financed investment binge that has run out of steam.

It's possible to maintain high economic growth while reforming the economy.

If China wants to escape these gloomy prognostications and avoid lower growth rates, reforms and economic rebalancing are essential. Further growth built on rapid credit expansion would be undesirable and risky. Fortunately, China's leaders seem duly committed to financial sector and other market-oriented reforms. But slowing growth momentum in the economy is constraining economic and political space to push forward those reforms.

There is no reason to panic—at least not yet. Reforms and rebalancing are in fact compatible with maintaining high growth rates. There is substantial misallocation of resources in China, so economic and financial sector reforms resulting in improved resource allocation can help China maintain growth in the government's target range of around 6% to 7%—even while promoting growth rebalancing in the short run.

The first channel is labor reallocation. A large pool of unutilized or underutilized labor, especially in rural areas, remains to be tapped. This is one of the goals of the government's urbanization program, although there may be better ways—involving less disruption and fewer congestion costs—of moving labor from unproductive sectors of the economy to more productive ones. This reallocation effect by itself can give a short-term boost to both aggregate productivity growth and GDP growth.

Second, an increase in private consumption growth can become a more important driver of GDP growth. This will require changes in the economy that generate more employment and diminish the precautionary savings motives of households. Household saving rates have been driven up by a weak financial system, reflected in a lack of diversification opportunities, the inability to borrow against future income and an inadequate safety net. The ownership structures of many firms and their financing sources also create incentives for higher corporate savings that are then plowed back into investment, some of which have marginal value at best.

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The People's Bank of China headquarters in Beijing.

Third, directing more financial resources to parts of the economy that are better at generating employment, especially the services sector and small- and medium-size enterprises, could add to employment growth. This would have the added benefit of reducing the capital intensity of growth.

Fourth, fiscal policy can play a more effective role at supporting growth, creating fewer risks to the financial sector and promoting growth rebalancing, such as by strengthening the social safety net. In a nod to this, last month the government set a modestly higher deficit target for the coming fiscal year, although more substantive changes in the composition of expenditures and the tax structure are warranted.

Fifth, the rate of investment growth can be maintained at a high level, even if the expansion of bank credit slows, if some of it is financed through alternative channels. For example, corporate bond markets could in principle do better at allocating capital.

Concerns about China's high rates of investment in physical capital, which accounts for nearly half of GDP, are legitimate. But China still has a far-lower capital-output ratio than richer, advanced economies and has vast needs for infrastructure in its interior provinces. The real challenge is to use better mechanisms to transform domestic savings into domestic investment in an efficient manner that allocates capital to its most productive uses. Improvements in corporate governance, the financial regulatory framework and legal reforms underpinning a market-oriented system are also essential for productive investment.

What else will it take to generate such positive shifts in the economy? A broader, more efficient and better-regulated financial system is crucial to accomplish the different aspects of rebalancing. A more flexible monetary policy framework that is not hampered by a tightly managed exchange-rate regime and a more supportive fiscal framework have to be part of the package. Institutional reforms and the freer play of market forces in the enterprise sector are necessary as well.

These are all major transitions. Time is short, political opposition is strong and the risks of stumbling are great. But so long as the government keeps moving in the right direction at a reasonable pace, the reforms and rebalancing can take place without the economy necessarily facing a sharp slowdown as a necessary concomitant to reforms.

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