Beijing's Steady Progress Toward Rebalancing

BY ESWAR PRASAD

While the world's attention has been focused on the political and economic problems of Japan and the U.S., one country has been quietly chipping away at some of its own economic problems. Recent data suggest a gradual but remarkable transformation in China, which is too early to declare victory, however, and the new leadership has its work cut out for itself.

New data suggest that it is time to focus on growing the Chinese economy. Growth is driven largely by exports and investment. Private and government consumption together accounted for more than half of China's output growth in 2011-12, suggesting a big shift in the composition of demand. Physical capital investment, the main driver of growth over the previous decade, is no longer the dominant contributor to growth. As for exports, a shrinking trade surplus has in fact dragged down growth these past two years.

China has made substantial progress in reducing its external imbalance. Its current account surpluses have shrunk steadily and markedly relative to their peak in 2007, which hit 7.6% and 10.1% of gross domestic product, respectively. In 2012, both of these surpluses were below 3% of GDP.

One reason for this shift is that China's strong growth, combined with economic weaknesses in its key export markets, has brought down the trade surplus. Another is that the government has eased restrictions on capital inflows and outflows, allowing Chinese investors and corporations to look to foreign investments for diversification purposes.

Capital outflows exceeded inflows in 2012, something not seen for over a decade. This has raised concerns about capital flight. But the reversal might simply reflect a maturing, richer economy with more open financial markets that allow investors to take advantage of diversification opportunities.

There are other signs of progress on domestic rebalancing as well. The decline in the share of private consumption in GDP has been halted. The share even went up slightly in the last two years, although it still remains well below that of every other major economy, advanced or emerging. Consistent with the government's objective of promoting the services sector, employment in this sector grew faster in 2012 than in the industrial sector. The share of these two sectors in GDP are now equal. This is not to say that all is well.

China is less dependent on exports and investment. The next step toward economic maturity? Real reform.

China's economic performance has been focused on the Chinese economy. There are problems lurking on the books of the big state-owned banks which have continued lending money at low interest rates. The shift away from state-owned to private enterprises has ground to a halt because large levels of debt. Overall employment growth remains meager, although the non-agricultural employment growth remains better than expected, which has helped China cope with the large levels of debt. Overall employment growth remains meager, although the non-agricultural employment growth remains better than expected.

China has a golden opportunity—growth recovering and inflation low—to look beyond short-term demand management and focus instead on improving the balance, quality and sustainability of growth. While its new leaders have sung the appropriate paens to reforms, now is the time to pick up the playbook from two years ago and set it on fire.

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An Open Letter to Shinzo Abe

BY MICHAEL AUSLIN

Dear Prime Minister Abe:

This week you come to Washington as prime minister of Japan for the second time. Many things have changed since your last visit in 2007. The world economy cratered under your watch as America's only major ally in the Pacific region. The U.S. military and its leaders are the world's most powerful. But neither will it all-or-nothing.

Your spending decision is important for both the Japanese and the U.S. economy. The proposed reforms include liberalizing capital markets, a stronger social safety net and other reforms that are clearly laid out in China's 12th five-year plan two years ago. Earlier this month the government announced a plan to reduce shibboleth savings and raise private consumption.

Beijing has hit upon a clever strategy, as it will be a lot harder for vested interests to block reforms that are sold as being for the benefit of the many.

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Mr. Obama and his country—by adjusting to the Trans-Pacific Partnership trade talks as well as to resolve the stalled plan to move U.S. Marines to a new base in Okinawa. Besides the economic benefits of the first, both these moves would improve Japan's relations with the U.S. and other allies.

I hope you will promise quietly to move forward on a decision to join the Trans-Pacific Partnership trade talks as well as to resolve the stalled plan to move U.S. Marines to a new base in Okinawa. Besides the economic benefits of the first, both these moves would improve Japan's relations with the U.S. and other allies.

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This is what you should say to Mr. Obama. You should be speaking to the people of Japan as much as to the President of the United States when you say it, for your actions in Washington will signal to your citizens how you intend to keep them safe as you work to rebuild Japan's economy. If you speak in concrete terms, the White House will get the message.

Mr. Obama will realize that, for all of Japan's problems, it retains enormous strengths that benefit not only itself but the U.S. as well. He will understand that while political dysfunction and budget cutting in Washington raises questions about America's future role in Asia, Japan stands ready to help preserve the liberal system that has made the Asia-Pacific region the most dynamic on earth.

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