China should stick to trial and error - but risk bolder trials.

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Can China sustain its rate of growth over the next few decades? Last week, I discussed one possible constraint - the country's political future. But questions should also be raised over its economic strategy. China has important choices to make, for its own sake and for that of the rest of the world.

China's strategy for economic growth has three signal features: the gradualism of its move from the planned economy to the market; the country's extraordinary integration into the world economy; and the level and growth of investment.

China's approach to policy formation is often called "gradual". But, suggests Min Zhao of the World Bank office in Beijing, a better definition might be "empirical": China has relied on a trial-and-error approach to policy formation.*

The direction, however, has been towards the market. This has been most true of China's embrace of the world economy. Since 1978, the volume of its trade has risen 70-fold, trade's share in gross domestic product has risen five-fold and the country's share in world trade has jumped from 0.8 per cent to 7.7 per cent.

Last year, China's ratio of trade to GDP was much the same as South Korea's, even though the latter has only 4 per cent of its population. China's trade ratio is more than three times as high as that of Japan or the US. Moreover, its current account surplus reached 7.1 per cent of GDP in 2005. The country's foreign currency reserves are now 40 per cent of GDP and are also the world's largest.

Not only is China vastly more open to trade than Japan, it is also far more reliant on inward foreign direct investment. Japan and South Korea developed their own world-beating companies. China relies on those of the world. Foreign invested enterprises generated 58 per cent of exports last year.

The reliance on FDI has been one of China's principal routes round the obstacle created by its relatively inefficient state-owned enterprises. The privileged access to credit of the public sector partially explains why the rise in gross investment rate to 45 per cent of GDP has not produced an acceleration in growth.

In a remarkable new report, the McKinsey Global Institute notes that private and foreign-owned enterprises generate 52 per cent of GDP, but are receiving a mere 27 per cent of bank credit.** Given the dominance of banks in China's financial system, this is a significant distortion. In the first half of the 1990s, China required Dollars 3.30 in investment to generate Dollars 1 of additional income, argues the report, but it has required Dollars 4.90 since 2001, which is "40 per cent more than the amount required by other Asian Tigers in their high-growth period".

China's growth has come to depend not just on a high rate of investment, but on a rising one. But how high can China's already extraordinary investment rate go? At some point, perhaps in the not too distant future, investment must stop growing faster than consumption.

China's dynamism has also depended on the efficiency of its rapidly growing export sector. The

trend growth in the value of China's exports of goods has been 11 percentage points a year faster than that of world trade over the past decade. At some point, export growth must slow sharply.

Moreover, if it had not been for the rise in the price of oil over the past few years, the current account surplus would have reached 10 per cent of GDP last year. Given the country's formidable export competitiveness and astonishingly high savings rate, it is not hard to foresee a rise in the current account surplus to Dollars 300bn (Pounds 161bn) a year in the not too distant future.

China, then, confronts formidable economic challenges: abroad, it must co-operate in managing the impact of its rise; at home, it must improve the efficiency of growth. A backlash, particularly in the US, against China's soaring exports, managed exchange rate and huge current account surplus is a big danger. Also important, however, are reforms that would lead to higher private consumption - now a mere 45 per cent of GDP - and more efficient investment.

A big question, then, is whether gradualism is still the best way forward. In a thoughtful recent paper, **Eswar Prasad** and Raghuram Rajan of the International Monetary Fund challenge that assumption.***

One reason for eschewing gradualism is that the international environment is unlikely to remain acquiescent for long: the pressure for faster movement on the exchange rate and the current account is certain to grow. Also important is the politics of reform: the opposition of predatory rent-seekers is making each change difficult. Something closer to a "big bang" may work better.

Changes in the Chinese economy also make gradualism riskier. As the economy has become more market oriented, it has become harder to shield areas of the economy where reforms have proceeded from the lack of reform elsewhere. Exchange controls are more porous today, for example, than a decade or so ago. Intervening massively in the foreign currency market while capital flows inwards risks generating dangerously unmatched balance sheets in the financial system.

Equally, the risk that a banking sector underpinned by government guarantees would be motivated to make another round of bad loans rises as liberalisation proceeds. Moreover, as the McKinsey report notes, the many constraints on the efficient operation of the financial system are interlinked. For this reason, reform demands an integrated approach.

China, in short, needs better balanced growth: it needs higher consumption and less - and less wasteful - investment; it needs a slower rate of growth of exports and smaller current account surpluses; it needs a more flexible exchange rate and smaller foreign currency reserves; and it needs a much more efficient financial system.

China has made vast progress over almost three decades. But it still has a long way to go. It should stick with trial and error, but risk bolder trials. As the IMF authors argue: "It may be time to move beyond feeling the stones and, instead, take some bigger steps on the road to reform."

*External Liberalisation and the Evolution of China's Exchange System: an Empirical Approach, www.worldbank.org.cn/English/home.asp

**Putting China's Capital to Work: The Value of Financial System Reform, April 2006, www.mckinsey.com/mgi

***Modernising China's Growth Paradigm, March 2006, www.imf.org