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World watches as China economic leaders take stage

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* Eyes on leader-in-waiting Xi for reform clues

* China-watchers hope Beijing picks up pace of change

* Fast growth but nearly a wasted decade for reformers

By Alan Wheatley, Global Economics Correspondent

LONDON, Feb 7 (Reuters) - A new guessing game is about to begin: will China's incoming generation of leaders show more courage than the current incumbents in tackling deep economic imbalances that threaten to bring growth to a sudden stop?

The question, easier to frame than to answer, is critical for the world economy. China has accounted for about a quarter of global growth in recent years, yet as far back as 2007 Premier Wen Jiabao characterised the expansion as "unsteady, unbalanced, uncoordinated and unsustainable". It still is.

The urgency of finding a solution is grabbing attention for three reasons.

First, fears persist of a crash in the property market - exhibit A for critics who say China's unprecedented investment rate of 49 percent of GDP is creating white elephants and incubating bad loans.

Second, debate has intensified in China about how "vested interests" - well-connected politicians, bureaucrats and state firms - are obstructing efforts to put the economy on a more stable footing and alienating the man in the street.

Third, the men who will chart China's course over the next decade are stepping out more onto the world stage.

Vice-President Xi Jinping, who meets U.S. President Barack Obama at the White House next Tuesday, is all but certain to take the reins of the ruling Communist Party from Hu Jintao in the fourth quarter and assume his title as state president in 2013. Wen is due to be succeeded by Vice-Premier Li Keqiang.

Eswar Prasad, a scholar at the Brookings Institution in Washington, believes the new leaders will want to correct the imbalances in the economy but will not attempt drastic changes until they have solidified their political base.

Senior bankers, for example, can be expected to put up fierce resistance to any attempt to compete away the plump margins they enjoy because of a state-mandated spread between deposit and lending rates.

"The system as it is structured works very well for those in positions of power," said Prasad, co-author of a new pamphlet on the role of the yuan in the global monetary system.

"But once they have gone through cementing their political position and once the external environment improves, I expect the new leadership will push forward much more aggressively with domestic reforms, including financial sector reforms, that are essential to rebalance the economy," Prasad said.

LOST DECADE

Just how badly Hu and Wen have dragged their feet on rebalancing is the underlying theme of a book by another prominent U.S. China-watcher, Nicholas Lardy of the Peterson Institute for International Economics in Washington.

Lardy argues that since 2004 reforms have been "anaemic", ranging from "cautious and incremental to non-existent".

In other words, for all its stellar growth, China is closing in on a lost decade of reform.

If anything, the imbalances have got worse in the past five years because Beijing has failed to overcome opposition to key reforms such as freeing up the exchange rate, decontrolling interest rates, curbing energy subsidies and requiring state-owned enterprises to pay dividends into the central budget.

The result is a significant misallocation of resources that contributes to a situation in which wages account for a low share and profits a high share of national income.

In turn, low household disposable income depresses consumption, while artificially low interest rates force households to salt away even more cash or invest in property to meet their savings targets.

And an undervalued exchange rate funnels too much of China's cheap capital into manufacturing, keeping the external surplus high.

"The longer the currency remains undervalued, the longer the allocation of investment resources will remain distorted and the greater the ultimate costs of economic rebalancing will become," Lardy writes in 'Sustaining China's Growth After The Global Financial Crisis'.

VESTED INTERESTS

Even if the new leaders are more reform-minded than their predecessors, they will need at least a year to establish their authority, Lardy believes.

"So the risk is that China will continue for another two or more years on the path of slow incremental economic reforms that are not aggressive enough to result in economic rebalancing," he argues.

Michael Pettis, a professor of finance at Peking University, believes policymakers will have to actively consider privatisation within two or three years as a means of redistributing income and wealth away from the state sector to households.

He said he had been struck by the growing number of commentators within China who see the rigidities of the state system as an obstacle to future economic and political growth.

"Their main concern seems to be over the constraints these special interests impose on further Chinese development, with the entrenched interests that have benefited over the last decade or two having become so powerful that they are making it increasingly difficult for China to adjust," Pettis wrote in his newsletter.

Will Xi and Li take on these entrenched interests or be captured by them?

"Cutting through this morass of interests and fears is not easy - but the success of the 2013-23 administration of Premier Li Keqiang will depend upon it," according to Stephen Green, Standard Chartered Bank's chief China economist.

In China's opaque politics, working out just who is advocating or resisting this or that reform is a thankless task, even for close observers such as Green.

In a report commending Lardy's book, he agreed that central government politics were to blame for the lack of reform but craved more detail about the people and mechanisms at work.

"Maybe one day, when the State Council archives are opened up, we will understand more about how the decision-making process changed from the reform-intense 1990s to the reform-timid 2000s. Was it fear, money, bureaucratic in-fighting, or just that the leadership was too occupied with fighting fires?" Green asked.