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# Growth and Reform in China

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*OVERVIEW*

**Bottom Line: Growth is slowing in China, which could constrain the pace of rebalancing and policy reform. China's long-term growth could disappoint markets.**

If you are an English football fan, you may have noticed an odd occurrence this preseason: the big teams are all touring in Asia. Booming shirt sales and rising viewership apparently are sufficient evidence that the Asian consumer is the future. Rebalancing is here.

For a more nuanced assessment of China's rebalancing and future growth prospects, the International Monetary Fund's (IMF) annual review of the Chinese economy is worthwhile reading. It raises several questions about growth and reform, the tradeoffs between the two, and the financial pressures ahead, which the news coverage failed to notice.

## *Good slowdowns and bad slowdowns*

Everyone agrees China's economy is slowing, but why it is slowing matters. The IMF's view is that the underlying momentum of the economy is strong. It forecasts growth this year of 7.75 percent, above the government's own 7.5 percent forecast, though the IMF acknowledges the risks are on the downside. Strong credit growth and signs of stabilization in investment are expected to support activity, while weak external demand, financial market uncertainties, and spillovers from the recent weakness in economic activity could weigh on growth. If the IMF is correct, there is room for a more aggressive reform agenda—even if such reform is likely to slow growth in the short term. These reforms would aim to contain financial risks while transitioning the country to a "more consumer-based, inclusive, and environmentally friendly growth path."

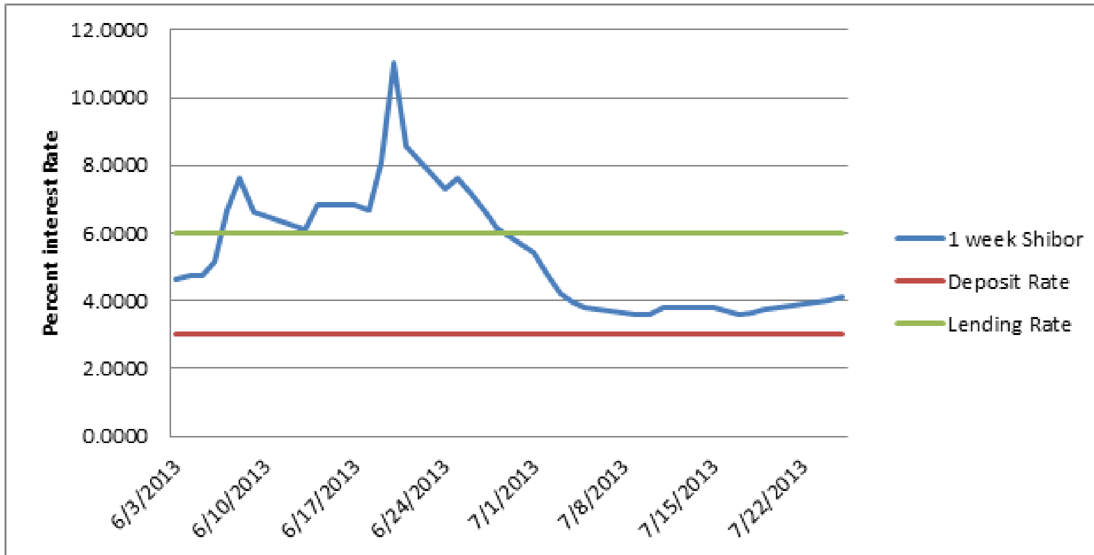
Conversely, many market participants see growth slowing more sharply, with forecasts for this year and next in the 6 percent range and downside scenarios of below 5 percent. At the same time, forecasts also broadly assume that there is a floor below which the government is not prepared to allow growth to fall. The government could try and protect this floor through easier fiscal policy, along the lines of the spending and tax incentives announced in mid-July. But the scope for such policies is limited, given the ongoing pressures to rationalize spending and financial policies. (Though, as shown in Chart 1, the recent tightening of credit conditions has proved temporary.) Consequently, weak growth dynamics could lead the government, under pressure from anti-reform critics, to slow the pace of reform.

> *Low growth should not be an excuse for delaying reform.*

I wonder if the focus on growth is warranted. Domestic commentary tends to highlight jobs, household income, and other indicators besides growth as driving policy. Further, to the extent that Beijing thinks economic reform is central to its ten-year mandate, weak growth could be a justification for faster, not slower reform, in order to bring forward the consumer benefits of a rebalanced economy. But the general concern

throughout the IMF report seems to be that low growth should not be an excuse for delaying reform.

Chart 1: Chinese Shibor, Deposit, and Lending Rates




*Source:* shibor.org

Certainly some structural reforms do boost growth. Opening markets spurs investment, and rebalancing should support the expansion of consumer-goods industries. But the IMF acknowledges that in China's case the most important reforms are likely to be a drag on growth in the near term. The IMF's policy prescription involves reining in credit growth and other measures to limit excessive risk-taking in the financial sector; allowing greater room for market forces (such as liberalizing interest rates, which will lead to higher borrowing costs for many firms); revamping local government and state-enterprise spending and investment; and eventually moving to a more market-oriented exchange rate. In the long term, these reforms promise major benefits. In the short term, however, this package of measures slows investment and growth, and brings long-simmering financial imbalances to the surface. Given such uncertainties, it is understandable if Chinese authorities are slower to act than the IMF hopes.

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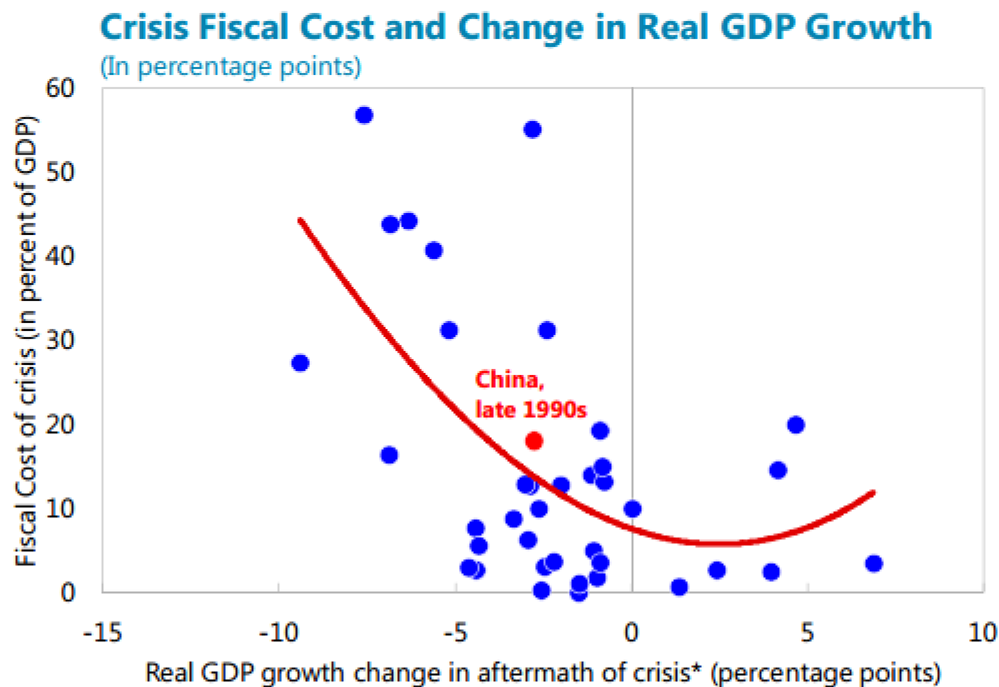
## THE TWO FINANCIAL CRISES?

Much of the focus recently has been on the prospects of a near-term financial crisis arising from years of overinvestment in low-return projects. In this regard, the Chinese government has to do two things: fix the incentives and put in place a new financial architecture, and deal with the overhang of bad debts and insolvency. Credit booms and busts often involve costly cleanups, both in terms of fiscal policy and lost growth.

Chart 2: Relationship Between Fiscal Cost of Crisis and GDP Growth




*Source:* International Monetary Fund, *People's Republic of China: 2013 Article IV Consultation.*

The IMF report touches on a number of important debates regarding the right sequencing of liberalization. One issue being hotly debated now is whether the government, in general, and the central bank, specifically, have gotten the sequencing of liberalization wrong by prioritizing capital-account liberalization. While the report endorses the idea that opening to international capital flows can be an important anchor and discipline on markets, it also acknowledges that given significant domestic distortions, opening prematurely can worsen the misallocation of capital.

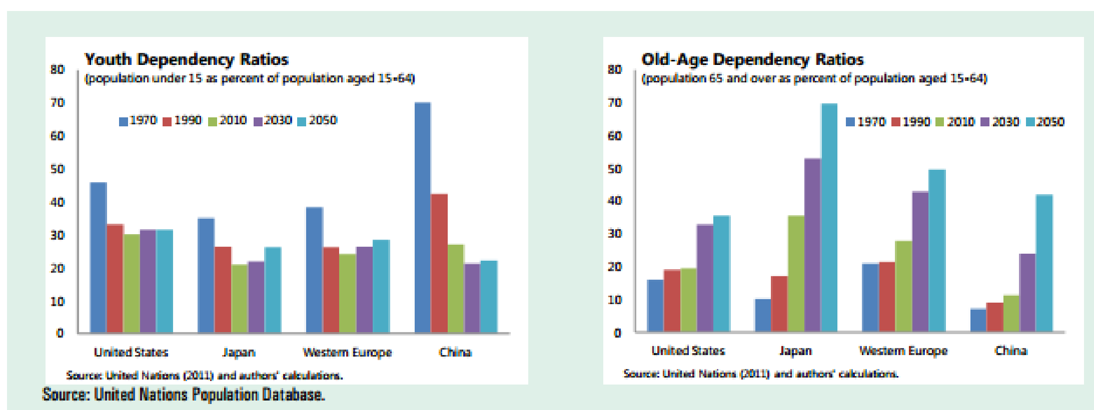
To its credit, the IMF report also focuses on the longer-term growth prospects and the need for rebalancing over time. One implication of efforts to rebalance is that the pattern of returns across the economy needs to change, creating winners and losers. The return on capital will fall, and the return on labor will rise. This will mean additional losses and additional financial stress during the transition. And this, in turn, implies the possibility of a second financial crisis along the path to rebalancing. The prospect that problems today may not manifest for many years underscores the importance of not losing focus on the longer-term challenges facing China.

### *Heading to 6 percent?*

The majority of market participants, save for those predicting a collapse in China, are expecting that Beijing will aim for 7 percent growth in the medium term. Advocates of this growth optimism will find little comfort in the IMF report.

One element of the growth outlook is adverse demographics. As shown in Chart 3, China is on the verge of a sizeable demographic shift due to a shrinking workforce and aging population. In the next twenty years, a sharp increase in retirement-age workers, coupled with a decline in young workers as a result of the one-child policy, will both reduce labor-force growth and increase the strains on the safety net. According to one report, China's elderly dependency ratio—the number of people over 64 as a share of the working population—is set to rise from around11 percent today to around 24 percent in 2030.

Chart 3: Youth and Old-Age Dependency Ratio Comparison




*Source:* "China's Demography and its Implications", by Lee, Xu and Syed (IMF Working Paper).

The IMF raises the possibility that a shrinking labor force could create a profound shift in labor-market dynamics known in the economics world as a "Lewis turning point," where surplus labor dries up and causes a surge in relative wages. While this is good for the rebalancing story (though many of these near-retirement workers will maintain high savings rates in coming years), it means a smaller contribution to overall growth from labor-force growth. In the IMF's reform scenario, investment also slows over time as the economy becomes more consumption-oriented.

In the context of declining growth in labor and capital, growth will fall sharply absent a substantial upturn in productivity. Here the IMF offers a mixed message. On the one hand, it argues that the long-run productivity effects of a strong reform effort could be profound. But the IMF also acknowledges it will take time. In sum, these risks look tilted to a period of lower growth, not unlike the long-term growth forecasts prepared by the Organization for Economic Cooperation and Development (OECD) and private-market analysts.

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China's ability to finance investment is facing increasing constraints due to shrinking resources and becoming more reliant on liquidity expansion, with associated risks of financial instability and asset bubbles. Altogether, the IMF report is most consistent with the view that Chinese growth will slow steadily in coming years, that reform will be slow, and predictions of a Chinese rise need to be tempered.

At the same time, China remains central to regional and global supply chains. Whether China takes a risk with an ambitious reform effort and rebalancing effort, or slows its transition in an effort to protect growth, will tell us a lot about the outlook for global growth.

## Looking Ahead: Kahn's take on the news on the horizon

*Fiscal Cliff Returns*
**History suggests a deal will be reached, but the showdown over government funding and the debt limit is likely to be messier than anticipated.**

*Argentina Debt Ruling*
**A court ruling, expected soon, is likely to be negative for the government.**

*Greek Financing Gap Soars*
**The IMF estimates an 11 billion euro gap, ensuring a showdown post German elections.**