Column: Is China's economy a house of cards?

BY ESWAR PRASAD *January 13, 2017 at 12:40 PM EST*

While doomsday warnings about the Chinese economy run rampant in the Western media, it is quite likely that the Chinese government will, in fact, be able to manage the economic, social and political tensions it faces, says economist Eswar Prasad. Photo by Kim Kyung-Hoon/Reuters

Editor's Note: The following is an adapted excerpt from economist Eswar Prasad's new book, "Gaining Currency: The Rise of the Renminbi."

Doomsday warnings about the Chinese economy run rampant in the Western media. That's largely because an economy not run on market principles has generated consistently high growth for such a long period of time, and that seems historically unprecedented. China simply does not conform to the conventional wisdom about the factors necessary for

sustained high growth: a well-developed financial system, the rule of law, democracy. Hence, the widely prevalent notion is that China's economy must be a house of cards, apt to collapse at the slightest ill wind. And that notion may well be comforting to those on the outside as China has become large and powerful.

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China's growth model has certainly created enormous risks, the likes of which have spelled doom for other economies in the past. Over the past decade and a half, growth has been driven in large part by massive and, to a significant degree, inefficient investment and an associated buildup of debt, most noticeably in real estate development, as China's many uninhabited apartment buildings attest. A financial system is supposed to allocate a nation's wealth to its most productive opportunities. But even the most generous interpretation of China's growth success has to acknowledge the inefficiencies and costs associated with a model that has delivered spectacularly in terms of official GDP, but has led to environmental degradation and a massive waste of resources.

The Chinese economy faces several daunting risks. The first is a surge of capital flowing out of China — basically, people taking their money out of the country — which could destabilize the financial system as well as the overall economy.

The second is a set of concerns about China's financial system as it is now, including the potential instability of the banking system (too many bad loans), wild swings in the stock market and the size of the shadow banking system (informal banking institutions that are not well regulated).

The third set of risks is related to more fundamental aspects of China's economy, political structure and policymaking. These include the possibility of a dramatic growth slowdown, political instability fed by the government's desire to further tighten its control and policy missteps.

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These risks do not fall into neat silos of course, and feedback loops among them could create even greater uncertainty. For instance, a slowdown in economic growth could lead to a surge in corporate bankruptcies and worsen the problem of nonperforming loans in the banking system, which in turn could trigger more capital outflows. China also faces a difficult and risky transition from a largely command-driven economy to a more market-oriented one. Indeed, many of the reforms and measures taken to promote the international role of the Chinese currency, the renminbi, have created their own risks for the economy.

Growth prospects

Although there are many reasons for concern about its financial stability, China long ago adopted the strategy of rapid growth, which has kept problems such as nonperforming loans at bay. That strategy seemed convincing, with caveats. Robert Fogel, a Nobel Prize-winning economist, argued that China's education system, dynamism in the rural sector, a rising services sector and a merit-oriented political system could all keep GDP growth at around 8 percent for two to three decades. In 2005, Dwight Perkins of Harvard University and Thomas Rawski of the University of Pittsburgh forecasted that China would register real GDP growth in the range of 6 to 8 percent from 2005 to 2015 and 5 to 7 percent over the following decade. They argued that China could generate sufficient productivity growth to make this a feasible outcome, but only if it undertook a number of economic reforms. In fact, China registered average annual GDP growth of 9.7 percent from 2005 to 2015, so growth in the range of 5 to 7 percent over the next decade, while still remarkable for such a large economy, would represent a significant drop.

China's slowing growth after 2013 has fueled even greater pessimism about the country's prospects. Crystallizing this view, Lant Pritchett and Lawrence Summers of Harvard make a strong case, based on empirical analysis of historical growth patterns of a large sample of countries, that no economy can escape "regression to the mean."

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if they have weak public institutions, high levels of corruption and are not democratic — all of which are true of China. They conclude: "China's experience from 1977 to 2010 already holds the distinction of being the only instance, quite possibly in the history of mankind, but certainly in the data, with a sustained episode of super-rapid growth [more than 6 percent per annum] for more than 32 years." They argue that the most likely scenario is that China's growth is likely to slow to around 4 percent.

Most growth forecasts for China tend to be conditioned on certain assumptions about policies, with more optimistic forecasts being predicated on continued reforms. Pessimists make an even stronger argument: that the rebalancing and economic transformation desired by the government will necessitate a slowdown. Michael Pettis of Peking University and I debated this through an exchange of open letters organized by Bloomberg News in March 2015. Pettis took the view that fixing the debt overhang and shifting away from credit-financed, investment-led growth would require growth to drop to 3 to 4 percent per year.

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While acknowledging the problems caused by the dubious-debt overhang, I argued that, with the right reforms, the government could maintain growth in the 6 to 7-percent-per-annum range at least over the next two to three years. My case rested on the following factors, which should enable China to grow without necessarily creating even greater debt problems.

- First, although its labor force is no longer growing, China still has a large pool of underutilized labor that could be moved to more productive employment, which underlies the government's urbanization strategy.

- Second, development of corporate bond markets and other financial markets that could allocate capital more efficiently — given that China still has investment needs — would benefit economic growth. (Despite high levels of investment, China still has a much lower capital-to-labor ratio than advanced economies — about one-sixth that of the U.S.)

- Third, an improved financial system could also do better at allocating capital and, in particular, financing growth in the services sector, which tends to generate better

employment growth than heavy manufacturing.

- Fourth, the low level of government debt owed to the public leaves China room to use fiscal policy to boost growth while promoting higher consumption; this can be achieved through suitably targeted tax cuts and more spending on the social safety net. (China has nothing comparable to the U.S. Social Security or Medicare systems.)

Policy instability: one step forward, two steps sideways

There are two major reasons to be concerned about the path that China is taking toward market-oriented reforms. The first is the unbalanced nature of the reforms. The second is the government's ambivalent approach toward economic liberalization and the operation of free markets.

Reforms on the real side of the economy have not kept pace with financial liberalization. The former includes further restructuring of state enterprises; liberalization of the services sector so new firms can enter more easily and operate with fewer restrictions; streamlining of the tax and public expenditure systems; and easing of restrictions on labor mobility within and across provinces. China's economy has also been impeded by the lack of a robust institutional framework — including transparency in the policymaking process, sound corporate governance and accounting standards, and operational independence for the central bank and regulatory authorities — that ought to supplement financial and other market-oriented reforms.

The turmoil in equity and currency markets during 2015 and 2016 appears to have shaken confidence in the economic management skills of the leadership.

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is by no means a small step for China and once taken, liberalization will be difficult to reverse. The real risk is that volatility could erode political support and economic space even for the reforms to which the technocrats are committed.

China to sustain strong growth.

An even more fundamental concern is that the government seems to be caught in a deep internal conflict between its stated objective of letting markets operate freely and its desire to maintain stability and control above all else. This conflict pervades the entire reform process. After three days of volatility following a move on Aug. 11, 2015 to free up the exchange rate and let its value be more market-determined, the government reverted to intervening in the foreign exchange market to keep the currency's value stable. Other reforms, while well-intentioned, have followed a similar one-step forward, two-steps sideways trajectory.

Such ambivalence about the functioning of markets colors the thinking of government officials. China's Fed, the People's Bank of China, held a press conference held in 2015 to soothe market concerns about its true intentions regarding the exchange rate. PBC Deputy Governor Yi Gang reiterated his faith in the market, saying, "Trust the market, respect the market, fear the market and follow the market." But, he added, the PBC would act "when the market's volatility is excessive, when the market begins behaving like a herd of sheep."

During the stock market turmoil, an official statement pointedly declared, "The stock market is required to serve the people and the party and the party alone represents the people. So if the market goes the wrong way or 'misbehaves,' it is unpatriotic and should be corrected. Anyone who drives or helps the market 'misbehave' is a traitor."

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In January 2016, George Soros, the famed financier who "broke" the Bank of England in 1992 by forcing it to devalue the British pound sterling and leave the European Exchange Rate Mechanism, declared that he was shorting the renminbi. That is, he was making a financial bet — no doubt a large one — that the renminbi would decline in value. Many other hedge funds were reportedly making similar bets; they would make a considerable amount of money if the renminbi were, in fact, to depreciate significantly.

The government's response was mainly rhetorical and orchestrated through official news media. A researcher for China's Ministry of Commerce wrote a front-page opinion piece in one of the leading newspapers under the headline, "Declaring War on China's Currency? Ha Ha." That article, along with other articles in Chinese official media, warned such speculators that waging a "war on the renminbi" or betting on the "ultimate failure" of the Chinese economy would be a bad move and threatened that "reckless speculations and vicious shorting will face higher trading costs and possibly severe legal consequences." Such strong rhetorical responses may strike a chord with Chinese citizens, but the reactions in financial markets suggest that they are hardly adequate substitutes for more substantive measures to rebuild confidence.

Western prognostications of the likelihood of such disastrous outcomes are probably overstated. It is quite likely that the government will, in fact, be able to manage the economic, social and political tensions it faces.

There are legitimate reasons to be concerned about the brittleness of China's economy. Moreover, its political structure appears to have become even more rigid under President Xi Jinping, raising the risk that political and social stability might unravel suddenly and dramatically if adverse shocks to the economy or other events were to break the Communist Party's tight control of society and the state. Indeed, one could make a plausible argument that a relatively modest trigger could set off a destabilizing chain of events. President-elect Donald Trump's threats of setting off a trade war could be one such trigger that hurts exports, creates more bad loans and causes economic disruption. On the other hand, Western prognostications of the likelihood of such disastrous outcomes are probably overstated. It is quite likely that the government will, in fact, be able to manage the economic, social and political tensions it faces — although the lack of flexibility in China's economic and institutional frameworks means that there are likely to be many missteps and stumbles along the way. No matter what happens with China's growth, one thing that is certain is that the economy is in for a wild and interesting ride in the years to come.

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