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# China: The Long and Short of Economic Reform

*Robert Kahn, Steven A. Tananbaum Senior Fellow for International Economics*

## OVERVIEW

### **Bottom Line: China looks on track to meet this year's growth target, but at the cost of delayed reform and growing imbalances. Should markets care?**

Recent news on the Chinese economy is good: second-quarter growth of 7.5 percent beat market expectations. Though government officials warned of a possible future slowdown, they remain confident that the economy will achieve its 7.5 percent growth target this year. Although gross domestic product (GDP) is far from a perfect measure of economic activity in China—in fact Beijing has been trying to downplay its importance for markets—other indicators of activity, such as manufacturing, exports, and use of raw materials, similarly show an economy that has been resilient to domestic and external shocks. Put aside questions about the accuracy of official statistics and the economy's forward momentum, easy credit conditions and the capacity of policymakers to provide additional stimulus all point to the target being met. Most private forecasters agree.

Though the markets are appropriately buoyed by the notion of a resilient Chinese economy, there are a number of reasons for concern over the next five years. In recent years, and notably since the Great Recession, extraordinarily high and rising levels of investment fueled by easy credit and a free-spending government have been the primary driver of Chinese growth. As a share of the economy, Chinese investment in 2013 rose to about 50 percent of GDP, more than double that of industrial countries and well in excess of other major emerging markets. This investment overshooting reflects a range of distortive policies at both local and central government levels, and has resulted in rising bad debts and massive excess capacity in real estate, construction, and manufacturing. These imbalances continue to build, and though the government has large financial buffers to address any future crisis, the scale of the adjustment that will ultimately be needed grows with each passing year.

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The government's latest economic reform strategy was launched with great fanfare at the third plenum of the eighteenth Central Committee of the Communist Party of China (CPC) in November 2013. Ambitious and comprehensive, Beijing's roadmap promised to reduce the role of the state in the economy and address government-fueled distortions over the longer term. Measures included efforts to reduce regulatory and administrative burdens and reform taxation, and make more land available for commercial

purposes. Demographic, migration, and land policies were at the core of the economic reform effort, as was an effort to impose hard budget constraints on state and local governments. The announcement was generally embraced at the time by both analysts and markets as having the potential for meaningful improvements in China's land, labor, and capital markets, as well as its capacity to boost sustainable long-term economic growth. It was always anticipated that reform would be gradual, but observers hoped to see material economic reforms by now.

Much has been written on the reforms that followed. The government has taken initial steps to address land reform, tightened oversight of the non-bank “shadow” financial system, begun the process of liberalizing conventional banking markets, and improved the rule of law. Separately, parallel discussions with the United States through the Strategic and Economic Dialogue (the most recent of those discussions took place just last week) have signaled a commitment to advance bilateral investment and trade cooperation, and China’s bilateral trade and investment negotiations with a range of countries have generally liberalized market access. But, overall, the first half of 2014 has seen the promise of reform more than its delivery. Indeed, since the plenum, for all the changes that have taken place, growth still remains reliant on the old model of easy credit and fiscal stimulus. From this perspective, the “rebalancing” of the Chinese economy from an export-driven, manufacturing- and investment-focused model to a more consumption-based and domestic demand-driven model, where markets are allowed greater freedom to allocate resources, remains a long-term goal.

The slow pace of reform, and the sense that the government has stepped back from earlier reform efforts aimed at cracking down on excessive financial leverage in the shadow financial sector and reining in undisciplined lending policies, likely reflect a broad range of political and economic concerns, including concerns about the pace of economic growth, social stability, and a slumping real estate market burdened by massive excess capacity. After an initial tightening, overall macroeconomic policy appears to have been loosened in support of growth and to avoid financial distress. In June, for instance, both the central bank and the banking regulator relaxed lending rules, especially for small and medium-sized enterprises and agriculture. Though described as selective, the overall effect of the change was significant, according to Xinxin Li of the Observatory Group. And, though talk is hawkish, moral suasion appears to be encouraging lending and perpetuation of the same distortive practices that lead to the financial problems in the first place. It likely will require a substantial improvement in construction and real estate markets before the authorities would consider tightening again.

Herein lies the conundrum. Although some structural reform can be growth-supporting in the short term, most of it is not. Most of the reform agenda will be disruptive in the short term, as it means recognizing losses, imposing hard budget constraints, and shifting resources away from currently profitable uses to more efficient purposes. Such shifts are easier to handle when growth is strong, but in the current environment, where the government is consolidating political power and slowing growth raises concerns about social stability, the political pressure to go slow on reform is profound. It is not surprising, therefore, that the government has slowed the pace of reform. In this environment, imbalances—including high debt levels, particularly among state enterprises and local governments—are bound to keep rising. Specific reforms will probably take months if not years to be rolled out.

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The International Monetary Fund (IMF) has argued in the past that strong growth provides the space for accelerated reform, but of course the opposite may be true: political demands for a particular growth target can limit the scope of reforms that slow growth in the short term. But delaying reform may make the eventual adjustment much more difficult. Even the IMF, in its most recent statement on China, highlighted that vulnerabilities and challenges present a risk of a sharp growth slowdown over the medium term, if not properly addressed.

## THE REFORM-GROWTH DILEMMA: A BROADER VIEW

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The dilemma between growth and reform has recently been highlighted by, among others, economist Michael Pettis. He criticizes the idea that there is an accepted growth model, or “Beijing consensus,” that can neatly explain China’s growth performance in recent years. Pettis instead points to a tension between the government’s desire to provide a growth-supportive environment today through improved “social capital” (the legal framework, the financial system, the nature of corporate governance, taxes, political practices and traditions, and other incentives to create value today) and the desire to create incentives for individuals and businesses to use resources

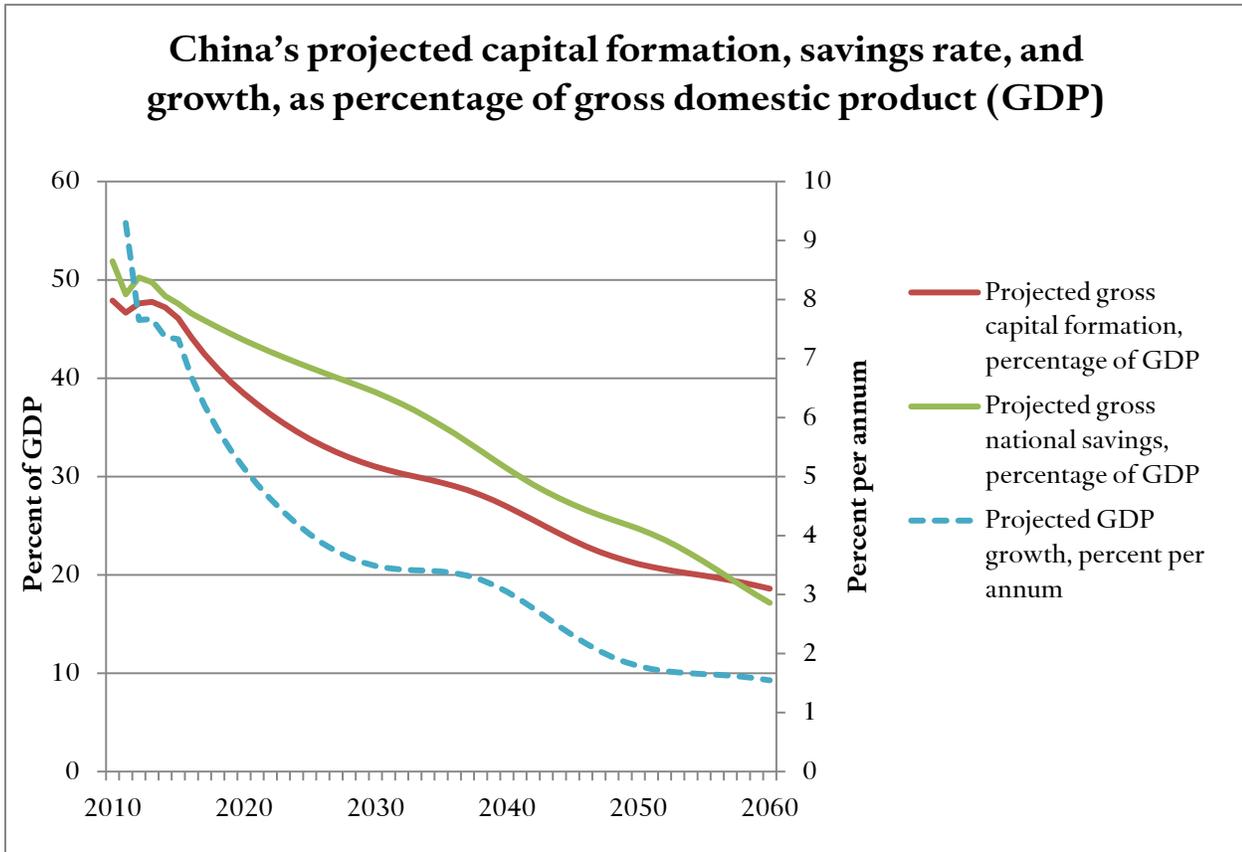
efficiently and productively over the longer term. Rent-seeking behavior reinforces and creates inertial pressures for the former and against the later.

Long-term reforms are difficult to implement, Pettis points out, because they often require a dismantling of the distortions and frictions that create rent for the elite, thus undermining the ability of the elite to capture a disproportionate share of the benefits of growth. Liberalizing reforms are likely to be resisted by elites that have benefitted from their absence, unless supported by sufficient wealth or productivity to raise all boats. In Pettis’s view, what China needs now is another set of liberalizing reforms that create incentives for Chinese individuals and businesses to change their behaviors in ways that generate long-term productivity and growth. These must include changing the legal structure, predictably enforcing business law, changing the way capital is priced and allocated, and other factors that determine incentives. But, in Pettis’s view, these reforms will likely be resisted by elites until debt levels are high enough to create a greater sense of urgency.

## LESS TIME THAN WE THINK TO TAKE ACTION

At the end of the day, the incentives to push pack the inevitable and necessary rebalancing of the Chinese economy should raise concerns that the adjustment to come will be more difficult and disruptive in terms of financial distress and effects on labor markets in China. Market forecasts are more sanguine, with most analysts seeing a steady reduction in trend growth to somewhere in the range of 5 to 6 percent. (Figure 1 shows the OECD’s long-term forecast for China, which illustrates the optimistic, soft-landing scenario.)

FIGURE 1: SOFTLANDING FOR THE CHINESE ECONOMY?



Source: Organization for Economic Cooperation and Development (OECD) Statistical Database

Such a soft landing provides a politically acceptable pace of job growth and allows reform to proceed in line with political realities. I am not so sure. The rapid rate of debt accumulation cannot be sustained for long, forcing the government to tap large (but politically contentious) reserve funds and fiscal buffers. Predicting the exact timing of crises is difficult; when crises happen, they happen in a day. The above analysis suggests that the political incentives are strongly tilted toward delaying reform until a crisis presents itself and that the rapid growth of imbalances will threaten the growth model faster than the authorities expect. All of this indicates that the markets' comforting assumption of a soft landing may be unfounded.

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

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### *Summer volatility*

In the United States, Federal Reserve Chair Janet Yellen has sought to calm markets, but some market participants are moving forward expectations of the first Fed rate hike in 2015, which could contribute to market volatility in thin summer markets.

### *Courtroom drama*

Argentina faces an end-month deadline for reaching a deal with holdout creditors following an adverse U.S. court ruling. Markets are holding steady on hopes of a deal, but a default looks increasingly likely.

### *Assistance for Ukraine*

The IMF looks set to approve another disbursement to Ukraine, but sharply rising financing needs will force a fundamental reassessment of the program in coming months.