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Modernizing China's growth paradigm

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Modernizing China's Growth Paradigm

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Modernizing China's Growth Paradigm

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ABSTRACT

Modernizing China's Growth Paradigm*

China has achieved tremendous economic progress in the last three decades, but there is much work to be done to make the economy resilient to large shocks, ensure the sustainability of its growth, and translate this growth into corresponding improvements in the economic welfare of its citizens. We discuss the complex challenges that Chinese policymakers face in striking the right balance in terms of speed and coordination of reforms. We argue that China's current stage of development, along with its rising market orientation and increasing integration with the world economy, may make the incremental and piecemeal approaches to reforms increasingly untenable and, in some cases, could even generate risks of their own. The present favorable domestic and external circumstances provide an excellent window of opportunity for bolder reforms and for tackling some deep-rooted problems without causing much economic disruption.

JEL Classification: P2, F3

Keywords: policy reforms, market-oriented economy, trade and financial integration, policy complementarities

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I. INTRODUCTION

China's remarkable growth performance over the last three decades is widely attributed to its unique development model. A principal element of this model has been an incremental and experimental approach to reforms, with the reform process being guided by some general principles rather than a detailed blueprint. This has been complemented by a dual-track approach, which involves maintaining a planned track while encouraging the development of a market track in different areas of the economy, thereby allowing for efficiency gains at the margin without creating losers in absolute terms (see Lau, Qian, and Roland, 2001). This development paradigm—with its virtues of flexibility, adaptability, and pragmatism in the face of various constraints to reform—has served China well, generating high and relatively stable growth over an extended period.

Our main contention in this paper is that this paradigm, for all its virtues and success so far, may be in need of an overhaul. The dramatic shifts in the structure of China's economy towards a complex market-oriented one and its increasing integration with the world economy are likely to expose shortcomings in this approach. Indeed, at its present stage of development, certain aspects of the incremental approach could pose significant risks to the Chinese economy. Notwithstanding the constraints that still exist due to deficiencies in policy and institutional frameworks, and the overhang of various legacy problems, there may now be few alternatives to bolder and more concerted reforms in order to maintain high growth and economic stability. This is not to say that a different approach is not without its own risks, but we view the traditional approach as increasingly untenable and likely to generate greater risks of its own. Furthermore, the policy distortions required to maintain the old approach could have adverse welfare consequences, though these may temporarily be masked by high growth.

II. SOME CONTEXT

Of the multiple transitions that China's economy has been undergoing—from rural to urban, from low income to middle income etc.—two are particularly relevant for our discussion. First, China is rapidly moving from a command economy to a private-sector-led one, with the private sector's share in GDP now estimated to be one-half to two-thirds. This process was set in motion with the market-oriented reforms instituted in the late 1970s. Unlike in the transition economies of Eastern Europe, however, this has not been precipitated by any drastic changes to the political system and has, instead, been fostered by the deliberate goal of moving to a "socialist market economy." Second, from being a relatively closed economy before the 1980s (in recent history), China has become very open to trade and more integrated into global financial markets.

Although these transitions have been actively encouraged by Chinese policymakers, each has brought with it some challenges. The move to a market-oriented economy has created employment and income uncertainty, and the restructuring of state enterprises has contributed to rising unemployment. Rising average incomes mask increasing disparities in income, especially between the rural and urban areas, which are generating political and social tensions. Increasing integration with the global economy has made China more dependent on external demand and more vulnerable to external shocks.

Nevertheless, China's economy has continued to grow at an impressive clip over the last two decades. More importantly, unlike many other emerging market economies, China has not experienced any crises or other sharp disruptions to growth during this period. Let us

take a closer look at what is behind this growth performance and how the different economic pressures have been managed so far.[2]

III. China's Path to High Growth

We begin by reviewing some of the key macroeconomic policies that may be relevant to understanding the contours of China's growth. The Chinese exchange rate policy has of course received the most attention recently. The renminbi's value against the U.S. dollar had been maintained at a fixed level since 1995, even during the Asian financial crisis when there were pressures for the renminbi to depreciate, indicating the importance that policymakers attach to this nominal anchor. On July 21, 2005, the renminbi was revalued against the U.S. dollar by 2.1 percent and, in principle, its value is now set with reference to a basket of currencies. In practice, however, the renminbi still appears to be pegged to the dollar, with little de facto flexibility.

Whether the maintenance of a fixed exchange rate is part of a mercantilist strategy to promote export-led growth has been the subject of intense debate. In any case, resisting underlying pressures for real exchange rate appreciation—coming from China's high productivity growth in its traded goods sector relative to that of its trading partners—has fed speculative inflows in anticipation of eventual renminbi appreciation. This in turn has led to a surge in the accumulation of international reserves since 2001.

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[2] On December 20, 2005, the Chinese authorities announced that the official GDP level for 2004 would be revised up by 16.8 percent as a result of a nationwide economic census conducted in 2004 that has yielded better estimates of service sector output. GDP levels have subsequently been revised back to 1993.

The management of capital flows has been another crucial component of macroeconomic policy. Extensive capital controls, along with tax benefits and other incentives, have been used to promote inward foreign direct investment (FDI) while other forms of inflows, especially portfolio debt, have been discouraged (Prasad and Wei, 2006). Capital controls have also played an important role in protecting the banking system from external competition by restricting the entry of foreign banks and by making it harder to take capital out of the country. The limited development of debt and equity markets means that the state-owned banking system is effectively the only official game in town, for both borrowers and savers.

China's approach to exchange rate policy and capital account liberalization may be indicative of a desire to maintain stability on the domestic and external fronts while opening up to trade and financial flows. And the large stock of reserves resulting from these policies may serve as insurance against vulnerabilities arising from a weak banking system. But there comes a point when the policy distortions needed to maintain this approach could generate imbalances, impose potentially large welfare costs, and themselves become a source of instability.

The uncertainties engendered by the transition to a market economy, the limited availability of instruments to borrow against future income to finance purchases (major durable goods, housing etc.), and the lack of international portfolio diversification opportunities have all contributed to high household savings (Chamon and Prasad, 2006). Financial system repression has meant that there are few alternatives to funneling these savings into deposits in the state-owned banking system. Households willingly hold bank deposits despite the weaknesses of the banking system because of implicit deposit insurance

provided by the government. This provides abundant liquidity for banks to expand credit which, because of the distorted incentives faced by lenders, largely finances investment by state enterprises. State enterprises that do make profits are not required to pay dividends, encouraging them to plow retained earnings back into investment. Thus, the investment boom in recent years has been fueled by cheap credit and overoptimistic expectations of future demand growth in sectors that are doing well at present. Inflows of speculative capital that are testing the exchange rate peg have added to the liquidity in the banking system and further complicated the control of credit growth.

Certain policy choices intended to maintain macroeconomic control have thus influenced the composition of domestic demand, making investment rather than private consumption the main source of demand growth. In the last few years, investment has accounted for more than half of nominal GDP growth and may now amount to nearly 40 percent of GDP. While factor accumulation is a time-honored path to higher growth for many developing countries, whether such a high level of saving intermediated mainly through an inefficient banking system can produce long-lasting welfare gains is dubious. The costs of these inefficiencies are probably ultimately borne by depositors, in terms of low real returns on their savings, or through the financing of fiscal transfers to firms and financial institutions. The investment boom has also raised fears of a resurgence of nonperforming loans if the economy, or even the few sectors that have accounted for much of the recent rise in investment growth, should falter (Goldstein and Lardy, 2004).

Financial sector reform and development are clearly crucial priorities for growth and stability. But they can not be seen in isolation from other macroeconomic policies, including exchange rate flexibility. Indeed, the discussion above suggests that arguments about whether

and by how much the renminbi is undervalued may not be the right way to frame the main issue about China's exchange rate regime. What is essential is that China introduce greater flexibility in its exchange rate, which would give it a more independent monetary policy and also allow the exchange rate to play a role in correcting external imbalances. It would also remove one of the hindrances to banking sector reform because a fixed exchange rate reduces the central bank's ability to use market instruments such as interest rates to guide credit growth and instead perpetuates a reliance on administrative measures, vitiating efforts to make the banking system more commercially oriented. In addition, by making capital account liberalization (a stated medium-term objective of the government) less risky and by creating incentives to develop financial products to hedge foreign exchange risk, a flexible exchange rate could help stimulate broader financial market development as well.

Such policy shifts would allow for growth to be rebalanced towards self-sustaining domestic demand and tilt domestic demand itself towards private consumption and away from investment. After all, it is ultimately consumption, rather than investment or even GDP, that is a better measure of economic welfare over the long term.

IV. Approaches to Reform

In discussing policy choices, it is important to recognize that Chinese policymakers are operating in a difficult environment with numerous institutional deficiencies, including a weak legal framework, poor governance, and economic data of dubious quality. Furthermore, local governments at the provincial and lower levels have a significant degree of autonomy in economic matters. Given the leadership's objective of maintaining political and social cohesion and stability, these make the process of undertaking policy reforms a high-wire balancing act.

Given these constraints, China has typically taken the approach of instituting reforms in an incremental manner. This has meant either taking small steps or confining reform experiments to specific provinces. An obvious example is the very modest first step recently taken towards the longer-term goal of exchange rate flexibility. Similarly, tax reforms are generally first instituted in one or two provinces; the experience is then carefully studied before rolling out a suitably revised nationwide version of the reform. Such experiences can be used to fine-tune reform strategies, while compensating losers from reforms through other redistributive means.

The learning-by-doing approach to reform has a number of advantages. In a second-best world with multiple distortions, where the effects of individual policy reforms can be unpredictable, it reduces the costs of policy errors and uncertain outcomes in the reform process. It also gives policymakers a clearer sense of the political and social pressures that could arise in opposition to such reforms, allowing those pressures to be tackled more effectively when the reforms are instituted at a broader level. For instance, the authorities have been willing to withstand external political pressures while they assess the domestic impacts of the first step towards exchange rate flexibility and use this assessment to overcome domestic concerns about the possible adverse employment and growth effects of this move.

There are three potential limitations to the incremental approach, however, as China's economy becomes more developed and complex. First, some critical reforms, especially those related to broad macroeconomic issues such as exchange rate flexibility or capital account liberalization, can not be isolated to specific geographical areas or sections of the economy. Second, as the economy becomes more sophisticated, factors become more mobile

and more able to take advantage of distortions. This implies that doing nothing, or very little, carries with it the risk of being overwhelmed by these mobile factors. For instance, additional small moves towards exchange rate flexibility could increase speculative inflows in anticipation of further revaluations, thereby further complicating the conduct of domestic monetary policy.

Third, and perhaps most importantly, China has reached a stage of development at which many key reforms are unavoidably interconnected. Restructuring of the banking sector would proceed much better if state enterprises were reformed and implicit pressures for state banks to continue providing cheap capital to state enterprises were eliminated. But reform of the state enterprises would mean more unemployment which, in the absence of progress towards constructing a more robust social safety net, could create social tensions.[3] Similarly, as noted earlier, exchange rate flexibility is important for financial sector reforms and overall macroeconomic management.

In short, it may become increasingly difficult to undertake individual reforms in isolation, and the traditional incremental approach to reform may not work quite as well given where China now stands in its development process, with a large and vibrant private sector and strong linkages to the world economy. Experimentation may also be more difficult, as both national and local reforms will have to be undertaken simultaneously and with a magnitude that prevents the forces of arbitrage from taking over and negating the effects of the reforms.

[3] Lin, Fang, and Li (1998) discuss how various state-imposed policy burdens, in turn, stymie state enterprise reform.

V. TIMING AND PRIORITIES

While the Chinese economy may remain resilient to most shocks, the move towards a market economy has set in motion forces that will be increasingly difficult to control. An incremental approach can worsen the risks that are invariably associated with the transition to a market-oriented system. For instance, in the absence of root and branch reform of the financial sector, freeing up the banking system while there continues to be an implicit assumption of government insurance of bank deposits could generate moral hazard problems that may lead to a resurgence of nonperforming loans. At the same time, a gradualist approach can potentially perpetuate existing inefficiencies, resulting in legacy problems that could take enormous resources to rectify.

There is also the more practical consideration that it may become increasingly difficult to keep a tight lid on certain parts of the economy. A prime example is that capital controls are becoming more porous as domestic and international investors find ways to evade them, which has become progressively easier through channels such as expanding trade. Maintaining a fixed exchange rate while the capital account becomes more open can be a dangerous combination (Eichengreen, 2004; Prasad, Rumbaugh, and Wang, 2005). But exchange rate flexibility without a well-defined alternative nominal anchor poses risks of instability as well.

Theory and experience from around the world suggest that anchoring monetary policy with an explicit long-run low inflation objective would be the most reliable way for the People's Bank of China (PBC) to tie down inflation expectations, and thereby to stabilize domestic inflation and employment against macroeconomic shocks (Goodfriend and Prasad, 2006). A flexible exchange rate and instrument independence for the PBC are essential for this monetary framework to function well, to contribute to macroeconomic and financial

stability, and in turn to provide a favorable environment for high output and employment growth. If supported by the political leadership, the announcement of a firm intention to put in place a low inflation objective could help galvanize a number of reforms required for this framework that would have significant benefits in and of themselves.

Financial sector reform is indeed a core priority, as the authorities well recognize. Such reform will necessitate making the state banks more efficient financial intermediaries that are driven by commercial considerations. But it will also involve developing broader financial markets that can give firms alternative sources of funds and provide households with alternative investment opportunities. Competition from other segments of the financial sector would help spur the banking system's reform efforts.

The financial sector is also one of the key sectors in which a difficult balance will need to be struck between picking up the pace of reforms and not getting too far ahead of institutional constraints. Continued interest rate liberalization, for instance, is important for the banking system to function efficiently. But an all-out sprint towards full liberalization without adequate regulatory and supervisory mechanisms in place could create perverse incentives that could decrease financial system stability.

Fiscal policy has a role to play in the reform agenda as well, especially in terms of strengthening the social safety net to reduce the political and social costs of market-oriented reforms. Reorienting some government spending towards essential social expenditures, including health care and education, and reducing uncertainty on these fronts may help to give households the confidence to increase consumption levels (Blanchard and Giavazzi, 2005). The low levels of explicit government deficits and public debt provide some room for maneuver in these areas. Here again, it will be important to make sure that other reforms,

including to the banking sector, are undertaken apace to avoid the further buildup of contingent liabilities that could put a bind on fiscal policy.

The political economy aspects of reform also pose some difficulties. Constituencies that favor the current system because it generates rents for them can be effective at blocking reforms. The current period of high growth and low inflation provides an opportunity to counter these forces by making available resources that could help broaden the dual-track approach to reform, allowing more of the economy to be opened up to market forces while weaning the rest of the economy from implicit or explicit state support. This could go in tandem with further opening of the economy to external influences, which could create coalitions in support of reform.

VI. Final Remarks

One cannot but admire the economic progress that China has achieved in the last three decades. But there is much work to be done to make the economy resilient to large shocks, to ensure the sustainability of its growth, and to translate this growth into corresponding improvements in the economic welfare of its citizens. One important lesson from the experiences of other countries is that periods of high growth can sometimes mask deep underlying problems. At the same time, favorable domestic and external circumstances may provide an excellent—but possibly narrow—window of opportunity for tackling deep-rooted problems without much economic disruption. For one, sustained capital inflows and appreciation pressures on the exchange rate may make it easier to manage the move towards greater exchange rate flexibility. Similarly, the current state of low inflation provides a good environment to consider setting a long-run low inflation objective as a nominal anchor. And

the favorable fiscal position provides some room for rethinking social expenditure priorities, particularly in education and health care.

We do not want to underplay the difficult balancing act that Chinese policymakers face. In fact, China may need a twin Goldilocks-ian outcome—for each set of reforms to proceed at a reasonably rapid pace and, at the same time, for a broad set of reforms to move along in tandem. Chinese policymakers have managed such balancing acts well in the past. But, going forward, it may be harder for them to feel their way through controlled policy experiments. Broad and significant policy movement will be more of a leap into the unknown, and will carry attendant risks, but the risks of not moving at a sufficient pace and along a broad front are even greater. Indeed, perhaps the best way to mitigate the unknowable risks at the current juncture will be, as part of the broad reform agenda, to develop flexible and potent policy instruments as well as streamlined economic decision-making structures that allow for nimble responses to unanticipated developments. In sum, it may be time to move beyond feeling the stones and, instead, take some bigger steps on the road to reform.

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