Squaring the Circle: How the Reforms Can Work

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SUMMARY The real challenge for sustaining rapid growth in China is twofold: increasing productivity through structural reforms, while boosting domestic demand through higher government expenditure.

Over the past five years China has experienced an unprecedented credit bubble. The nation's debt-to-GDP ratio has risen by more than double the amount that South Korea and the US saw before their respective financial crises in 1997 and 2008. At the same time, China's economic growth rate has slowed from its historic average of 10% to around 7%, and further decline seems likely. Pessimists see a financial crisis or economic collapse in the making, and argue that a sharp credit tightening is the main policy imperative.

These concerns are overstated. The real challenge for sustaining rapid growth is twofold: increasing productivity through structural reforms, while boosting domestic demand through higher government expenditure. Reforms can be built around three themes in the government's Third Plenum Decision of November 2013: more efficient urbanization, a bigger role for the private sector, and a rationalized pattern of regional investment. The crucial supporting instrument is a fiscal overhaul—already underway—which will increase government demand.

Debt: serious but manageable

China's debt problems stem from its 2008-09 mega-stimulus which took the form of an explosion in bank lending. By 2010 the worst seemed to be over and the government scaled back bank lending by a third, but shadow banking, subject to fewer controls, quickly emerged to fill the gap. Altogether, the credit boom pushed China's gross debt above 230% of GDP.

This high credit ratio is concerning, but it is not a signal of imminent financial crisis. With a strong central government balance sheet and high household net worth, China has few of the common risk factors associated with a crisis. Its current account surplus averages 2-3% of GDP, external debt is just 10%, and foreign exchange reserves are 40%, so external vulnerability is low. Domestically, total credit is fully funded by bank deposits (financial crisis typically hits when the credit/deposit ratio rises well above 125%) and relies little on flighty wholesale funding. China simply does not fit the well-established pattern of other crisis countries.

There are indeed risks associated with the debt accumulated by opaque local government financing vehicles (LGFVs) and their links to speculative land development. But these risks are modest: a December 2013 report by the National Audit Office estimated China's consolidated central and local government debt at 60% of GDP, much lower than most developed countries and roughly in line with India and Brazil.

A bigger concern is corporate debt, the main driver of the credit surge. Yet even here the risks are not of crisis dimensions. The IMF estimates China's non-financial corporate debt at only just above the Asian median of 96% of GDP. There is little evidence rising debt has caused financial stress among firms generally, although pockets of vulnerability exist in sectors such as property development, steel, cement and shipbuilding.

Ultimately, of course, debt must be got under control. The best way to do this is to focus on productivity-enhancing reforms and new sources of demand that can stabilize economic growth at about its current level, thereby making the necessary deleveraging less painful.

Gain without (too much) pain

Conventional wisdom holds that China now has basically two options. It can implement structural reforms which will cause a sharp growth slowdown in the short term, but will enable sustained growth at a somewhat lower level (say around 6%) for another decade. Or it can buy a little more short-term growth by putting off reforms, at the cost of driving growth down below 5% in a few years' time. (See chart below from IMF).

The IMF believes that rapid reform causes a more negative near-term growth effect because it assumes that a faster fiscal adjustment and higher interest rates will lead to slower credit growth and a sharper decline in investment. This scenario also minimizes the potential of structural reforms to increase productivity.

This may be too pessimistic. A short-term slowdown in the growth rate is indeed likely, not because of the cost of structural reform, but because of the need to slow the rate of construction activity so that the excess housing stock can be absorbed. This adjustment will probably require GDP growth to slow to 6-6.5% for two years. But after that, there need not be any contradiction between reform and growth. China can sustain an annual growth rate of 7% in the second half of this decade if it puts into effect three major reform initiatives flagged at last year's Third Plenum: more efficient urbanization, realigned roles for the private and state sectors, and a better targeted regional development strategy. These reforms should be supported by a revamp of the fiscal system to increase government consumption demand. Progress on the productivity agenda is mixed at best, but fiscal reforms are moving ahead.

Let people go where they want

One key to higher productivity growth lies in more effective urbanization. The urban-rural productivity gap manifests itself in the 3:1 ratio of urban to rural per capita income, the largest disparity in the world. The transfer of workers from country to city accounted for as much as a third of the 10% average GDP growth rate over the past three decades. Further productivity gains can be harvested allowing the development of denser, larger cities. And giving rural migrants full residence rights and access to social services would encourage migrants to save less and consume more. The resulting consumption boost could raise the national consumption/ GDP ratio by 2-3 percentage points, making it easier to secure the demand needed for more sustainable growth.

Despite rapid urbanization, China's urban population share of 53% is below what one would expect at its level of income, because of its stringent residence permit (*hukou*) system. One consequence is that China's service sector has been repressed compared to its Asian peers. Shifting to a more service-oriented economy would ease pressure to stimulate growth for the sake of employment, since services generate a third more jobs per dollar of output than manufacturing. If these were increasingly high-value services, growth in productivity and wages would not be compromised.

The government released a framework for "new-style urbanization" in March 2014, with a target of extending full urban residence rights to an additional 100mn migrants by 2020. The first concrete step, in June, was a relaxation of hukou restrictions in towns and small cities. But the urbanization initiative is flawed in ways which could curb desired productivity gains. First, the hukou reform eases migration to small cities but maintains tight controls on migration to big cities. This is exactly the opposite of what is needed,because bigger cities are more productive users of capital and generate more and better jobs.

Second, the new urbanization plans do little to encourage denser development within cities. Research clearly shows that incomes and consumption rise more quickly in densely populated areas.

Urbanization-related productivity increases have declined in recent years due to waste from the excessive conversion of rural land for urban use, which has led to the property bubbles and “ghost cities,” rather than productive activity.

Make more space for private firms

A second source of productivity growth lies in increasing the role of the private sector and streamlining the state-owned enterprises (SOEs). Since the global crisis of 2008, the average rate of return for industrial SOEs has stagnated while that of private firms has continued to grow. Private firms’ return on assets is now about double that of their SOE competitors.

Many analysts infer that the underlying problem is weak SOE profitability. But this is not quite right. We can express the return on assets as the product of two ratios: the profit margin (profits/revenues) and asset turnover (revenues/assets). When we decompose the ROA of state and private firms this way, it immediately becomes apparent that the profit margins of state and private firms are almost identical. The big difference is in asset turnover, where private firms are far more productive. In other words, private firms generate much more revenue from a given asset base, even though the profit they earn on each dollar of revenue is about the same as for state firms. The source of this discrepancy was the 2009 stimulus, which was channeled mainly through SOEs and encouraged them to create redundant capacity.

The government’s proposed solution to the SOE underperformance problem is “mixed ownership,” under which SOEs will sell minority equity stakes to private shareholders. Under pressure from these new, more market-oriented shareholders, it is hoped, the SOEs will up their game. This approach is unlikely to work, since it alters neither the SOEs’ ultimate control structures nor the incentives of the managers. A better solution would force state firms to retreat from certain sectors, and make clear the right of private shareholders to influence the selection of SOE managers. Unfortunately, none of this is likely so long as the state insists on retaining majority ownership stakes and appointing top managers. State ownership remains especially strong in high-value services such as finance, education, health and telecommunications, which offer the greatest potential gains in productivity and employment. Allowing domestic and foreign private interests to play a much bigger role in these areas must be part of the productivity-boosting agenda.

Rebalancing the regions

Finally, productivity could be enhanced by reconsidering state-directed regional investment plans. Since the late 1990s China has launched a series of regional development initiatives (“Develop the West,” “Center Rising,” “Revive the Northeast”) with the aim of reducing inequality between the prosperous coastal provinces and the interior. The share of the state budget allocated for investment for the coastal provinces fell from 26% to 21% from 2000 to 2010, while the western provinces’ share rose from 26% to 41%.

These programs promoted both sensible and wasteful infrastructure projects, and although they did succeed in moderating regional inequality, they are now increasingly used by provincial governments to justify low-return investments—a tendency reinforced by the 2009 stimulus. Over the past 15 years, the incremental capital output ratio (ICOR) for western provinces has averaged around 4.5—that is, it takes US$4.50 of capital spending to generate one dollar of extra output. For coastal provinces the average ICOR has been a much healthier 3. The nation’s productivity would be enhanced by facilitating the migration of both capital and people to the more productive regions, and by shifting the composition of investment in favor of social and environmental services that reflect the real preferences of households.

Fiscal not financial reforms are the key

The productivity-boosting *potential* of reforms in urbanization, enterpris¬es and regional development is clear, but the government’s urbanization and enterprise reform blueprints are flawed, and there is as yet no evidence of change in the regional development strategy. The main cause for optimism lies in the June 30 decision by the Politburo to authorize comprehensive reform of the fiscal system by 2016. Fiscal reform is crucial for two reasons. First, fiscal arrangements determine the relationships between central and local governments that lie at the heart of so many of China's economic problems. Second, a more effective fiscal system would enable direct budgetary expenditure, rather than credit-induced invest¬ment, to stimulate aggregate demand.

The basic problem with China's fiscal system is that it confines local governments' share of revenues to around 45%, even as their mandated share of expenditures has risen from 65% to 85% over the last 15 years. As their fiscal imbalances grew, local governments were forced to find off-budget revenues—typically from land sales and shadow banking—to fund their needs.

The fiscal reform package aims to reduce these local budget shortfalls by expanding the value-added tax to include services and instituting new resource and property taxes. It also calls for the restructuring of local government debts (often into long-term bonds) and for the elimination of loans backed by land. Multi-year budgeting may reduce incentives for off-budget revenue collection to meet short-term fiscal targets, local officials will be assessed in part on how prudently they manage their debts.

A restructured fiscal system will relieve the pressure on commercial and shadow banks to fund infrastructure projects, but more importantly it will enable a more balanced structure of aggregate demand. Most analyses of China's unbalanced growth model focus on the high share of investment in GDP and the low share of consumption. The inference is that sustainable growth requires curbing investment and stimulating more personal consumption. But personal consumption has grown at an average real rate of 8-9% over the past decade or more and is unlikely to accelerate. Sustainable fast growth therefore cannot rely on stepping up the pace of household consumption. Instead, a sustainable high-growth agenda should aim to bolster public-sector demand by reducing reliance on debt-fueled SOE investment and increasing the role of state budgetary expenditure.

This may sound heretical to those who believe that private-sector dynamism cures all ills. But China's state is unusually parsimonious in its social expenditures and has plenty of room to grow. Consolidated government expenditures are around 28% percent of GDP, compared to an average of 35% for other high-middle income countries, and 45-50% for many OECD economies. And the proportion of government spending that goes to social services and transfers is relatively low. As a share of GDP, China's social spending and transfers are roughly half the level of comparable middle-income economies. With a stronger revenue base and a clearer mandate to fund social services, government consumption could increase from its current 13% percent of GDP to around 18% by the end of the decade. Combined with a modest increase in the personal consumption share, this would offset a significant decline in investment share and provide the demand needed for GDP growth of at least 7%.

Commentary outside China has largely ignored the ambitious fiscal agenda, while lavishing intense scrutiny on financial-sector issues and obsessing over small changes in interest rates and the exchange rate. Many see fully liberalizing interest rates within two years as a litmus test of the country's commitment to reform. But given the current nature of China's economic system, financial liberalization will be less effective than fiscal reforms in altering behavior of economic agents.

The strong commitment to fiscal overhaul is a critical and generally overlooked part of Xi Jinping's policy agenda. If paired with better-conceived strategies on urbanization, enterprise reform and regional development, China could sustain a growth rate of 7% or more for several more years based on a more balanced structure of household spending, public-sector consumption, and better targeted investment. Stronger growth would enable the debt problem to be brought under control, without the need for draconian credit tightening. Success is far from assured: the productivity reforms are flawed and can still be blocked by change-resistant bureaucrats and SOEs. Much more work on both the design and implementation of economic reforms is needed before we can be confident China has found the path to sustainable high-speed growth.

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