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Major Challenges to China's Economic Stability
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Major challenges to China's economic stability center on the authorities' ability to continue to deliver rapid economic growth and development. Real GDP growth on average of 8 percent a year is viewed by the authorities as essential to broaden opportunities to participate in the formal economy, particularly for rural resident, and to generate sufficient employment for new entrants into the work force.

China has made remarkable progress especially over the past 15 years, rising to become the second largest economy in the work and the world's leading exporting nation. On the basis of these enviable achievements, China would appear to be a daunting economic colossus. However, there are substantial reasons to doubt that that China will be able to maintain rapid growth, unless the country makes major changes in its economic policies and further substantial reforms in its economy.

Why Economic Growth in China May Falter

Chinese Premier Wen Jiabao in March 2007 recognized the economic challenges that China faces and the need for policy changes and further reforms when he summed up the situation as:

> "There are structural problems in China's economy which cause unsteady, unbalanced, uncoordinated and unsustainable development."

In a more recent assessment of China's economic prospects in March 2010, Premier Wen essentially reiterated his earlier remarks when he said:

> "The biggest problem in China's economy is still imbalances in the structure -- that economic development is not stable, balanced, harmonious and sustainable."

These comments indicate the fundamental problems in China's economy, and the authorities' awareness of them. It is not encouraging though that, to judge from the Premier's comments, not much progress is being made to put China on a more sustainable long-term growth path.

There are two basic reasons to believe that China's growth could falter in the period ahead:

1. China’s economic model with its heavy reliance on investment and exports to generate growth will not be able for much longer to continue to deliver rapid growth.

2. China’s political system is likely to continue to create hurdles that will adversely affect the ability of the economy to grow rapidly.

The End of Investment-Driven, Export-Led Growth

Since the mid-1980s, China's economic growth has been driven by investment. Distortions in basic prices (such as low costs for capital, land, energy, other utilities, and pollution abatement); tax and other incentives; and institutional arrangements have strongly favored investment over consumption.

These policies worked fine in promoting growth until the early 1990s, when problems emerged. Investment growth began to slow as the productive capacity that new investments created exceeded domestic demand. To maintain investment and sustain rapid output growth and adequate employment growth, the government engaged in expansionary fiscal and monetary policies, which gave rise to serious inflation problems in the mid-1990s.

In 1994 and 1995, the Chinese government put in place three major reforms that modified the growth model to deal with the problem of the excess capacity generated by rapid investment:

1. One hundred percent foreign-owned firms were permitted, and these firms were provided incentives to lure investment to China and to concentrate it in the production of exports and other traded goods.
2. China’s dual exchange rate system was eliminated, and the value of the new single exchange rate was set at a somewhat depreciated value.
3. Reform of the state-owned enterprises was actively pursued, relieving these firms of their social responsibilities and cleaning up their balance sheets—launching a wave of new investment.

After the reforms, China retained its heavy reliance on investment to drive growth, but exports and the substitution of domestic production for imported goods provided the necessary outlet to ensure that the excess of productive capacity over domestic demand created by new investment was fully utilized. Hence the designation of China’s development model as investment-driven, export-led growth.

But time is running out on the ability of this model to continue to produce sustained rapid growth. Ironically, this in part is because of the model's success.

Continued heavy reliance on investment to drive output growth will add to productive capacity and require continued strong export growth. However, mustering the necessary export growth will be a difficult task to achieve.

China is the world's largest exporter and to be able to maintain sufficient export growth to sustain investment, China will have to take an ever-increasing share of world trade. This will be a hard task at a time when world trade is growing significantly slower than it did in the previous two decades and when all of the world's major economies are looking to exports to provide stimulus for growth. To be able to do this, China's producers will have to significantly lower their export prices to overcome stiff competition in world markets.

Consequently, profitability of exports will decline, and as a result, Chinese firms would be expected to cut their investment as rates of return decline. Chinese banks too, if they are operating on a commercial basis, should be increasingly reluctant to finance firms' investment. Therefore on its own, growth in China's GDP would be expected to slow.

Moreover, the situation facing China could be even worse if its attempts to maintain export growth were to invite serious trade retaliation from its major trading partners, especially if China seeks to maintain a competitive advantage by limiting the appreciation of its exchange rate.

China's government of course could step in and prop up GDP growth with expansionary fiscal and monetary policy—as it has done for the past two years. While such policies may be successful for a short period of time, eventually they will create serious problems that will have to be dealt with and economic growth could slow sharply as a consequence.

This is a lesson the Chinese authorities should have learned from their efforts to hold up economic growth in the early 1990s. Nevertheless, there appears to be a substantial risk that the early 1990s experience may be repeated. Over the period 2009-10 and into 2011, rapid credit growth has been maintained to try to hold up output growth. It is beginning to be reflected in a rising inflation rate. While the authorities are aware of the risks of inflation, the decision to maintain relatively rapid credit growth in 2011 suggests that a greater priority is still being place on achieving the official target for real GDP growth of at least 8 percent.

Changing the Economic Model

China's economy needs to be rebalanced away from investment and exports toward greater dependence on consumption to generate growth. To do this will entail the implementation of some major policy changes and market-oriented economic reforms. The Chinese authorities recognize the need for change, but they think that there is still plenty of time to act. They also appear to expect that the rest of the world will give them as much time as the Chinese feel is necessary to make this transition. However, the patience of other countries with the slow rate of change in some of China's policies—especially its exchange rate policy—is wearing thin.

The chief requirements for a rebalancing of China's economy are to remove key price distortions and make other policy changes to eliminate inefficiencies and incentives favoring investment over consumption.

Perhaps the most significant price distortion in China is the very low cost of capital. In a country that is thought of as possessing abundant cheap labor, capital is even cheaper, and because of low capital costs, along with inefficiencies in the allocation of capital through the financial system and government policies, production in China tends to be relatively capital intensive.

The ceiling imposed on interest rates paid on savings deposits is a major factor behind the low cost of capital. This ceiling holds down bank lending rates and reduces the opportunity cost for firms to use their retained earning for investment. This ceiling needs to be lifted. At the same time, the cost of capital cannot be raised significantly without permitting more exchange rate flexibility and the country's currency needs to be allowed to appreciate more rapidly.

A higher cost of capital and a stronger currency will help curb investment in export- and import-substituting sectors. Household incomes would be boosted by a rise in bank deposit rates, significantly raising investment income, and consumption would increase. Appreciation of the exchange rate would also stem the substantial overinvestment in the export sector that is taking place, and it would stimulate consumption, as the price of imported goods would fall creating a rise in the real incomes of Chinese households.

Financial market reform is also needed to improve the intermediation of savings in China. Lifting the cap on deposit rates would not only help push up the cost of capital, it would also increase competition in the banking sector and provide incentives for banks to expand credit to new customers. Bond and equity markets must be developed to provide alternative sources of financing for firms and a much broader array of assets for households to invest in. Better access to credit would reduce the incentives of both firms and households to hold large savings. Small- and medium-sized firms have had to rely largely on retained earnings or the assets of their owners to finance investment. Consumers also have had limited access to credit. Better credit access and higher yielding assets to invest in would reduce household saving and raise household incomes over time, boosting consumption.

Moreover, the government needs to continue improving critical social services, especially education, health care, and pensions. Reducing the uncertainties surrounding the provision of these services will substantially diminish households' strong precautionary savings motive and give households the confidence to raise consumption.

Hurdles Posed by Problems in the Political System

It is not readily apparent that the authorities are up to the task of making the necessary policy changes and economic reforms needed to rebalance China's economy because of problems posed by the political system.

The near-term problem is that the current leadership is relatively weak and has an ingrained instinct toward caution. Major economic policy decisions are made by consensus among the members of the State Council (consisting of roughly fifty people, including government ministers and senior members of the Chinese Communist Party), and it has proven difficult to reach a consensus on major economic reform issues among such a large group given their varied interests. There is a strong tendency to cling to the status quo and to favor policy strategies that involve taking only small steps to change the economy. The scheduled change in leadership in March 2013 does not look like it will change this situation significantly.

The leadership change itself also poses problems for getting any significant changes in economic policies. All major positions at the central, provincial, and local government levels will change with the change in leadership. Given the considerable jockeying for position that is going on now and the uncertainties in economic prospects, no one is advocating major changes in economic policy. Decisions on positions in the new government will be made in November 2012. Moreover, it is unlikely that the new government will take major policy actions in its first year in office as the new leadership attempts to establish itself and secure its sources of power within the Chinese Communist Party. The result is a likely policy vacuum for the next three years.

But there are more a fundamental, underlying political issues that will make it difficult for China to pull off the needed rebalancing of its economy. It is not clear whether development of a more market-oriented economy is compatible with the views of the Chinese Communist Party regarding how it wishes to maintain control over the country. Other countries in East Asia controlled by single-party governments for long periods of time (including Malaysia, Korea, Singapore, and Taiwan) have successfully sustained rapid economic growth and development. But these countries have been willing and able to separate economic from political control. In China, the Party appears reluctant to relinquish economic control. Its philosophy since the onset of economic reforms in 1978 has been that the government should control "the commanding heights of the economy." Clinging to this philosophy could severely limit the development of a more market-oriented economy and undermine China's ability to maintain rapid growth.

The reluctance to concede economic control is reflected in macroeconomic policies. There continues to be heavy reliance on direct intervention in the economy instead of relying on indirect instruments of macroeconomic control. This is particularly evident with monetary policy, where government decisions on credit policy continue to play an important role. It also is reflected in the ongoing heavy management of the exchange rate. The reluctance to concede economic control is also reflected in industrial policy. It is illustrated by the introduction of the indigenous innovation policy and by China's opaque review process for mergers and acquisitions.

The supremacy of the Chinese Communist Party is mandated, so consequently it will be difficult to more firmly establish the rule of law in China. There is talk about the need to improve the justice system, but the party is reluctant to let the courts challenge its supremacy by being the final arbiter of disputes. The rule of law is fundamental for sustaining economic growth and development. Individuals and firms need predictability in economic arrangements and assurances that contracts and property rights can and will be effectively enforced.

In the initial phases of China's development, ad hoc arrangements largely based on relationships between businesses and well connected officials tended to be adequate substitutes for the lack of a strong rule of law. Initially, high returns on investment served to offset the risks associated with the potential unpredictability of such relationship-based arrangements. But such ad hoc arrangements are not durable as an economy grows and becomes more complicated, returns on investment decline, and centers of political power and influence shift. As a consequence, increasing uncertainty in economic arrangements inevitably will lead to lower investment and slower economic growth.

Conclusions

One of the keys to maintaining China's internal stability is the ability of the country to continue the pace of its growth and development. Without sustain, rapid economic growth, China will be unable to continue to fulfill the rising expectations and aspiration of it population. It is essential for China's economy to be rebalanced away from heavy dependence on investment and exports toward greater reliance on consumption to drive growth. Although the authorities believe there is ample time to bring about this shift in the economy, the reality is that they have much less time to accomplish it than they believe if growth is to be sustained without significant disruption. The current external economic environment is considerably less favorable than China experienced before the recent economic and financial crisis, and this unfavorable environment is likely to persist for some time. In these challenging economic circumstances, other countries are less likely to be lenient and will push more vigorously for changes in China's external policies and demand a faster rate of exchange rate appreciation.

At the same time, there is great reluctance in China to speed up reform. This reluctance in part grows out of the political process and the jockeying for position in the new government to be formed in November 2012 that is going on now. It also reflects the likelihood that China's new leaders will be no more decisive on economic policy than the current leadership, and policymaking will remain consensus-driven. In such an environment, policy changes and reforms necessary to bring about economic rebalancing will be difficult to enact because of strongly held and divergent views among key interest groups within the Chinese Communist Party. In particular, it will likely be difficult to overcome relatively hard-core support for the status quo in economic policies because of the potential impact policy changes and reform could have on the party's position in the economy.

The need for major policy changes and reforms coupled with the strong reluctance of the authorities to initiate such policy changes at a sufficiently rapid pace suggest that China risks facing considerable instability over the next several years. Current relatively expansionary macroeconomic policies in the pursuit of continued economic growth could add to this instability, in particular by fanning inflationary pressures. Ironically, by trying to cling to the Chinese Communist Party's current position in the economy, the authorities could end up sowing the seeds for growing social disharmony that they are trying so hard to avoid.