



ECONOMIC VIEWPOINT

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China's Need to Reform

China's economic downturn has created a dilemma for its policymakers. Do they continue with policies to artificially boost the growth rate, thereby creating greater risks for the economy, or do they begin to address the long-delayed need for fundamental reform.

The current situation of excess capacity in industry, excessive credit to the financial sector, and concerns about the employability of the millions who have recently escaped poverty creates a volatile mixture. The worst policy choice appears to be the current one of providing further liquidity to troubled firms, maintaining the questionable lending decisions of state owned banks. Efforts to prop up unprofitable firms increase the size of the financial bubble. Recent declines in the stock market show that many are buying the notion that this is not a temporary slowdown. To this must be added the recent outflow of capital, which continues to depress the renminbi. Normally this would help exports; however, with global demand in the doldrums, this simply cuts profit margins, making declining industries less viable. It also puts the authorities in a difficult situation of balancing the globalization of the currency versus the desire to use capital control instruments to prevent more capital flight.

Similar to other countries, we are witnessing an excessive reliance on monetary expansion to drive extra growth; however, in China not only does this not sustain economic expansion, but it also creates larger financial-sector bloating as seen in the huge expansion in corporate indebtedness. Overall Chinese debt is now at an unhealthy level of 240 percent of GDP. Indebtedness has tripled since the year 2000 and much of this financed excessive industrial expansion and, more recently, aggressive overseas acquisitions. Both phenomena would not be possible without permissive credit expansion, accompanied by poor supervision or purposeful neglect of weak balance sheets or both.

Unwinding these excesses will be difficult to manage without incurring major losses that will tax public funds and China's huge level of reserves. Is this financeable? Yes. Is it desirable? No.

The major problem with government's decision to fuel the fire rather than beginning the series of inevitable reforms is that the cost of adjustment is increasing, the reform of the economy is delayed, and the average Chinese citizen is losing ground in the quest for further welfare gains.

What adjustments are being delayed and at what cost? First and foremost, the rebalancing of domestic demand to shift from an over-reliance on exports to domestic consumables is overdue. Instead of pouring credit in overly indebted firms in ultimately declining industries, putting purchasing power in hands of consumers can help raise standards of living. Providing consumers with credit, as was done in Korea when rebalancing away from exports was a policy goal, is not risk-free; however, the continued bloating of indebted firms merely increases the level of eventual non-performing loans when the bubble bursts. China's formal financial sector is in trouble and its shadow banks even more so. Turning a blind eye and continuing the flow of credit is an ill-advised policy choice. It would be better to selectively starve uneconomic firms while at the same time moving public investment away from low-return projects to needed action on public investment needs in water and sanitation, environmental management, and air quality improvements. The costly current misallocation of resources is simply delaying China's economic advancement.

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