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CHINA'S ECONOMY IN THE NEW ERA

Rebecca Arcesati

One of the most pressing challenges facing the Chinese leadership in Xi Jinping's second mandate will be the further implementation of economic reforms. According to **Michael Pettis**, non-resident Senior Fellow at the Carnegie Endowment for International Peace and Professor of Finance at Peking University, structural readjustment is the precondition for the success of China's future economic agenda. In order to identify the optimal trajectory for China's growth model, in Pettis' view, one must look back at the country's economic history. Like other countries, China's development has undergone phases of major transformation.

The first phase coincided with the introduction of "liberalizing reforms" in 1978. These were aimed at opening China up to the world, while eliminating institutional constraints and elite opposition to reforms. According to Pettis, the implementation of these types of liberalizing reforms is only successful – thus not leading to regime change – either in parliamentary democracies, or in highly centralized autocracies, like China. In this light, it can be argued that Deng Xiaoping's centralization of power in the 1980s paved the way for China's growth miracle. Deng's 1992 Southern tour, which relaunched economic reforms after a deadlock, was precisely aimed at tackling resistance to his policies by existing elites.

The second stage, common to other developing economies around the world, is the so-called "investment-driven economic miracle", also known as Gerschenkron's model. In 1962, Alexander Gerschenkron observed that developing countries tend to have low savings rates. Faced with the risks associated with excessively relying on foreign capital, these countries can also develop their economies by forcing up savings rates in order to funnel domestic savings into investments to fuel growth. This is normally achieved by contracting consumption rates through a reduction in the household share of GDP. According to the speaker, the fact that China has arguably the lowest household income share of GDP ever recorded cannot be explained by Chinese families' innate preference for saving money. Rather, this trend has been determined by a government design to ensure systematic wealth transfers away from households and towards the government and businesses. These transfers were accomplished through currency manipulation, low wage growth relative to productivity, and negative interest rates. Subsequently, the

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Michael Pettis addresses the audience at the Bridge Café in Wudaokou for ThinkIN China's 63rd event.

Chinese government directed this wealth into short-term infrastructure investments. China forced savings into investments to the highest rate ever seen in history, realizing an investment-driven miracle at a time when the country needed it the most.

However, every country that experienced an investment-driven boom sooner or later faced the dilemma of overinvestment, in parallel with the emergence of powerful groups opposed to reforms. It is in this third phase that China stands today. The speaker argued that each country has an 'optimal capital level': a level of investment – depending on a set of legal, financial, educational, and political institutions – determining the rate at which workers are able to use resources productively. Beyond this limit, injecting capital into the economy ceases to be productive and becomes inefficient, unless further institutional reforms are implemented. China has passed this critical point: additional investments in unutilized infrastructure facilities and the redundant production capacity of traditional manufacturing are bringing more costs than value to the economy. Ultimately, in Pettis' view, this is at the heart of China's structural problems: Beijing invests too much, fueling an unsustainable increase in debt.

Given the above-mentioned issues, the fourth and next phase should be "economic rebalancing". In order to reverse the cycle of unproductive investment and debt, China urgently needs to silence opposition from powerful elites, before it can implement an ambitious set of liberalizing reforms. Pettis suggested Xi could achieve this in two steps: first, by drastically re-centralizing power after the decentralization of economic policymaking from the late 1990s. Second, by addressing the debt problem in its two dimensions of flow of debt and stock of debt.

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The flow of debt is the mechanism allowing Chinese debt to rise at the fastest rate ever seen in history. Such rapid increase is due to the extremely low consumption of households, which in turn encourages misallocation of investment towards sectors of the economy which are no longer productive: simply put, the government artificially creates demand in order to keep the manufacturing sector operational, thus guaranteeing employment. To reduce investment while containing unemployment, consumption must be encouraged, which requires raising households' share of GDP at the expense of elites and local governments – the main beneficiaries of the current growth model. Unfortunately, after former Premier Wen Jiabao acknowledged the serious imbalances of the Chinese economy, the situation worsened between 2007 and 2012. It is no coincidence that, by the end of the early 2000s, Chinese media began discussing the issue of "vested interests": these groups, in fact, voiced their opposition at a time when the government expressed its intention to rebalance the economy by transferring more wealth to households.

A related issue concerns the stock of debt. China's amount of debt is unsustainable for a developing country because it constraints growth. According to Pettis, China must assign the cost of debt to the only economic sector that is able to sustain it: the government. Traditionally, households are indirectly forced to bear the cost of debt through taxation, as happened during the banking crises in the U.S. and Europe. Indeed, China also forced households to bear the costs of the banking reform in the 2000s: unsurprisingly, consumption dropped from an already low 46 percent of GDP in the year 2000, to 35 percent in 2008. Making Chinese families pay for the debt is clearly unfeasible. Assigning such task to small and medium enterprises is also risky: Pettis noted their political vulnerability, as well as their pivotal role in ensuring future economic growth.

Only the government has enough resources to pay for China's debt: according to a recent study, it has a considerable net position as a percentage of GDP, much higher than most countries. This means it can liquidate its assets, and use the proceeds to pay down debt and increase the households' share of GDP. Again, this implies wealth transfers from local governments to ordinary citizens. Pettis argued that, during the 19th Party Congress, the Chinese establishment has demonstrated its political willingness to do so. Yet, elite opposition makes it hard to predict whether these reforms will ever be implemented. What is certain is that the success of readjustment normally comes at huge costs.

In what Pettis described as the "ideal rebalancing scenario", China has to reset its unfeasible GDP growth target at around 2 to 3 percent, while ensuring that households' incomes grow by 4.5 to 5 percent. This way, local governments would pay for the debt by liquidating their assets, and growth would decelerate without causing social turmoil. According to Pettis, the government is already trying to adopt this strategy: whether Xi Jinping has consolidated its power enough to accomplish it will only be seen when such reforms begin. In the meantime, some provinces are experimenting with different wealth transfer strategies to workers and pension funds. The political momentum for the introduction of structural reforms seems to be there, but won't necessarily translate into a smooth readjustment for China.

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