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China Risks Stagnation, Ex-Goldman Dealmaker Says

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- Fred Hu says bureaucracy has no appetite for economic reforms
- Central planning leads to slow growth and economic misery: Hu

China risks economic stagnation unless it quickly removes barriers hampering entrepreneurs seeking to enter industries from health care to education to financial services.

That's according to Fred Hu, a former Greater China chairman for Goldman Sachs Group Inc. who has advised the central government on financial, pension and state-enterprise reforms.

"Economic reforms have been slow-paced, way short of expectations," said Hu, founder and chairman of Beijing-based investment firm Primavera Capital Group. "China should discard outdated regulations and policies that have hampered new business formation. Unfortunately doing so means taking power away from over-extending government agencies and bureaucrats. Right now, the bureaucracy just has no appetite to undertake such reforms."

With the government focused on maintaining economic stability ahead of the 19th Party Congress late next year, Hu, 53, isn't optimistic overhauls will accelerate soon. But once that party gathering is cleared, Hu is hopeful that President Xi Jinping -- who he described as a "committed reformer" -- will push forward structural changes that can see the world's second-biggest economy continue to grow at a moderately rapid rate.

'Brilliant Economist'

When Henry Paulson led Goldman Sachs for a decade before becoming U.S. Treasury Secretary in 2006, Hu was his point man in China, playing a pivotal role in the investment bank's landmark purchase of a stake in Industrial & Commercial Bank of China Ltd. and arranging stock market listings for firms including Bank of China Ltd. In his 2015 book "Dealing with China," Paulson described Hu as a "brilliant economist" who understood the Chinese economy and its leaders "better than just about anyone I knew."

Delaying reforms could cause China to fall into the so-called middle-income trap, says Hu. That's when a country's economic progress stalls because it fails to become more innovative even as rising wages and other costs cause it to lose competitiveness in manufacturing industries from clothes to furniture.

Hu said he's "not sanguine" about the nation's housing market over the next year or two and noted that it faces capital outflow pressures from likely U.S. interest-rate hikes and the policies of President-elect Donald Trump, who has criticized China's trade practices.

"The key factor is the domestic policy uncertainty in China, which has weighed down investor confidence," he said. "The more delayed urgent reforms are, the greater the risks for China to be stuck in the traditional growth model that's already under tremendous strains."

Here are excerpts from a recent conversation with Hu:

What's the state of economic reform in China?

What most worries me about China is the slower-than-expected pace of economic reforms. Perhaps there may be some kind of rethinking going on within the highest decision-making body, or perhaps due to the distraction of the anti-corruption campaign, reforms have been piecemeal, ad hoc, and short of bold actions. Given the imperative for China to adopt a new growth model based on innovation and modern services, the most urgent task is to overhaul and remove those barriers that prevent innovators and entrepreneurs from shaking up the inefficient structure and creating new businesses.

What regulations and policies must be discarded?

Outdated and ineffectual regulations are still widespread throughout the Chinese economy, but those are particularly harmful in the service sectors such as health care, education and financial services, where arbitrary bureaucratic rules still trump market incentives and competition, resulting in glaring inefficiencies and appalling inequity for ordinary Chinese citizens. Deregulating service sectors is essential to rebalancing the economy especially as heavy industries are under acute pressures of overcapacity.

What's at stake if reforms are slow-paced?

The dire consequences of failing to reform quickly and boldly would be loss of growth momentum, a slow descent into economic stagnation, and China falling into the middle-income trap.

Will emphasis on maintaining political stability delay reforms?

China always attaches a great deal of importance to political and social stability at any time, likely more so between the present time and the 19th Party Congress next year. So it indeed likely means more delays for economic restructuring.

Are you optimistic that Xi will accelerate reforms after the congress?

President Xi is a committed reformer. I'm hopeful that he will muster his power and energy to implement bold economic reforms following the 19th Party Congress. Assuming China implements structural reforms in the next five years, I expect China will continue to grow at a moderately rapid rate.

Is the Communist Party still efficient at decision-making, or is it suffering from gridlock?

Under China's current political system, China recorded an economic miracle and became a global economic powerhouse over the past three decades, lifting hundreds of millions of people out of abject poverty and creating a prosperous middle class in urban China. However, one should keep in mind that China, under the same one-party rule, was once left far behind not only by America and Western Europe, but also by industrialized East Asia, and for many decades ranked among the world's poorest countries, in the same company of South Asia and Sub-Saharan Africa, until Deng Xiaoping dramatically changed China's course in 1978.

Strategic policy choices matter crucially within a given political system, with pro-market, pro-trade policies leading to strong economic growth, whereas central planning and closed-door policies led to low growth and economic misery.

Will policy makers become gridlocked?

Ironically, an often-touted benefit of a one-party political system is supposedly policy continuity and stability, in contrast to political uncertainty and gridlock more commonly observed in the multi-party democracies. But a highly centralized system with power concentrated in too few individuals runs the risk of sucking out all the grass roots autonomy and energy and individual initiatives essential to a vibrant entrepreneurial economy.

— With assistance by Kevin Hamlin