PROJECT SYNDICATE
A WORLD OF IDEAS

Economics
FEB 28, 2016

Michael Spence

Michael Spence, a Nobel laureate in economics, is Professor of Economics at NYU's Stern School of Business, Distinguished Visiting Fellow at the Council on Foreign Relations, Senior Fellow at the Hoover Institution at Stanford University, Academic Board Chairman of the Asia Global Institute in Hong Kong, and Chair of the World Economic Forum Global Agenda Council on New Growth Models.

Fred Hu

Fred Hu is Chairman and Founder of Primavera Capital Group, a China-based global investment firm.

MILAN – Uncertainty about China's economic prospects is roiling global markets – not least because so many questions are so difficult to answer. In fact, China's trajectory has become almost impossible to anticipate, owing to the confusing – if not conflicting – signals being sent by policymakers.

In the real economy, the export-driven tradable sector is contracting, owing to weak foreign demand. Faced with slow growth in Europe and Japan, moderate growth in the United States, and serious challenges in developing countries (with the exception of India), the Chinese trade engine has lost much of its steam.

At the same time, however, rising domestic demand has kept China's growth rate relatively high – a feat that has been achieved without a substantial increase in household indebtedness. As private consumption has expanded, services have proliferated, generating employment for many. This is clear evidence of a healthy economic rebalancing.

The situation in the corporate sector is mixed. On one hand, highly innovative and dynamic private firms are driving growth. Indeed, as a forthcoming book by George S. Yip and Bruce McKern documents, these innovations are occurring in a wide range of areas, from biotechnology to renewable energy. The most visible progress has come in the information technology sector, thanks to firms like Alibaba, Tencent, Baidu, Lenovo, Huawei, and Xiaomi.

On the other hand, the corporate sector remains subject to serious vulnerabilities. The rapid expansion of credit in 2009 led to huge over-investment and excess capacity in commodity sectors, basic industries like steel, and especially real estate. The now-struggling pillars of China's old economic-growth model bear considerable responsibility for the current growth slowdown.

Despite these challenges, the reality is that China's transition to a more innovative, consumer-driven economy is well underway. This suggests that the economy is experiencing a bumpy deceleration, not a meltdown, and that moderate growth can reasonably be expected in the medium term – that is, unless the financial system's problems intensify.

As it stands, non-performing loans are on the rise, owing largely to the weaknesses in heavy industry and real estate. While official sources report that NPLs account for 1.67% of loans held by commercial banks, the Chinese investment bank CICC estimates the figure to be closer to 8%. If so, the banking sector – and the wider economy – could suffer considerably.

Whether it does depends on the decisiveness of the policy response. As in the late 1990s, after the Asian financial crisis, China may need to rely on the large state balance sheet for loan consolidation, debt write-offs, and bank recapitalization.

But the concerns do not end there. Net private capital outflows remain substantial, and show no signs of slowing. As a result, the reserves held by the People's Bank of China (PBOC) have declined by roughly $500 billion over the last year, with particularly large declines of some $100 billion in each of the last two months. These outflows, together with volatility in the stock and currency markets, have left investors and policymakers increasingly worried.

Unfortunately, a clear explanation for this behavior has yet to emerge. Some blame it on the combination of progress toward opening the capital market and an overvalued exchange rate, anticipating that net inflows will resume once the currency resets closer to market level. Others suspect the influence of inside information: The capital exodus is a signal that economic conditions and growth prospects are much worse than official figures imply.

Still others cite the impact of President Xi Jinping's intensive anti-corruption campaign and, more generally, declining official tolerance for heterodox views. Those who feel directly threatened by the anti-graft campaign might be inclined to take their money out of China. But many others may be doing so for fear that, far from giving the markets a more "decisive role" in the economy, the government may be moving to assert greater control. Capital tends to flow to places where rules are clear and stable.

Given China's systemic importance in the global economy, uncertainty about its plans and prospects is bound to send tremors through global capital markets. That is why it is so important that the Chinese government increase the transparency of its decision-making, including by communicating its policy decisions more effectively. Consider the soothing impact of PBOC Governor Zhou Xiaochuan's recent statement (following a long and baffling official silence on exchange-rate policy) that the central bank would keep the renminbi "basically stable" against a basket of currencies and the dollar.

But the principal unaddressed problem affecting China's financial system is the pervasiveness of state control and ownership, and the implicit guarantees that pervade asset markets. This leads to misallocation of capital (with small and medium-size private enterprises struggling the most) and the mispricing of risk, while contributing to a lax credit culture. The absence of credit discipline is particularly problematic when combined with highly accommodative monetary policy, because it can artificially keep zombie companies afloat.

To resolve this problem, China's leaders must segregate the state balance sheet from the credit allocation system; but there is no clear roadmap for doing so. Moreover, they should build on efforts taken to open up the capital account, thereby improving the efficiency of capital allocation over time, though this process is undoubtedly complicated by the capriciousness of cross-border capital flows.

China's current bout of economic volatility is likely to persist, though increased transparency could do much to blunt it. Add to that the smart use of state resources, together with sure-footed reforms, and China should be able to achieve moderate yet sustainable long-term growth.