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China needs slower, better growth

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http://www.ft.com/cms/s/0/df759354-a0c8-11df-badd-00144feabdc0.html

Earlier this year China posted robust growth of 11.9 per cent, prompting worries that the country was overheating. Recently the mood has changed, with signs of a slowdown. Manufacturing output grew at its slowest rate for 17 months in July, while predictions suggest third-quarter growth will dip below 10 per cent. Concerns are now being voiced that a faltering of the Chinese economy will imperil the global recovery.

Such short-term concerns are premature. Remember that China posted growth in 2009 of 9.1 per cent, a merely respectable achievement by Chinese standards, but impressive nonetheless in the midst of a global financial catastrophe. Most of this came from new infrastructure investment, which probably added 8 percentage points, offsetting a sharp fall in exports. Yet although China's huge stimulus package was a great success, it also stored up serious problems for the future.

Rushed investment in roads and buildings leads to waste, which will have dire long-term consequences for China's improved, but still fragile, banking system. Investment in infrastructure avoids overcapacity, but bring returns only if it goes hand-in-hand with stronger manufacturing and other growth. Where will tolls come from if there is no traffic on an eight-lane highway? How then will the bank loans be repaid?

Such issues have been under-examined as Chinese policymakers grapple with how to halt a housing boom. Low interest rates and excess liquidity created by 2009's huge credit expansion have driven house prices to dizzying heights. From January 2009 to May 2010, in 36 big cities, residential house prices increased by 40 per cent. In Beijing, Shanghai, and Shenzhen rises were even greater.

Justifiable or not, high house prices have caused immense public resentment, and as a result China's leaders have of late been attempting to undo some of their own work. Over-expansionary monetary policy began to be withdrawn in the second half of 2009. Credit expansion was reined in. Policies to contain the fever of property development also followed. For the first time, both a property tax and a capital gains tax are under discussion.

Thankfully, these measures seem to be working, with property sales cooling. Indeed, weaker growth this year is mostly explained by deliberate policy changes in Beijing. Europe's sovereign debt crisis and the slowdown of the global economy may have an impact later this year, but they have not done so yet.

Now the real economic debate in China focuses on whether the government should move again, this time to reverse the new slowdown it itself initiated. Some western economists, in particular, worry that China's property market is beginning a collapse that will hit the nation's banking system. But, in my view, wobbling because of the current dip in growth would be a mistake.

Yes, at the moment there is a tug of war between house buyers and property developers. Whether prices fall will depend on who blinks first. But this, in turn, depends on whether both believe in the credibility of government policy. If the government stands firm, house prices will fall. Of course, if controls are implemented haphazardly the government risks such a collapse. But currently a 30 per cent drop is the worst-case scenario. Chinese households have low debt levels and even a dramatic fall could be borne by well-capitalised banks.

Overall, therefore, China's short-term fiscal position remains much better than almost all other big economies. It is in the long-run that all is not well. A viable economy cannot be built on steel and concrete alone, and China's problem is more its poor allocation of resources than the bursting of a property bubble. At present real estate, at around a quarter of total investment, simply takes up too much economic room.

The economy's list of structural problems is also long, including over-dependence on investment and external demand, an unacceptably wide gap in incomes, too few social goods and an underdevelopment of the service sector. Slow progress in anti-corruption campaigns and institutional reforms are also worrying.

In the long-run, however, it is the pattern of growth that needs most urgent attention. Investment and exports have been the twin engines of China's growth. But investment growth will soon hit a ceiling imposed by social, environmental and natural resources. The danger is that deflation will set in and the growth process will break down. Increasing exports can postpone, but not prevent, this reverse.

Following the increase in the size of the Chinese economy and the general slowdown of the global economy, China's export drive is also crashing into a stone wall of trade friction and protectionism. To sustain growth it must lower investment and rebalance its current account. Improving the quality, rather than the quantity, of growth should be the priority.

China has concentrated obsessively on GDP growth for far too long. But growth is not a good excuse for postponing much-needed structural adjustment. This readjustment, when it comes, will inevitably lead to a slowdown. But it is the only way to lay a solid foundation for sustainable growth in the long-run. And the longer the delay, the more painful the adjustment will be.

The writer is an academician with the Chinese Academy of Social Sciences and a former member of the monetary policy committee of the Chinese central bank

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