CHINA DEBATE

ESWAR PRASAD, CORNELL UNIVERSITY, AND MICHAEL PETTIS, PEKING UNIVERSITY

Prasad vs Pettis on the Future of China's Growth

Bloomberg Brief invited two leading China academics to discuss whether far-reaching reforms can maintain growth in the world's second-largest economy at its current pace. Eswar Prasad says that expansion can continue at 6 percent to 7 percent, while Michael Pettis argues that rising debts and high costs of reform mean a sharp slowdown is inevitable.

The opening round of arguments appears on pages 1 through 3. Replies from Prasad and Pettis appear on pages 4 and 5.

Michael Pettis is a professor at Peking University's Guanghua School of Management and a senior associate at the Carnegie Endowment for International Peace. He is the author of several books, including Avoiding the Fall: China's Economic Restructuring (*http://ceip.org/JWogj1*). From 2002 to 2004, he taught at Tsinghua University's School of Economics and Management and, from 1992 to 2001, at Columbia University's Graduate School of Business. He is a member of the Institute of Latin American Studies Advisory Board at Columbia University as well as the Dean's Advisory Board at the School of Public and International Affairs.

Eswar Prasad is the Tolani Senior Professor of Trade Policy at Cornell University and the author of The Dollar Trap: How the U.S. Dollar Tightened Its Grip on Global Finance (*http://TheDollarTrap.com*). He is also a Senior Fellow at the Brookings Institution, where he holds the New Century Chair in International Economics, and a Research Associate at the National Bureau of Economic Research. He was formerly chief of the Financial Studies Division in the International Monetary Fund's Research Department and, before that, was the head of the IMF's China Division.

MICHAEL PETTIS'S OPENING ARGUMENT:

China Faces a Sharp Slowdown

China's growth has been rapid, but driven in recent years by wasteful investment. The price of returning to healthier growth will be a sharp deceleration in the years ahead.

When a country's growth has been driven by wasteful investment, GDP growth exceeds real economic wealth creation, productivity is overstated, and debt rises faster than debt servicing capacity. This has been the problem with China's growth of the last several years. Beijing's response is the economic reforms proposed during the third plenum, aimed at unlocking greater productivity potential in the Chinese economy and returning the country to a sustainable growth path.

But this higher productivity will not lead to higher GDP growth. It will not even allow China's economy to continue growing at current rates. On the contrary, successful implementation of the reforms will cause GDP growth rates to drop sharply. There are at least four reasons to expect healthier but slower GDP growth over the rest of this decade if the reforms are implemented.

First and most obvious is China's over-reliance on credit to generate growth, with much new borrowing needed simply to prevent borrowers from defaulting on existing loans. Since 2009–10, Beijing has attempted to rein in credit growth. Each time credit growth has decelerated, and GDP growth rates dropped so sharply that Beijing was quickly forced to relent. Because growth is more dependent than ever on credit, as Beijing finally acts to rein in credit growth decisively, GDP growth will drop sharply.

Second is the reversal of mechanisms that goosed growth by transferring resources from the household sector to subsidize manufacturing, infrastructure building and real estate development. These mechanisms – including the undervalued currency, slow wage growth and financial repression – put downward pressure on household income even as they subsidized manufacturing and investment.

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OPENING ARGUMENTS…
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That led directly both to higher growth rates and to the investment and consumption imbalances from which China suffers and which it plans to reverse. As Beijing reverses policies that once acted to increase growth, the result must be slower growth.

Third is Beijing's recognition that cheap credit and limited accountability have created excess capacity in industry and real estate. Local governments have supported this build-up of capacity to boost growth and, with it, revenues and local employment. As Beijing acts to wring out excess capacity, we will inevitably see a reversal of the earlier growth impact.

Finally, because many years of overinvestment have left a large amount of unrecognized bad debt on bank balance sheets, China's GDP growth has been overstated by the amount of the unrecognized losses. Over the next decade as Beijing cleans up its financial system, this bad debt will either be explicitly recognized or, more likely, implicitly written off over the remaining life of the loan. Either way, as the losses are recognized, growth over the next several years will automatically be understated by the amount previously overstated.

These reforms, and others – like attempts to protect the environment – will ensure that even as China's real economic productivity improves, its GDP growth numbers will drop as the reforms are implemented. For now, most commentators argue that by increasing productivity, real reform will ensure a soft landing of GDP growth rates of 7 to 8 percent during the rest of President Xi Jinping's administration. A growing minority worries, however, that rapidly rising debt will force China into a hard landing.

Although rising debt increases the probability of a hard landing, for now I expect neither outcome. More likely, I believe, is a "long landing," during which growth rates will drop by roughly one to two percentage points every year for the rest of this decade. Implementing reforms will protect China from a hard landing. It will however force much lower, albeit healthier, growth rates.

ESWAR PRASAD'S OPENING ARGUMENT:
China Can Maintain Growth at Current Levels

In the last decade, a steady drumbeat of warnings has predicted imminent collapse of the Chinese economy. They have so far proven wrong. For all the imbalances, inefficiencies, and risks created by China's growth model, the economy has continued to deliver remarkable growth.

China cannot outrun its problems forever. Rising local government debt, unbalanced growth, and a fragile financial system pose big risks. As the economy eases into relatively sober growth of around 7 percent, these problems are becoming more apparent.

The party plenum in November 2013 and a subsequent meeting of top officials in December set out a raft of ambitious reform proposals to tackle these problems.

There are three elements to any reform effort: framework, tactics, and implementation. China is doing well on the first two, but the third remains a challenge.

Major economic reforms are often undertaken under the shadow of a crisis. China has torn up the traditional playbook and its leaders seem willing to muscle through key reforms at a time when short-term growth is secure, even if that involves some risks and dislocations.

To do this, China has created narratives that build broad support and provide a framework for communicating the logic and desirability of contentious reforms.

Take the plan to reduce inequality, announced in early 2013. In fact, the plan did not emphasize redistribution. Rather, it encompassed financial market liberalization, reform of state-owned enterprises, and labor mobility. These are key elements of the reform agenda, but face fierce opposition from vested interested in the state sector and local government. The framework of tackling inequality was used to leverage popular support necessary to push those vested interests aside.

Then come tactics. China's approach might seem plodding and hyper-cautious, but in an economy beset with

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Michael Pettis's Main Arguments:

- China's growth has been artificially supported by excess credit and investment.
- Unwinding the excesses will push the growth rate down.
- Expect growth to fall by 1 percentage point to 2 percentage points every year for the rest of the decade.

Eswar Prasad's Main Arguments:

- Risks are real, but China's leaders have shown commitment to reforms required to sustain growth.
- With proper implementation of these reforms, growth can be maintained around 6 percent to 7 percent.
- Low government debt and vast hoard of FX reserves reduce the chance of financial crisis.

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multiple inefficiencies, caution has merit. Consider the proposal to eliminate the ceiling on interest rates paid on bank deposits. The ceiling has stifled bank competition, resulting in households getting minuscule inflation-adjusted returns on their deposits for much of the last decade.

Removing the ceiling has risks. Weaker banks may offer higher interest rates to compete for deposits and make riskier loans; they would set themselves up for failure. While it puts in place a deposit insurance system to reduce these risks, the government has chipped away at the deposit rate ceiling by allowing the proliferation of other saving products with higher returns. This approach has its own risks but helps catalyze interest rate reforms.

Small indirect reform steps elicit less opposition, pose fewer risks from the reforms themselves, and make course corrections easier.

Implementation is the hard part. The present system serves the big financial institutions, large state enterprises, and provincial governments well. It will take hard-nosed political leadership to overcome resistance from these politically powerful groups.

The list of reforms and the timeline proposed in the third plenum documents – from a decisive turn towards a market-oriented economy to broad financial market reforms, from restructuring of the public finances to the elimination of the one-child policy – are the reforms that China needs.

If all of the proposed reforms are implemented in the next three to five years, they will improve the allocation of resources, push up productivity, and make growth more balanced. Taken together, they will allow China's economy to continue growing at 6 to 7 percent for the next few years.

A valid short-term concern is the difficulty of exiting the cycle of investment-led growth financed by rapid credit expansion. The balance is a difficult one. A rapid slowdown of growth could bring financial system risks to the fore and complicate reform efforts. Higher growth creates more resources but allows problems to fester, creating bigger risks for the future.

While the rapid credit expansion is worrisome, a financial meltdown is unlikely because of the relatively low level of government debt and the vast hoard of foreign exchange reserves and other assets the government holds, which gives it room to maneuver.

Top leaders' understanding of the gravity of the situation and their willingness to push through reforms are grounds for optimism. History has proved China doomsday theorists wrong for the last thirty years. If third plenum commitments to broad-ranging reforms are translated into forceful actions, it will prove them wrong again.

CHINA DEBATE

ESWAR PRASAD, CORNELL UNIVERSITY, AND MICHAEL PETTIS, PEKING UNIVERSITY

Prasad vs Pettis on the Future of China's Growth (Round 2)

Leading China academics Michael Pettis of Peking University and Eswar Prasad of Cornell University lock horns in the second round of their debate on the future of China's economy. Pettis doubles down on the argument that reforms will push growth down rather than up. Prasad argues that by releasing productive potential, policy shifts can maintain growth near the current levels.

ESWAR PRASAD'S REPLY:

We seem to agree, or at least share the hope, that China is likely to have healthier growth in the coming years, less driven by investment and fueled by cheap credit. You have correctly pointed out that the current growth model has been wasteful and inefficient.

Still, one has to acknowledge that China has managed a difficult balancing act for a sustained period – keeping the economy growing at a rapid clip. That has generated enough resources to give its citizens a dramatic improvement in standards of living over the last three decades and also to tackle some of the problems that growth itself has created. At the same time, China cannot expect to outrun its problems forever and China's leadership seems to recognize this.

This brings us to our point of substantive difference – whether the reforms necessary to put China on a better growth necessarily imply a much slower pace of growth. You expect that "growth rates will drop by roughly one to two percentage points every year for the rest of this decade." And this, if I understand correctly, is a best case scenario if reforms are implemented as promised. Drifting towards a minimal growth rate sounds like a savage payback for undertaking a bold and broad set of reforms.

Why do I think that reforms can help China sustain moderate growth rates in the 6 to 7 percent range rather than lead to a massive slowdown?

First, a better financial system that allocates resources more efficiently would allow for higher productivity growth that to some extent offsets a slower pace of investment. If banks have the right incentives to direct credit away from the large, state-owned enterprises – and if they have good risk-management capabilities in place – then more credit would flow to small and medium-sized enterprises. This would give the service sector a much-needed boost and also generate better employment growth.

Second, liberalization of bank deposit rates and development of broader financial markets could help in the rebalancing effort. Higher returns on savings, a better social safety net, and better opportunities for risk diversification would promote household consumption by reducing precautionary motives for saving. Some of this rebalancing is already taking place, albeit very slowly, with the consumption to GDP ratio at least not falling further and – in the last two years – edging up slightly.

Third, reducing restrictions on labor mobility and providing better social support systems in China's cities could help move the vast pool of underutilized rural labor to urban areas where it could be more productively employed. This would cushion some of the drag from unfavorable demographics that could soon result in a shrinking labor force.

Fourth, the government's investments in infrastructure, while certainly over the top in some areas, could play an important role – if directed judiciously to where the economic payoffs are greatest – in unlocking the productive potential of the interior provinces.

I share your concerns about the serious, and rising, risks that China's leadership need to grapple with and the inefficient growth model that China seems wary of weaning itself away from. But the leadership's acknowledgement of the seriousness of those risks and the apparent determination to move forward with market-oriented reforms are promising signs.

Implementing those reforms, and avoiding the risks involved in the transition to a market-oriented economy, is going to be challenging. Fortunately, the Chinese government has enough resources and policy space to cope with some of those transitional risks.

Ultimately, if the proposed reforms are implemented, I envision a more benign future for the China economy – with growth that is more moderate by its own historical standards, but that is more sustainable from economic, social and environmental perspectives.

MICHAEL PETTIS'S REPLY:

There has indeed been, as you note, a drumbeat of warnings predicting China's imminent collapse. But China's failure to collapse does not prove the bull case, especially when most China skeptics – me included – never predicted or expected any such thing. Our argument has been a

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MICHAEL PETTIS'S REPLY...
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very different one. We predicted that as China rebalanced, growth rates would drop much more sharply than expected. This is exactly what happened.

In order to understand China's growth prospects I think we must recognize that while a growth model can deliver healthy growth for many years, this growth can itself transform conditions to the point where the model is no longer able to deliver. At that point the economy must adjust to a new, more appropriate approach.

The Chinese growth model is a version – in probably its most extreme form – of the investment-led growth model described by Alexander Gershenkron fifty years ago. To simplify tremendously, growth in "backward" economies is supported by policies that subsidize investment while suppressing consumption (usually by constraining household income growth). These "backward" economies are ones in which the level of capital stock is much lower than the country's social and institutional ability to absorb investment efficiently.

Early on, many years of high investment allowed China to catch up. Once it did, however, continuing to invest in the same way and to the same degree was no longer wealth enhancing. At this point the economy needed institutional and social reforms to continue growing. The political logic of the system, however, forced, as it almost always does, continued high investment growth. With it came increasing investment misallocation.

Almost by definition, debt began to rise faster than debt servicing capacity. This, clearly, was unsustainable, but of course even an unsustainable system can go on for many years. It was as long ago as 2007 that former Premier Wen Jiabao described the Chinese economy as "unsteady, unbalanced, uncoordinated and unsustainable," but it proved politically very difficult for Beijing to implement the reforms his advisers suggested. As a result, the distortions associated with the growth model continued. Debt surged even as the consumption imbalance deteriorated until late 2011. We have only seen in 2012–13 the beginning of any partial rebalancing, although during this time there has been at best only a deceleration in the growth rate of credit.

Even the minimal amount of rebalancing that has occurred in the past three years has already lopped three percentage points off China's GDP growth rate, just as many of us predicted. China still has a long way to go to rebalance its economy. By my calculations consumption growth must outpace GDP growth by 3 to 4 percentage points every year for at least a decade just to allow China to raise the household consumption share of GDP to a still-low 50 percent.

You say that "if all of the proposed reforms are implemented in the next 3–5 years, they will improve the allocation of resources, push up productivity, and make growth more balanced." Of course you are right. But this, I think, is only half the story.

The proposed reforms will certainly unleash greater productivity, but they will also eliminate the mechanisms that had previously turbo-charged economic activity and which showed up in the form of higher reported GDP growth rates. They will cause a sharp deceleration in economic activity even though growth will be more productive than in the past. The fact that growth rates have dropped by almost a third even before the reforms were implemented suggests to me just how much further they must drop.

The Chinese economy does not need to collapse to prove the bulls wrong. Contrary to the bullish consensus it will not continue growing at current rates for the remainder of this decade. The logic of the system and the historical precedents both suggest that the faster China's economy adjusts, the lower GDP growth will be, but the more optimistic we can be for China's long-term future.