China's Coming Economic Shift

By Chi Lo

Control versus market forces.

Most China observers may not notice a structural change in China's economic policy that could potentially revive the economic prowess of the Middle Kingdom and underscores the fear of the coming threat of China in the global system. This change is reflected in the difference between China's recent economic management policies and those in the previous economic cycles, which indicates that Beijing's policy might have evolved toward a commitment to structural reform even at the expense of economic growth.

But skeptics still doubt Beijing's willingness to make structural changes, as many of the new policy initiatives continue to look at odds with market-determined resource allocation. The real question is whether market forces will work to improve China's system, as conventional wisdom has assumed. What if the market fails in China? Meanwhile, U.S. President Donald Trump's "America First" policy is aggravating the risk of Chinese hardliners pushing for policies to protect national security over continued opening up. If market forces do not work as intended in China and if China really goes back on liberalization, what would all this mean for the world?

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A STRUCTURAL CHANGE

In the past easing cycles (2008–2009, 2011–2012, 2014–2015), Beijing used the same bailout tool kit of subsidies for corporate investment, measures for boosting the property market, and subsidies for household consumption, along with instructions for the People's Bank of China to pump liquidity and cut interest rates significantly, for the commercial banks to engage in a lending frenzy, and for the state-owned enterprises and local governments to borrow and invest in infrastructure. The purpose was to boost growth.

China's economy has shifted from export-led to domestic-led growth.

However, in managing the economic downturn that started in July 2018, China has been highly selective in the fiscal, monetary, and regulatory stimulus it has provided. Hawkish policy messages that insist on no wholesale reflation have often accompanied the targeted easing measures. This new easing approach shows Beijing's commitment to prioritizing growth quality over quantity via structural reforms and debt reduction. Massive liquidity injection, for example, appears to be a thing of the past.

There are two main reasons for this change in policy tactics. First, Beijing's policy objective has changed significantly, with Chinese President Xi Jinping's administration prioritizing growth quality and financial stability through reduction in excess capacity and debt growth maximization. Second, there are policy constraints stemming from the difference between the backdrop of this and the past cycles. This time, the economy has a lot of debt, the renminbi has weakened, and the current account surplus has dropped to around 1 percent of GDP, while in the previous cycles China had much less debt, a strong renminbi, and a large current account surplus.

Under this "new normal" policy direction, which aims at keeping GDP growth at a moderate (6 percent to 7 percent) range while implementing structural reforms and paring debt, China's total factor productivity growth is expected to recover from the decline in the previous years.

Previous debt-fueled excess investment in upstream industries, property, and infrastructure led to sluggishness or decline in productivity growth. President Xi's new normal policy has shown some initial success, with improving marginal efficiency of debt financing leading to an improvement in growth quality as seen in the rise in the output-credit ratio.

To maintain domestic supply chain competitiveness, attract foreign direct investment, and address the developed world's criticisms on its trade and investment practices, Beijing has embarked on cutting taxes and loosening foreign ownership restrictions, and pledged to improve intellectual property protection regulations and increase penalties on property rights violations.

SKEPTICISM ABOUT MARKET REFORM

However, many players remain unconvinced of Beijing's willingness to let market forces play a bigger role in the system. Indeed, many of the new policy initiatives seem to be in conflict with market principles. Notably, the Chinese insurance and banking regulators' proposal in November 2018 to set a "1-2-5" target for bank lending to the private sector has raised serious concerns about Chinese banks being asked to provide a "national service" to support growth at the expense of their profitability.

China's Ambitions

The risk of China turning inward is not likely. From a self-interest perspective, since China is a major export market for many Asian economies, closing itself off would hurt its neighbors' economies, thus destabilizing China's "backyard." This, in turn, would hurt Beijing's ambition to become the regional leader in Asia with global influence, which is one of the goals that President Xi Jinping wants to achieve by 2049 in his "Chinese Dream."

—*C. Lo*

President Xi Jinping

The "1-2-5" lending target proposes that private sector loans should account for at least one-third of new corporate loans at large banks, two-thirds at medium and small banks, and 50 percent at all banks in three years starting from the date of implementation.

The regulators have also asked banks to lend at lower interest rates than normal corporate loan interest rates to small and micro enterprises since July 2018. The market estimates that these initiatives could add ¥1 trillion to ¥2 trillion of bad loans to the banking system in three years, and the lower interest rate for small businesses was generally unprofitable for banks.

China has tried to speed its opening process since the trade dispute with the United States intensified in June 2018.

While these new policies aim at overcoming banks' reluctance to lend to the private sector, the more crucial question is whether banks' aversion to private sector lending is a market decision of capital allocation or a result of market failure? It is both.

Lending to the state-owned enterprises is less risky due to Beijing's implicit guarantee policy. Private businesses have no implicit guarantee and are smaller and, thus, riskier. So the banks seem to be making a rational market-determined choice. However, the private sector has consistently outperformed the state-owned enterprises in their financial returns, and many of China's most successful businesses are private companies. But banks have denied lending to them, so private companies have to rely on expensive venture capital or even shadow financing.

This phenomenon reveals the irony that the supposedly market-driven banks have persistently failed to pick winners. It also suggests market failure in the Chinese banking system and argues for policy intervention to correct the situation. Of course, China needs structural reforms to correct the distorted incentives in its capital allocation process. But these will take time and are hard to implement in the short term. Meanwhile, Beijing has embraced debt reduction, which has hurt the private businesses more than the state-owned enterprises.

All this is not to deny the healthy dose of skepticism about Beijing's market liberalization motive, which is indeed a conundrum that the Communist Party has to resolve. This puzzle has roots in the fact that the Communist Party's ideology of control clashes with the economic reform spirit of market freedom. The point is that the new monetary policy and regulatory initiatives to force banks to lend more to the private sector are, arguably, stop-gap measures to reduce the negative externality of the deleveraging policy.

Suspicion about Beijing's market liberalization resolve raises another question: Is it turning inward to counter the external pressure on constraining its expansion and the internal deflationary pressures of structural reforms and deleveraging?

RISK OF CHINA GOING BACK ON LIBERALIZATION

China's economy has shifted from export-led to domestic-led growth as net exports—a component of GDP—have stopped contributing to GDP growth since 2009. Meanwhile, domestic consumption has been contributing more than 60 percent of GDP growth since 2015 and the trend is rising, albeit very slowly. Other data seem to show that China's opening-up process has

Unintended Consequences

President Trump's "America First" approach has increasingly been seen by China as hostility to its ascent in the global system. On the one hand, this could create a benign unintended consequence for China by rallying more domestic support for President Xi's structural rebalancing efforts. On the other hand, China's hardliners could hijack this hostile perception and push for defending national security and reversing the opening-up policy.

The risk to the world is that an aggressive U.S. foreign policy could prompt an aggressive Chinese resistance that would hurt the world by creating a downward spiral in global trade and investment dynamics. Rising Sino-U.S. trade tensions are already raising concerns that slower growth in China, Europe, and the United States in 2019 would lead to a global recession later.

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lost momentum, raising concerns about an inward policy shift in the future.

For example, after a long steady decline from 16 percent when it joined the World Trade Organization in 2001 to 7 percent in 2014, China's average tariff rate has risen back up to 8 percent since 2016. This rate is more than double the U.S. and European average rates. Meanwhile, invisible barriers to foreign investment, especially in the services sector, have remained high, and Beijing's "Made in China 2025" industrial policy, launched in 2015, has provided policy subsidies for local companies in high priority (mainly high tech) sectors such that many foreign countries have cried foul.

RISK TO THE WORLD

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Meanwhile, some Chinese national security hawks have "demonized" the Belt and Road initiative, forcing Beijing to scale back on this ambition. The slowdown in Belt and Road will inevitably reduce one of the much-needed resources of development finance for infrastructure investment and public goods in the developing world.

RISK CONTAINED

Nevertheless, the risk of China turning inward is not likely. From a self-interest perspective, since China is a major export market for many Asian economies, closing itself off would hurt its neighbors' economies, thus destabilizing China's "backyard." This, in turn, would hurt Beijing's ambition to become the regional leader in Asia with global influence, which is one of the goals that President Xi wants to achieve by 2049 in his "Chinese Dream."

Furthermore, a reduction in trade could erode China's structural reform momentum. Beijing has already slowed down its debt reduction and structural reform efforts since July 2018 to protect growth during the trade war with the United States. If it were forced to turn inward and pump-prime the domestic sector further to boost growth, that could derail the reform plans. Closing itself off would also erode the incentive stemming from foreign competition to overhaul the state-owned enterprises, whose investment returns are far inferior to those of the private sector.

Indeed, China has tried to speed its opening process since the trade dispute with the United States intensified in June 2018. Beijing, with the blessing of senior officials including Premier Li Keqiang, has approved some significant foreign direct investment deals, allowing multinational corporations including Tesla, ExxonMobil, German chemical giant BASF, and German automaker BMW to set up wholly owned factories in China or acquire majority (75 percent) stakes in their Chinese joint-venture partners.

By committing to these foreign direct investment deals by pushing back against vested interests and reactionary forces,

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Beijing seems keen to show that it has finally understood the "promise fatigue" among foreign investors and is trying to correct the problem. These recent moves complement Beijing's other policy measures, especially tightening on intellectual property protection policy, to address the developed world's complaints about China's structural behavior.

Failing to heed these subtle changes in China's economic management policy risks misreading the China challenge and making erroneous policy and business decisions to meet that challenge. ◆