China’s Key to Sustainable Growth

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China’s massive underemployment problem—an army of surplus labor estimated at about 200 million persons—has been characterized as the “real” global imbalance to which China and the world will have to adjust. Some observers have argued that, in coping with this problem, China’s salvation can come only from the dynamic foreign-financed export sector, because the domestic financial sector is moribund and irremediable. China’s exchange rate policy is seen as essential to this approach, a key to sustaining its export growth.

Economic data do not, however, support the contention that the exchange rate is the main determinant of China’s export growth. More importantly, at this stage of its development, China could not continue thriving on a predominantly export-oriented growth strategy. Especially given China’s size, development of domestic demand will be essential to its long-term stable and sustainable growth. This, in turn, will depend critically on reforming and further developing the financial sector.

In China, national savings amount to almost half of GDP. For a developing economy, high saving in principle has the benefit of providing cheap and abundant capital that can help generate growth in employment and output.

For want of other financial investment opportunities, however, most Chinese savings end up as deposits in state-owned banks, which have done a poor job of intermediating these funds. This money has helped fuel a recent investment boom, with gross investment now amounting to about 45 percent of China’s GDP. A significant fraction of this investment has been undertaken by state enterprises concentrated in a few sectors, suggesting that much of this investment may not be productive or could result in a buildup of excess capacity in those sectors.

Thus, even as China has become the world’s manufacturing workshop, the financial system has been building up significant new unproductive assets by continuing to support old domestic-oriented firms. This growth strategy is akin to filling a bucket that has a big hole in the bottom. Would it not make more sense to fix the banking system?

The authorities clearly view this as a crucial reform priority. Incentive systems are gradually being changed and the recent liberalization of lending rates will eventually help banks to make more commercially-oriented lending decisions. The authorities have also long argued that such domestic reform priorities that are essential for stable and robust long-run growth are far more important than exchange rate flexibility.

But financial sector restructuring can not be divorced from other policies. It is inevitable that policy choices such as the exchange rate regime enter into the picture. Maintaining a fixed exchange rate reduces the independence of China’s monetary policy. In the face of capital inflows and pressures for appreciation, the government is forced to keep interest
rates low. This implies cheap, subsidized capital to banks and firms. The government then has little choice but to use administrative measures (including moral suasion) rather than market-oriented measures to control growth in lending and investment. This is not consistent with training the banking system or state enterprises to respond to market incentives.

With investment growth at unsustainably high levels, less repressed interest rates would give banks strong incentives to assess risk more carefully and price their loans based on the commercial viability of their borrowers. This would impose a higher cost of capital on weaker firms (an option that is already available to banks but which they seem reluctant to use), thus reducing their profits and making it harder to justify lending to state enterprises that are only marginally viable. This could also help reorient lending towards relatively more efficient private sector enterprises.

But wouldn’t such measures depress domestic demand? And worse, wouldn’t a decline in investment reduce China’s long-term growth prospects? We think not.

First, if the efficiency of investment improves and thus provides a higher expected return on saving, the fraction of income that is saved by individuals, who may be targeting a particular level of post-retirement saving, could fall. Second, if more careful investments reduce the risk of boom-bust cycles, households would have a lower need for precautionary savings. Moreover, a high investment rate is hardly the way to economic nirvana if such investment is misdirected with scant regard for commercial principles.

Given the dominance of China’s banking sector in its financial landscape, restructuring the banks is a key priority. But development of the broader financial sector, including equity and bond markets, is crucial as well. This would provide much-needed competition to the banking sector by giving savers a wider range of investment and borrowing opportunities and giving firms alternative sources of funding.

There is, unfortunately, no magic wand in the form of a clearly-defined template about how best to kick-start financial sector development and reform. And there are numerous risks associated with developing these markets, which will require careful supervision and regulation. In tackling these difficult challenges, it would surely help Chinese policymakers to do away with the constraint of maintaining a fixed exchange rate and the attendant distortions that it requires.

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