Reform or Perish

The Communist Party knows what it needs to do. What's missing is the will.

BY MICHAEL PETTIS | NOVEMBER 7, 2012

BEIJING — Now for the hard part. After three decades of astonishing economic growth, powered by a first set of radical reforms in the late 1970s and early 1980s and a second set in the mid-1990s, China's incoming leaders are facing what might be the country's greatest economic and political challenge. They must create a new growth model, with a very different financial system, a substantially modified state sector, and the political reforms necessary to accommodate both.

How these seven (or nine) men respond to these challenges in the next five to 10 years will determine the country's long-term growth prospects. If they succeed, China will continue to grow, albeit more slowly, and could even one day join the tiny club of formerly poor countries like South Korea that have attained developed-country status. If they mismanage the adjustment, growth will evaporate, leaving China stuck in the notorious **"middle-income trap"** from which few developing countries have ever escaped.

Given its astonishing success in implementing economic reforms and engineering rapid growth, it is tempting to believe that Beijing has the talent, far-sightedness and determination to make the transition successfully. History, however, suggests otherwise. Many countries that followed variations of China's investment-driven model have grown miraculously for a decade or more, but few managed the move to developed-country status.

Take the Soviet Union. By the 1960s, the USSR had generated nearly three decades of exceptional growth, leaving most analysts convinced that it would soon surpass the United States economically and technologically. It didn't happen. Real productivity growth stalled by the late 1960s, and today, nearly 50 years later, Russia's GDP is smaller in relative terms from its peak. Brazil saw extraordinary growth from the late 1950s to the late 1970s, but fell back during the "Lost Decade" of the 1980s and has still not achieved the economic successes many expected nearly a half century ago.

China's spectacular growth over the past 30 years, like that of the USSR and Brazil before it, was made possible mainly by the ability of policymakers to control credit and unleash waves of investment when needed. This allowed Beijing to keep growth rates high regardless of the circumstances and no matter how the leadership managed domestic problems. It was able to avoid a surge in unemployment when it restructured the hugely inefficient state-owned industries in the 1990s by sharply increasing infrastructure investment. Investment spending helped it smooth over the social dislocations caused by its rigid and antiquated political structure. It eased political conflicts and factional fighting by directing billions of dollars into pet projects, much of which the politically connected have since siphoned off. China grew vigorously through the Asian crisis of 1997, the Chinese banking crisis a few years later, and, the collapse of the global economy in 2007-08. In each case, unrestricted access to savings allowed China to power growth by pouring cash into the projects of its choice.

But no longer. Officially, government debt is under 25 percent of GDP, but it's likely much higher. Investment has reached its limit, and now excess investment has itself become China's greatest economic problem. Many years of high and often wasted investment in such baubles as empty airports, bridges to nowwhere, vacant office buildings, and underutilized steel factories have resulted in debt levels growing much faster than the ability to service that debt. And more "investment" only worsens the problem.

With the loss of its most powerful tool for economic management, Beijing must change its growth model. And it will. The fierce debate among Chinese economists and policy advisors over the past two years suggests that Beijing knows it must sharply reduce investment rates.

But doing so causes two problems. First, without the ability to increase investments at will, China's economic volatility will increase sharply. Second, if China can no longer depend on investment growth to drive high levels of economic activity, it must increasingly rely on growth in household consumption, which, at 35 percent of GDP is the lowest seen anywhere in modern history.

What can Beijing do to ensure continued rapid consumption growth? Contrary to myth, China's low consumption rate has nothing to do with the fabled Chinese propensity to save. Because China's wealth distribution is extremely unequal, the rich consume a far lower share of their income than the poor, reducing consumption overall.

More importantly, at under 50 percent of GDP, Chinese households control a very low share of the country's total income. While their wealth has grown substantially in the past few years, the economy overall has grown far more quickly, leaving them with a constantly falling share of the total.

To spur growth in household consumption, Beijing needs to redistribute wealth and spur the growth of household income. The former is always hard to do, and if economic activity slows with the reduction in investment growth rates, as it must, the latter will also be difficult.

Beijing must directly or indirectly transfer to the household sector some of the tremendous wealth accumulated by the state sector over the past three decades, for example, by privatizing companies and using the proceeds to shore up the social safety network, or granting land title to peasant farmers. Chinese households could then substantially increase

consumption to compensate partially for a rapid reduction in investment. This would keep China's economy growing in a healthy way.

Beijing, in short, must bring investment rates down quickly before the country experiences debt problems. But to keep growth from collapsing it must also boost household consumption by transferring wealth from the state and the elite to the middle and lower classes. The scale of these transfers, however, will disrupt domestic politics and will require the kinds of reform in political and financial institutions that are sure to unleash substantial opposition.

The task is urgent but difficult, one that is likely to cause tremendous strain on the political system. Powerful sectors and families will resist any elimination of the distortions that have rewarded them so bountifully. But if these distortions are not eliminated, China's economy, like that of many before it, will stall, and its astonishing transformation will be a thing o the past.

The more successful China's new leaders are in managing this adjustment, the better for everyone -- not just in China but all over the world. The United States and Europe should accommodate a China that implements real structural reforms and rebalances its economy in a healthy way by tolerating some flexibility in the trade and capital accounts as Beijing as it faces its most difficult reforms yet.

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