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The Path to Sustainable Growth in China

Eswar S. Prasad¹

Tolani Senior Professor of Trade Policy, Dyson School, Cornell University
Senior Fellow & New Century Chair in International Economics, Brookings Institution

Chairman Reinsch, Vice Chairman Shea, and honorable members of the Commission, thank you for the opportunity to share with you my views on the status of market-oriented economic reforms in China and the implications for its domestic growth prospects and for the world economy. In this testimony, I will also evaluate progress on some of the reform priorities identified in the twelfth five-year plan (which covers the period 2011-15) and discuss possible priorities for the thirteenth five-year plan (covering the period 2016-20).

Over the past year, China’s GDP growth has slowed significantly, producer prices continue to fall, and various other indicators of economic activity have weakened, including growth in industrial production, investment, and imports (Figures 1-3). In short, the headline data indicate that the economy is losing growth momentum. On the other hand, there has been some progress on growth rebalancing—the consumption to GDP ratio is up slightly, and the services sector’s share in the economy has continued to rise.

What do these developments portend for the future of the Chinese economy? Separating the trend from the cycle, especially in real time, is a challenge in any economy and especially for a developing economy that is still undergoing massive structural change in many dimensions. As the economy matures and becomes richer, both in terms of absolute size and per capita income, traditional convergence effects alone would dictate a slowdown in China’s growth.² But China still has considerable growth potential and a long way to go in its transition to even an upper middle-income economy. The economy faces many risks emanating from the rapid but in some

¹ I am grateful to Karim Foda for excellent research assistance.

² A related argument is that China will soon be subject to a middle-income trap—an empirical regularity that countries face growth slowdowns when their per capita income hits a certain threshold. See Barry Eichengreen, Donghyun Park, and Kwanho Shin, 2013, “Growth Slowdowns Redux: New Evidence on the Middle-Income Trap,” NBER Working Paper No. 18673. Another argument is that episodes of high growth tend to be followed by periods of markedly slower growth, and that persistently high growth of the sort China has experienced over the last three decades is already a statistical anomaly and is unlikely to last. See Lant Pritchett and Lawrence Summers, 2014, “Asiaphoria Meets Regression to the Mean,” NBER Working Paper No. 20573.

respects unbalanced growth that has vaulted it to its present status as the world's second largest economy.

The path that China's economy takes will depend to a large extent on the successful implementation of the reforms that were articulated in the twelfth five-year plan and that will need to be carried forward in the next five-year plan, which will be developed during the course of this year.

The stated desire of China's new leaders to promote economic reforms provides grounds for cautious optimism. The broad objective of the twelfth five-year plan is to reorient growth to make it more balanced and sustainable, even if it means settling for slower average growth than in the previous decade. The thirteenth five-year plan is likely to provide further impetus to reforms that improve the country's pattern of economic development. The challenge for the new leadership is to break down the opposition of interest groups that prefer the status quo and to implement reforms needed to attain their stated objectives. There are also economic challenges in the reform process itself as some of the reforms are risky and could generate unexpected outcomes in an economy that is beset by many problems and distortions.

Progress on the Twelfth Five-Year Plan

The twelfth five-year plan that was approved by the National People's Congress in March 2011 appeared to herald a turning point in China's economic development. It represented, at least in rhetoric, a marked shift in emphasis from high growth to the quality, balance, and sustainability of that growth. The longer-term objective of the plan was to reorient growth to make it more balanced and sustainable from different perspectives--economic, social, and environmental.

Small Steps in the Right Direction

There were promising signs of a push for reforms in the first half of 2012, as a number of modest but significant actions signaled progress towards economic reforms. The central government made some opportunistic moves to kick-start momentum on a few key measures. It increased the flexibility of the exchange rate (in principle) when the renminbi was not under pressure to appreciate, relaxed the cap on interest rates paid on bank deposits, increased foreign investors' access to capital markets, and encouraged certain informal financial firms to become part of the formal banking system. Each of these moves had broader significance.

For instance, giving informal financial firms the opportunity to join the formal banking system served multiple ends. It brought these institutions under the ambit of the banking regulator and was an attempt to reduce the risks they posed to financial stability. Moreover, they now provide more overt competition for established banks.

To overcome resistance to liberalizing deposit rates and abandoning the fixed spread between deposit and loan rates (thereby cutting in to bank profits), the government cleverly took a small step when it cut rates—freeing up banks to offer deposit rates

marginally higher than the base rate, arguing that this would make the rate cut more palatable to depositors.

These modest steps towards reforms came to a halt in the latter half of 2012, partly due to some unexpected political turmoil in the lead-up to the leadership transition that got underway in the fall of the year.

A Fresh Boost to the Plan Objectives

The new leadership of President Xi Jinping and Premier Li Keqiang has made financial sector and market-oriented reforms a centerpiece of its economic plan. The communiqué of the Third Plenary Session of the eighteenth CPC Central Committee, released in November 2013, laid out a broad strategy of market-oriented reforms but in a manner consistent with a dominant role for the state. This apparent contradiction indicated that the government does not intend to upend state control of key enterprises but, rather, subject them to greater market discipline. Still, the communiqué set out a time frame of five-six years for a set of substantive market-oriented reforms. The commitment to reforms seems to have generated some positive effects although the reforms themselves are relatively modest so far.

Rebalancing the Economy

A major objective laid out in the twelfth five-year plan was to rebalance domestic growth and increase the share of private consumption in GDP. This is seen as necessary to ensure greater social stability by increasing the benefits that accrue to the average household from China's strong GDP growth. In addition, shifting away from a capital-intensive production structure is important for increasing job growth and ameliorating the destructive environmental consequences of rapid growth. There has been at best incremental progress on these dimensions. However, external imbalances have shifted down sharply, with both the trade and current account surpluses remaining at low levels while the accumulation of foreign exchange reserves has fallen sharply.

Internal Rebalancing: Modest Progress

Investment growth propelled China's growth over the last decade, accounting for more than half of GDP growth.³ During and right after the financial crisis, investment growth was crucial for sustaining economic momentum. Both real estate investment and infrastructure investment have been important contributors to overall investment growth in recent years.

For an economy with a capital stock per worker ratio that is about 9 percent of the U.S. level (as estimated by the World Bank), additional investment in physical capital seems desirable. However, much of the investment that China has undertaken in recent years has been financed through loans provided by state-owned banks, raising concerns about the emergence of nonperforming assets on the books of the large state-owned

³ For more details, see Eswar Prasad, 2009, "Is China's Growth Miracle Built to Last?" *China Economic Review*, Vol. 20, pp. 103–123.

banks if these investments turn out not to be commercially viable. Investment-led growth meant that employment growth, which has averaged less than 1 percent a year over the last decade, was relatively muted compared to the fast pace of output growth.⁴ This pattern of growth also has deleterious environmental consequences.

The Chinese government has had to cope with the twin challenges of boosting domestic consumption in order to make growth more welfare enhancing for its citizens and of generating higher employment growth in order to maintain social stability. The growth model fostered by government policies had, until recently, resulted in a rising share of investment and a declining share of private consumption in GDP. Moreover, weak employment growth and high investment growth had resulted in labor income falling as a share of national income and personal disposable income falling as a share of GDP. The government has also been trying to channel more bank credit towards the services sector, which has the potential to provide more employment.

Since 2011, there has been progress in many of these dimensions. Consumption growth (private plus government consumption) overtook investment growth as the main contributor to overall GDP growth in 2011-12, although the relative growth contributions of consumption and investment have been roughly equal over the period 2013-14 (Figure 4). In 2012, the share of private consumption in total GDP stopped declining and rose slightly, although the level of this ratio—at 37 percent in 2014—still remains well below that of virtually every other major advanced or emerging market economy (Figure 5).

Another positive development is that, from 2011 to 2014, the share of the service sector in GDP rose by about 4 percentage points to a level of 48 percent (Figure 6). The share of the industrial sector has fallen by a corresponding amount over this period, and now accounts for 43 percent of GDP. This is a marked change from the situation in 2005, when the share of the service sector in GDP was 41 percent and that of the industrial sector was 47 percent.

Moreover, the Chinese household saving rate, which had trended upward during the previous decade, has finally begun to decline (Figure 7). For urban households, household saving as a share of disposable income declined from a peak of 32 percent in 2012 to 31 percent in 2014. Factors such as rising wages have helped boost consumption demand. Other fundamental reforms, including a stronger social safety net and a better government-funded health care system, will be necessary to further shift consumption patterns of Chinese households by reducing precautionary saving.⁵ The twelfth five-year plan had acknowledged these issues and proposed a number of

⁴ The annual growth rate of non-agricultural employment averaged around 2.5 percent during this period, although this in turn has to be set against the growth rate of non-agricultural output, which has been 2-3 percentage points higher than that of overall GDP.

⁵ For an analysis of the factors driving the trend increase in saving rates of urban households, see Marcos Chamon and Eswar Prasad, 2010, "Why Are Saving Rates of Urban Households in China Rising?" *American Economic Journal: Macroeconomics*, Vol. 2, No. 1, pp 93–130; and Marcos Chamon, Kai Liu, and Eswar Prasad, 2013, "Income Uncertainty and Household Savings in China," *Journal of Development Economics*, Vol. 105, pp. 164-177 .

measures that would increase the coverage and extent of government financing of health care, pensions, and the broader social safety net.

There are other aspects of balanced growth where the government has taken measures that seem to have yielded at least modest results. Growth needs to become more balanced in terms of reducing regional disparities in economic development, especially when one compares the coastal versus the interior provinces. To respond to this issue, the government has directed large amounts of infrastructure funds towards interior provinces through the Develop the West campaign. The rise in food prices in recent years has reduced rural-urban income disparities although both official data and estimates by academics suggest that overall inequality, as measured by the Gini coefficient, remain very high by international standards.

In short, the picture that one can paint with macroeconomic data is one of small but notable improvements in the balance of domestic growth in most dimensions, although there are many underlying risks that are being masked by high growth. Maintaining high and stable growth, even if somewhat below the levels of the past decade, is therefore an important objective of policy reforms.

Significant Progress on External Rebalancing

China's current account and trade surpluses have shrunk markedly relative to their peaks in 2007, when they hit 10.1 percent of GDP and 7.6 percent of GDP, respectively. In 2014, the current account surplus was 2.1 percent of GDP, up slightly from 1.9 percent of GDP in 2013 (Figure 8). The trade surplus rose to 3.7 percent of GDP in 2014, up from 2.8 percent of GDP in 2013. In the early months of 2015, both export and import growth have fallen sharply, reflecting weak external and domestic demand conditions.

In March 2014, the daily fluctuation band of the renminbi-dollar exchange rate was widened to 2 percent on either side of a reference rate set by the People's Bank of China (PBOC). In practice, China has maintained a policy of tightly managing the value of the renminbi relative to the U.S. dollar. The renminbi is one of the only major currencies that has not depreciated significantly relative to the U.S. dollar. Over the past twelve months, the renminbi's value has fallen by only 0.2 percent relative to the U.S. dollar. As a consequence, over this period, the renminbi has appreciated by 21 percent relative to the euro and by 15 percent relative to the Japanese yen (Figure 9). On a trade-weighted basis (either nominal or inflation-adjusted), the renminbi has appreciated by 8 percent since March 2014 (Figure 10).

China's foreign exchange reserves, which rose by \$509 billion in 2013, increased by only \$22 billion in 2014 (Figure 11). In the last half of 2014, China's reserves in fact fell by \$150 billion. This was partly accounted for by valuation effects as the dollar value of China's holdings of euro and yen-denominated assets declined due to the depreciation of those currencies relative to the U.S. dollar. The remainder signals intervention by the PBOC to keep the renminbi's value relative to the dollar stable in the face of large shifts in its balance of payments.

These shifts are attributable to two factors—the lower level of China’s trade surplus in recent years and the deficit on the capital account, implying that more capital (other than accumulation of reserves) flowed out of the country relative to the amount that came in. This represents an important change in the nature of China’s overall capital exports (which is roughly equivalent to the current account surplus). Balance of payments data show that, in 2014, China’s current account surplus was \$214 billion while the increase in international reserves, which effectively amounts to official capital outflows, was \$22 billion. This implies that private net capital outflows amounted to about \$192 billion.

The capital account deficits have sparked concerns about capital flight, with the connotation being that domestic residents and corporations that see trouble brewing on the domestic macroeconomic front are sending capital out of the country. A more benign interpretation, one which I favor, is that rising capital outflows are a natural consequence of steps that China is taking to open up its capital account and remove restrictions on outflows. As the economy matures and financial markets develop, domestic retail and institutional investors will look to foreign investments as a way of diversifying their portfolios. Moreover, Chinese corporations and financial institutions are in quest of investments abroad to diversify their operations and as a conduit for acquiring technical and managerial expertise.

Tension between Growth and Reforms?

One of the central questions now facing Chinese policymakers is the following—can China maintain high growth without a further massive expansion of credit and while undertaking economic reforms? A number of analysts have argued that these two sets of goals cannot be achieved simultaneously and that a substantial shift away from an investment-led growth model would necessarily require a sharp slowdown in growth to the 3-4 percent range.⁶ My view is that reforms and rebalancing are compatible with growth in the range of 6-7 percent over the next couple of years. Of course, there is general agreement that high growth built on a shaky foundation of rapid credit expansion without reforms and rebalancing would be undesirable and risky. In considering the delicate balancing act that the Chinese government faces, it is useful to first consider the risks.

Risks

Even the relatively benign picture of growth rebalancing depicted earlier is not without risks. The level of investment remains high, at nearly 47 percent of GDP. This investment boom is to some extent feeding on itself—so long as financing is available for construction and infrastructure projects, investment in ancillary industries pays off. But the slowdown in the investment machine is already exposing excess capacity in

⁶ This view has been articulated forcefully by Michael Pettis. See, for instance, the Pettis-Prasad Bloomberg Debate: http://www.bloombergbriefs.com/content/uploads/sites/2/2015/03/SC_031615-Pettis-Prasad-Debate.pdf For a more nuanced view, see Martin Wolf “China Will Struggle to Keep its Momentum,” *Financial Times*, April 7, 2015.

industries such as cement, steel, aluminum, and hard glass. This will dampen employment and household income growth. Banks fear a resurgence of bad loans on their books if consumption demand doesn't grow fast enough to soak up output from the new factories. In turn, a weakening of domestic consumption growth could eventually increase the dependence on export-led growth, exactly the reverse of the balanced private consumption-led economy that Chinese leaders want.

The drop in housing market prices is another potential source of risk to both the real economy and the financial sector. Residential investment growth has been an important component of overall investment growth, so its sharp decline could presage a significant reduction in GDP growth. The direct financial system risks are likely to be limited since residential mortgages are still not widespread, large down payments provide a buffer against modest declines in house prices, and it is believed that only a few large developers are exposed through high leverage. But the knock-on effects could be large as many of the industries that feed into residential construction would end up with high levels of spare capacity.

The high level of debt in the economy is emblematic of the tensions inherent in China's unbalanced and unsustainable growth model. A recent report by McKinsey estimates that China's total debt level reached 282 percent of GDP in 2014.⁷ While the level of gross debt in China is certainly high, the fact that much of this debt accumulation is financed by China's domestic savings suggests not so much a source of financial risk as of major inefficiencies and waste because of a broken system of allocating capital. Since the state owns most of the key creditors and debtors, it is less likely that a financial shock could set off a cascade that results in a financial crisis or a collapse in growth. Nevertheless, resolving some of this debt will impose a large burden on the economy in the future.

Striking a Balance on Reforms

On the positive side, there is clearly commitment to deal with these problems including the rapid accumulation of debt. Whether policy makers can do so without severely crimping growth, given the significant economic and political constraints to reforms, is the key question. The actions of the PBOC over the last year highlight the difficult tension the government faces.

The PBOC has mainly relied on a variety of indirect measures to support economic activity rather than unleashing a rapid expansion of credit that could add to the existing problems. Some of these measures have involved expanded government funding for development banks, cuts in reserve requirements for smaller banks, and incentives to banks for lending to specific sectors of the economy. The irony of course is that such measures vitiate the objective of financial market reforms as they involve a state-determined allocation of resources. But at least they signal that the PBOC is trying to limit the damage rather than rolling back reforms. Concerns about slow growth have,

⁷ The estimated breakdown is as follows--Government: 55 percent of GDP; Financial institutions: 65 percent of GDP; Nonfinancial corporations: 125 percent of GDP; Households: 38 percent of GDP. See McKinsey Global Institute "Debt and (Not Much) Deleveraging" February 2015.

however, led to two of cuts in policy interest rates and one reduction in the required reserve ratio in recent months [a further RRR cut of 1 percentage point was introduced on April 19, 2015, after the official version of this testimony was submitted]. This has resulted in a slight uptick in the rates of growth of credit and M2 (Figure 12). Given the slowing growth momentum, more of these broad monetary easing measures are in prospect and could pose a challenge to the objectives of pushing forward banking reforms and rebalancing the economy by reining in investment growth.

The government has not fully unleashed one weapon that could support growth in the short term and facilitate longer-term rebalancing—fiscal policy. China's government budget deficit and explicit public debt levels remain low by international standards. Rather than accumulating more implicit debt through an increase in nonperforming assets in the banking system, it would be more efficient for the government to use fiscal policy directly to support growth and also promote longer-term growth rebalancing by strengthening the social safety net.

For instance, funding a more comprehensive catastrophic health insurance program could help restrain the savings of elderly households. A better safety net would reduce precautionary savings. And of course financial market reforms that generate higher returns on savings and allow for portfolio diversification, both domestically and abroad, could also reduce savings.

While the Chinese leadership might know what to do, slowing momentum on domestic growth and a weak external environment have eroded political support and tightened economic space for reforms. Yet, the government seems to remain committed to its agenda, although the pace and scope are certainly at very modest levels.

Are Reforms Compatible with High Growth?

There is substantial misallocation of resources in China so economic and financial sector reforms that result in improved resource allocation can help China maintain growth in the government's target range of around 7 percent even in the short run while promoting growth rebalancing. How is this possible? There are a number of inter-related strands underlying the argument, with the proviso that each of these represents a difficult but not insurmountable challenge.

First, labor reallocation. A large pool of unutilized or underutilized labor, especially in rural areas, remains to be tapped and drawn into productive employment. This is one objective of the government's urbanization program, although there may be better ways-- that involve less disruption and fewer congestion costs--of moving labor from unproductive sectors of the economy to more productive ones. This reallocation effect by itself can give a short-term boost to both aggregate productivity and GDP growth.

Second, an increase in private consumption growth can become a more important driver of GDP growth. This will require changes in the economy that generate more employment and diminish the precautionary savings motives of households. In some recent research (see footnote 5), I have found that a weak financial system (lack of diversification opportunities, inability to borrow against future income) and

precautionary savings driven by an inadequate safety net have contributed to rising household saving rates. The ownership structures of many firms and their financing sources also create incentives for higher corporate savings (retained earnings) that are then plowed back into investment, some of which has marginal value at best.

Third, directing more financial resources to parts of the economy that are better at generating employment, especially the services sector and small and medium enterprises, could add to employment growth. This would have the added benefit of reducing the capital intensity of growth.

Fourth, in the short run, fiscal policy can play a more effective role at supporting growth, creating fewer risks to the financial sector and promoting growth rebalancing (for instance, by strengthening the social safety net). In a nod to this, last month the government set a modestly higher deficit target for the coming fiscal year, although it would have been better to see that accompanied by more substantive changes in the composition of expenditures and the tax structure.

Fifth, the rate of investment growth can be maintained at a high level even if the expansion of bank credit slows if some of it is financed through alternative channels such as corporate bond markets. Moreover, even if investment growth declines by 1-2 percentage points, other components can make up for this.

Concerns about China's high rates of investment in physical capital are warranted. But China still has a much lower capital-output ratio than advanced economies such as the U.S. and still has vast needs for infrastructure in its interior provinces. The question is whether the allocation of domestic savings into domestic investment is being intermediated in an efficient manner that allocates capital to its most productive uses.

Of course, a cross-country comparison of capital-output ratios by itself is overly simplistic. Improvements in corporate governance, the financial regulatory framework, and legal reforms that underpin a market-oriented system are all essential for productive investment. President Xi has indicated that his government will push forward with reforms in these dimensions, but only to the extent that they are necessary for a market-oriented system to work better. Of course, one should have no illusion that they presage sweeping institutional, legal, or political reforms--President Xi has made it abundantly clear that those are not on the cards.

What will it take to generate the shifts in the economy I have outlined? A broader, more efficient, and better-regulated financial system is crucial to accomplish the different aspects of rebalancing laid out above. A more flexible monetary policy framework that is not hampered by a tightly managed exchange rate regime and a more supportive fiscal framework have to be part of the package. Institutional reforms and the freer play of market forces in the enterprise sector are necessary as well.

These are all major transitions, time is short, political opposition is strong, and the risks of stumbling are great. But so long as the government keeps moving in the right direction at a reasonable pace, the reforms and rebalancing can take place without the economy necessarily facing a sharp slowdown as a necessary concomitant to reforms.

The Reform Agenda

The main challenge for China, especially since it faces a rapidly aging population and a labor force that is likely to start shrinking soon, is to maintain rapid productivity growth. This will require a shift towards higher value-added production, a more efficient allocation of resources through a better financial system, and more balanced growth.

The twelfth five-year plan (the Plan) remains the blueprint for China's reform agenda. It lists a large number of reform priorities but has limited detail on specific courses of action for achieving the long-term objectives. In the remainder of this section, I selectively summarize a few key reform priorities. There are many more—including reforms to the tax and expenditure systems, pension reforms, reforms to corporate governance in state-owned enterprises—that I do not examine in detail.

For instance, the government has taken important steps to reform local government finances by capping their debt levels, modifying revenue-sharing and the federal-local sharing of responsibility of social expenditures, and allowing the direct sale of bonds rather than having local governments resort to special financing vehicles. The government also intends to reform of the "hukou" system of household registration that restricts the movement of rural residents to urban areas. China's leaders have stressed the importance of urbanization as an engine of growth and reform of the hukou system is seen as an important element of that process, which should also improve labor mobility more generally.

Financial sector development

Financial sector reform and development remain key priorities. The Chinese government recognizes that a more efficient financial system can play an important role in increasing productivity by reducing inefficiencies in the allocation of capital. A reformed banking system may also respond to incentives to lend more to small- and medium-sized enterprises, especially in the services sector, that tend to be better than large enterprises at generating employment.

China's banking system appears well capitalized and the ratio of nonperforming loans relative to assets for the overall banking system is low. These figures mask a number of well-known problems, including persistent incentives to lend to state-owned enterprises rather than private sector enterprises, weak risk management capacity that results in rationing of credit to small and medium-sized enterprises, and asset portfolios that include a large amount of subpar assets that may turn into nonperforming loans if GDP growth were to slow further.

The government has committed to full interest rate liberalization. Lending rates have already been liberalized and the PBOC has signaled that it will move towards full liberalization of deposit rates by the end of 2014. An explicit deposit insurance system covering deposits up to a certain threshold will also be instituted this year, in place of the implicit full deposit insurance that now exists. These reforms will give banks more leeway and the right incentives to price their deposit and loan products according to market conditions, improve competition, and impose some degree of market discipline

on banks. These developments will also improve the interest rate transmission channel for monetary policy. However, legacy problems that permeate the state-owned banking system—in particular, the large stock of outstanding loans to state-owned enterprises—will make it difficult to change distorted incentives in the banking system.

China's financial system remains bank-dominated, with limited corporate bond market development and limited scope of securities markets. The Plan recognizes the need to broaden and deepen financial markets in order to improve their overall functioning and enhance their contribution to balanced growth. But this remains an aspiration rather than an objective backed up by a well-defined strategy.

Capital account opening

China is eager to make the renminbi an international currency and has already taken a number of steps in that direction.⁸ While the Plan did not lay out a timeline for opening up the capital account and making the currency fully convertible, there are clear indications that this is seen as a policy objective over the next 5-10 years as it would set the stage for China's ascendancy in global financial markets and make the renminbi an international currency. Specific initiatives to open the capital account in a calibrated manner, such as the Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) schemes, have been expanded significantly. Other avenues to open the capital account, including the Shanghai-Hong Kong Stock Connect, and the Shanghai Free Trade Zone, have been undertaken and are apparently seen as providing templates for other cities in China to participate in such selective opening.

The Chinese government has recently taken a number of significant steps to increase the use of the renminbi in international transactions, including trade settlement. A number of international financial centers, including Frankfurt and London, have been authorized to conduct renminbi business and settlement. Furthermore, the PBOC has signed local currency swap lines with an increasing number of central banks, with the number of arrangements approaching 30.

Exchange rate flexibility

Appreciation pressures on the currency have given way to short-run pressures in the other direction, suggesting that a more flexible currency would depreciate in the short run. This could cause some tensions with the country's trading partners, even though China would only be responding to calls to make its exchange rate more market determined. In addition to concerns about currency volatility (and the limited availability of hedging instruments to deal with such volatility), this seems to be holding up the government from freeing up the exchange rate further. Still, a more flexible exchange rate regime is desirable and would serve China well in the long run, particularly as the

⁸ See Eswar Prasad and Lei Ye, *The Renminbi's Role in the Global Monetary System*, Brookings Institution Report, February 2012. Also see Chapter 12 in Eswar Prasad, *The Dollar Trap: How the U.S. Dollar Tightened Its Grip on Global Finance*, Princeton University Press, February 2014.

capital account becomes more open and it becomes more difficult to tightly manage the currency's value.

A more flexible currency would give the central bank a much freer hand in changing interest rates to meet the twin objectives of high growth and low inflation. Faster currency appreciation, which is likely to resume (if China's growth stabilizes and reforms continue) since China still has higher productivity growth than its major trading partners, would help rebalance growth by increasing the purchasing power of domestic households. This would happen directly through the fall in the price of imported goods and, at times of high inflation, also by giving the central bank room to raise deposit rates, giving households a better rate of return on their savings.

Industrial policy

The Plan laid out two sets of objectives in this area. The first is to upgrade and restructure a group of traditional industries. Industries such as iron and steel, automobiles, and textiles are identified as needing technical upgrading as well as consolidation to benefit from scale efficiencies. The second objective is to foster and develop strategic emerging industries that are intended to develop into future pillars of the economy. These tend to have a hi-tech or environmental focus and include energy conservation and environmental protection; bio-tech; high-end manufacturing equipment; and new energy (including nuclear and renewable energy). One concern that needs to be tracked carefully as these objectives are transformed into concrete policy measures is whether they will shift industry dynamics in a way that favors state-owned firms. This might have the effect of rolling back some of the gradual shift in the last two decades towards a more private sector-led industrial structure.

Summary and Implications for the U.S. and the World Economy

Since the financial crisis, China has made substantial progress on reducing its external imbalances, with the surpluses on both the current account and the trade balance falling sharply from their peaks in 2007. China has also made limited progress on domestic rebalancing, although physical capital investment intermediated through a weak banking system still remains a major contributor to growth.

There are substantial challenges to putting in place the reforms needed to improve the quality and efficiency of growth, continue the shift away from capital-intensive production, generate more employment, and allow more of the benefits of growth to filter down to the average household.

China's growth and reform process will have direct and indirect implications for the U.S. through a number of channels. Although its overall trade balance fell steadily and sharply from 2007 to 2012, the bilateral trade surplus that China runs with the U.S. has in fact increased and hit a peak of \$343 billion in 2014.⁹ If the shift towards private

⁹ These numbers are based on U.S. trade data. Chinese data show a smaller surplus of \$237 billion in 2014. These numbers are overstated because of the fact that about two-fifths of China's trade is processing trade, with relatively low value added in China.

consumption-led growth proves durable and intensifies, China's demand for imports of consumer goods and services would rise, especially if the exchange rate continues to appreciate. This could help boost U.S. exports to China. The ability of U.S. firms to take better advantage of this growing market of course depends on a number of factors, including the level of market access that is provided to them.

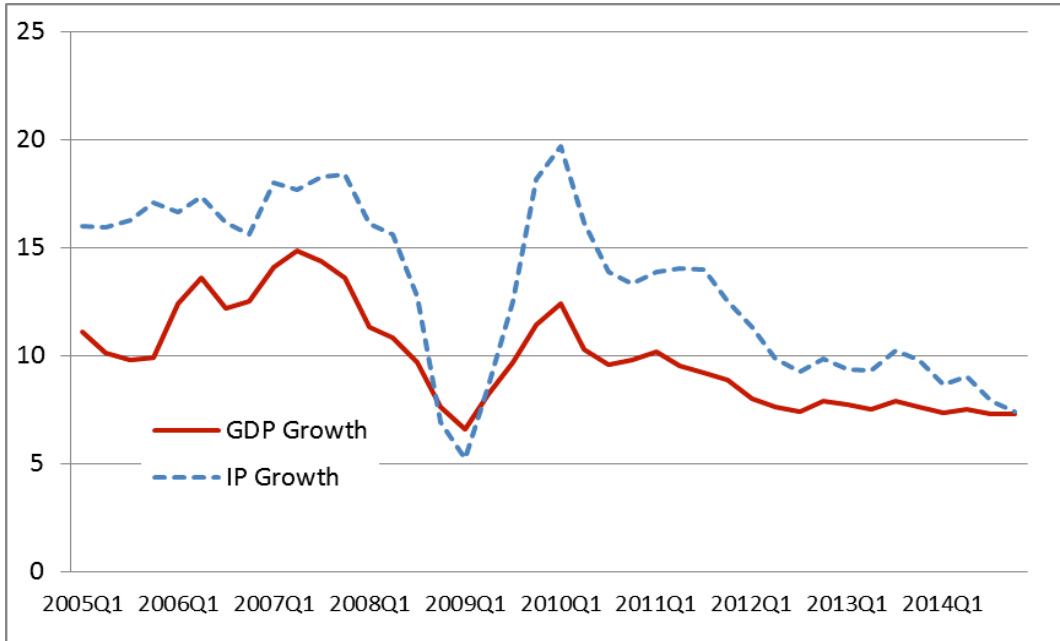
The pace of reserve accumulation is likely to remain low in the future and, as a consequence, China will demand fewer U.S. Treasury securities. Lower levels of official purchases of Treasuries could be offset by financial flows to the U.S. through other channels, including mergers and acquisitions activity, equity investments by state-owned enterprises and banks, as well as investments by private and institutional investors. Many of these investors may also choose to acquire U.S. Treasuries but probably not at the same level as official purchases by the central bank.

China is clearly taking some important steps towards upgrading its industries and moving towards more hi-tech and high value added production. With various incentives and explicit government support, China is likely to make quick progress in clean energy and information technologies. The U.S. and other advanced economies could start losing ground in new technologies if China successfully implements its strategy of technology leap-frogging. But there could also be many opportunities for U.S. companies to use their technological forte to gain a foothold in the Chinese market.

The Chinese economy faces many major risks arising from its pattern of unbalanced development and even the process of reforms has created its own challenges. Nevertheless, there are grounds for optimism that, if the government remains committed to reforms and can implement them at a reasonable pace, China can maintain growth at around 7 percent per year over the next 2-3 years. What happens in the longer term will depend to a great deal on what is done in the next few years to set the economy on the right course.

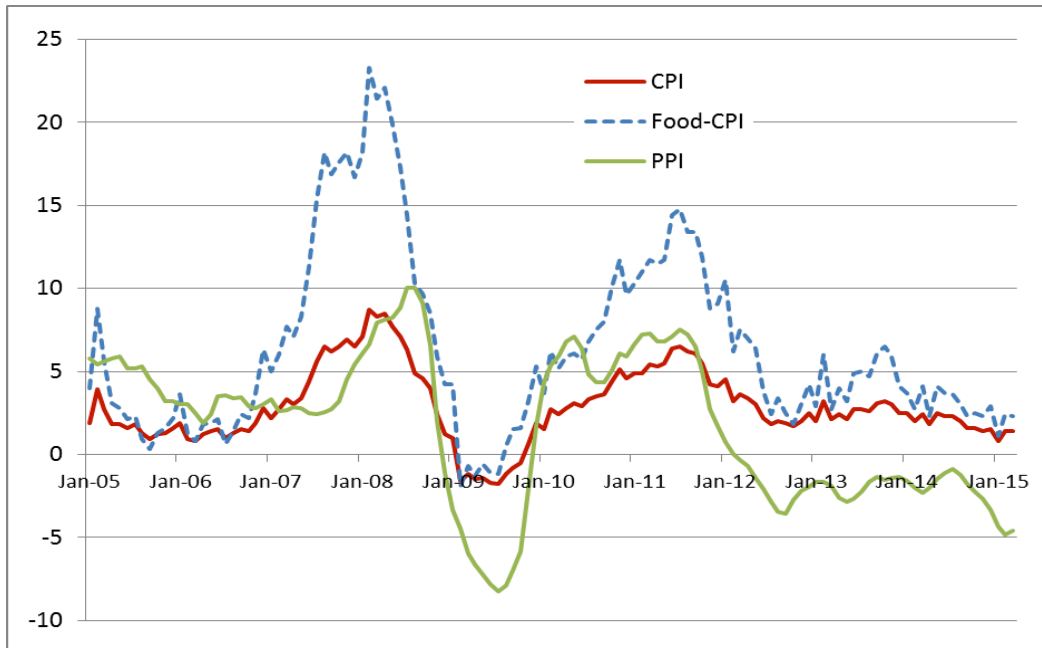
President Xi has strongly signaled in his public statements that there will be continued impetus for reforms, including measures to tackle corruption. The priorities are clear but it remains to be seen if the government has the political will to stay the course on an ambitious reform agenda, battling against the vested interests that want to maintain the status quo and coping with social pressures from the short-term dislocations that the reforms might create. China's leaders may have little choice, however, if they want to maintain their legitimacy and social stability.

Figure 1. China: GDP and Industrial Production Growth
(year over year quarterly growth rates; in percent)



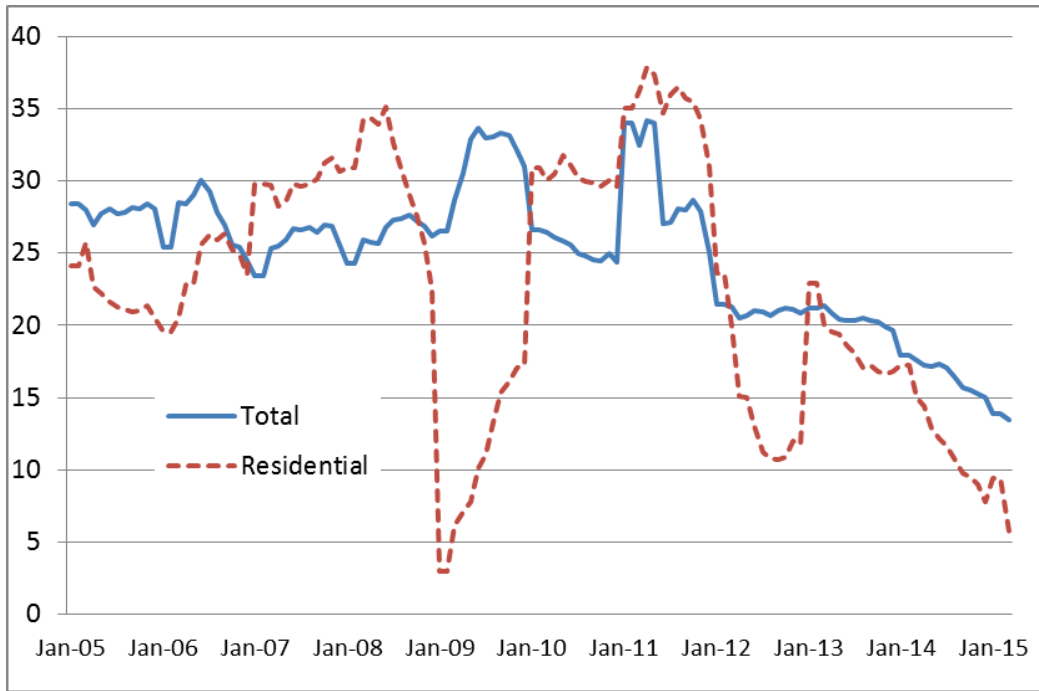
Data sources: National Bureau of Statistics (GDP growth) and World Bank (IP growth)

Figure 2. China: Inflation
(year over year changes in price indexes; in percent)



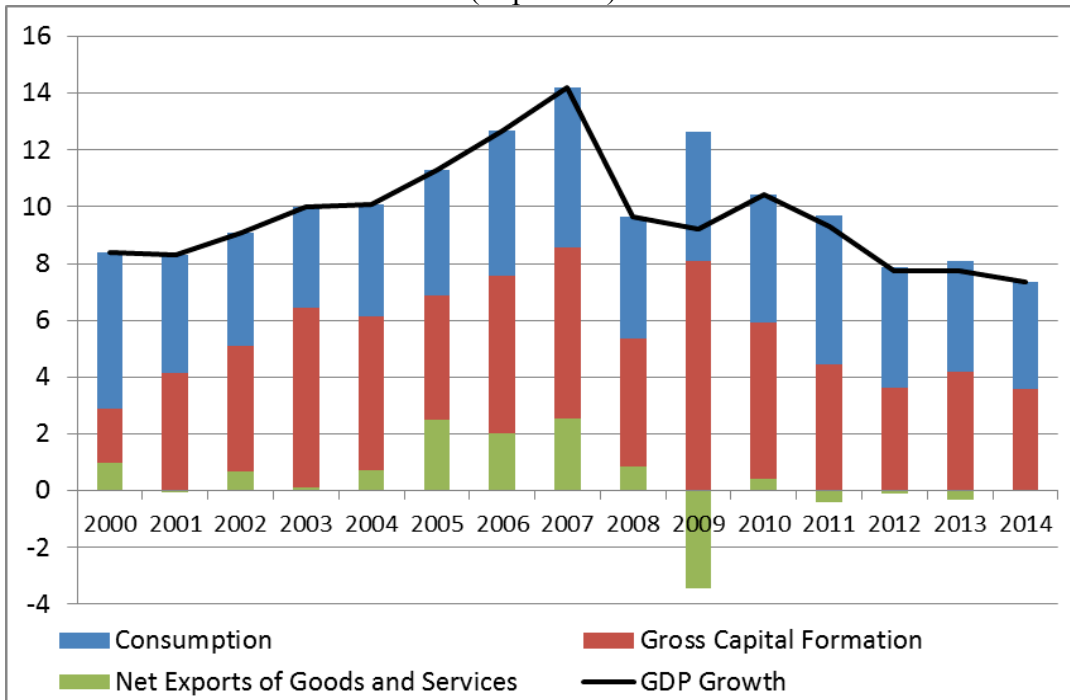
Data source: National Bureau of Statistics.

Figure 3. China: Fixed investment Growth
(year over year growth; in percent)



Data source: National Bureau of Statistics.

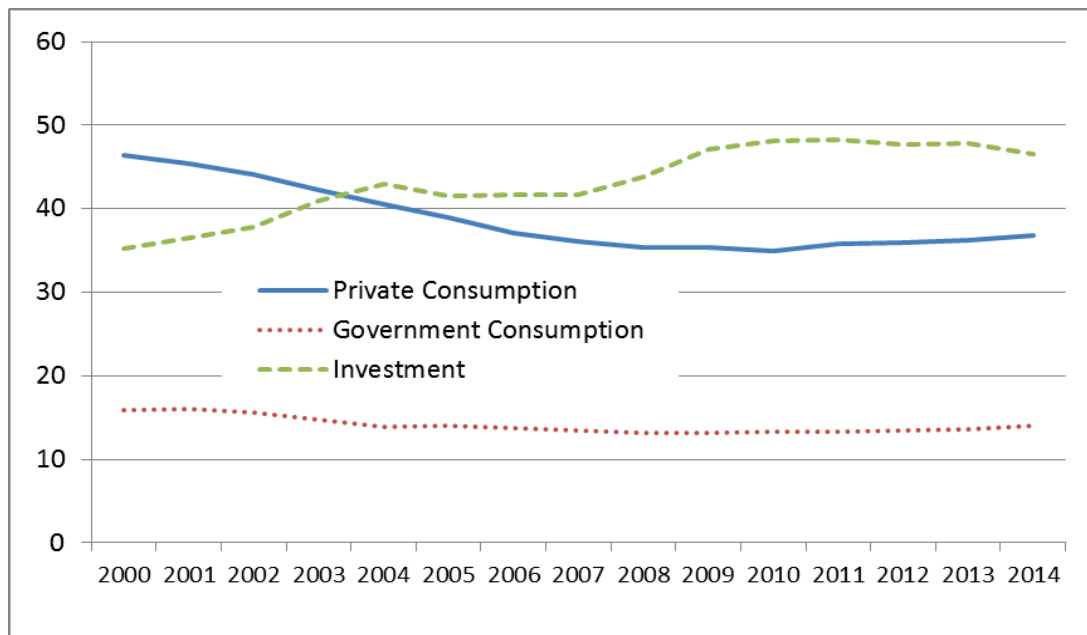
Figure 4. China: Contributions to GDP Growth
(in percent)



Data source: National Bureau of Statistics

Notes: Consumption includes private and government consumption.

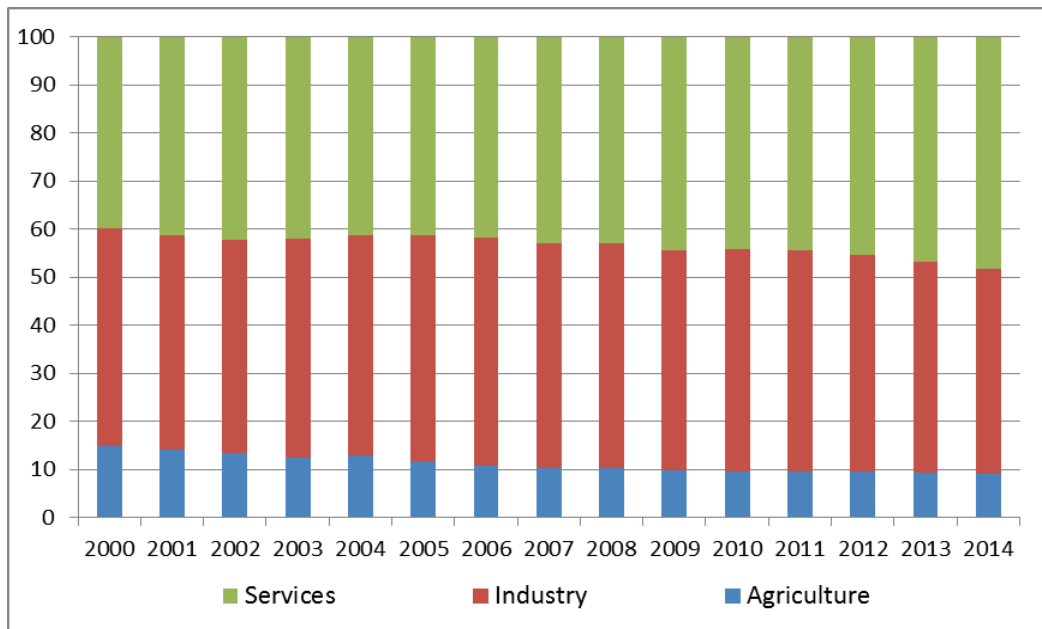
Figure 5. China: Composition of Domestic Demand
(variables expressed as ratios to GDP; in percent)



Data source: EIU CountryData.

Notes: Data for 2014 are estimates. Investment includes gross fixed investment and stockbuilding.

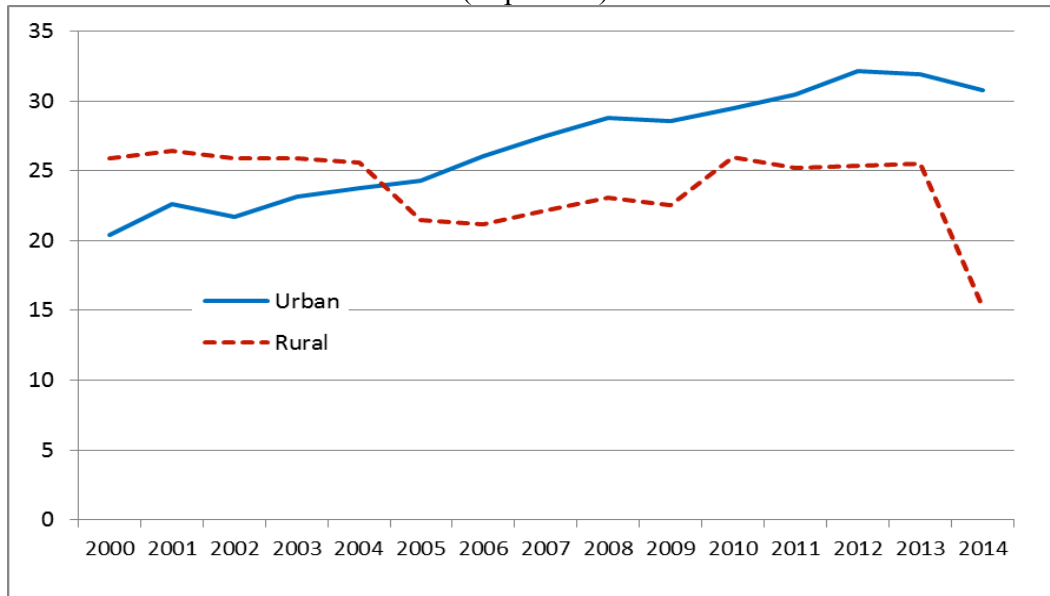
Figure 6. China: Sectoral Composition of GDP
(variables expressed as ratios to GDP; in percent)



Data source: National Bureau of Statistics.

Note: Agriculture refers to primary industry, Industry to secondary, and Services to tertiary.

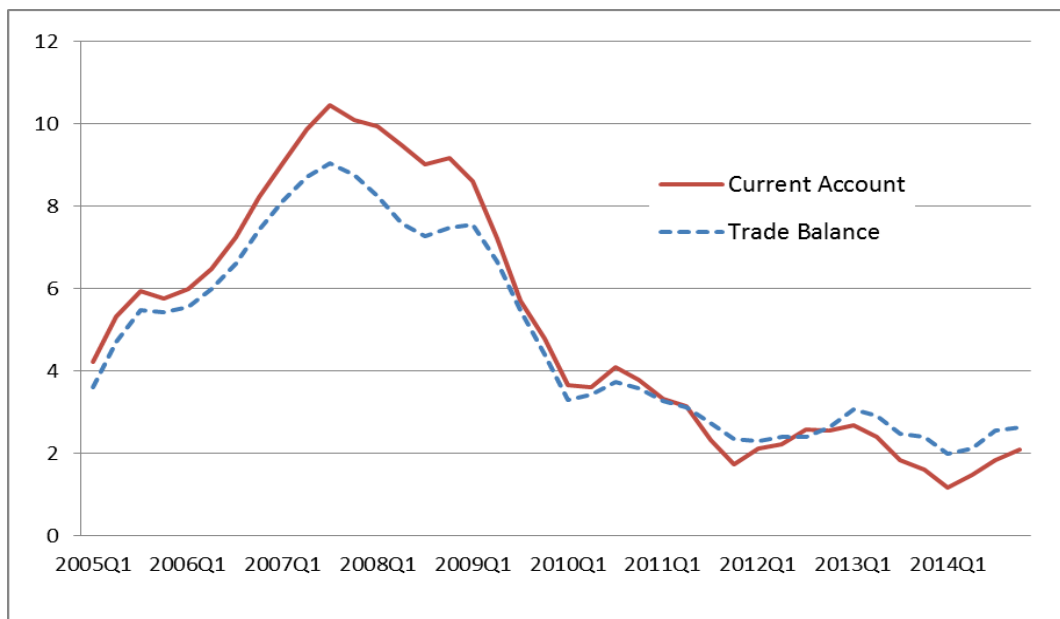
Figure 7. China: Household Saving Rate
(in percent)



Data source: National Bureau of Statistics.

Notes: Saving rates from the Urban and Rural Household Surveys and are expressed as shares of disposable income and net income, respectively.

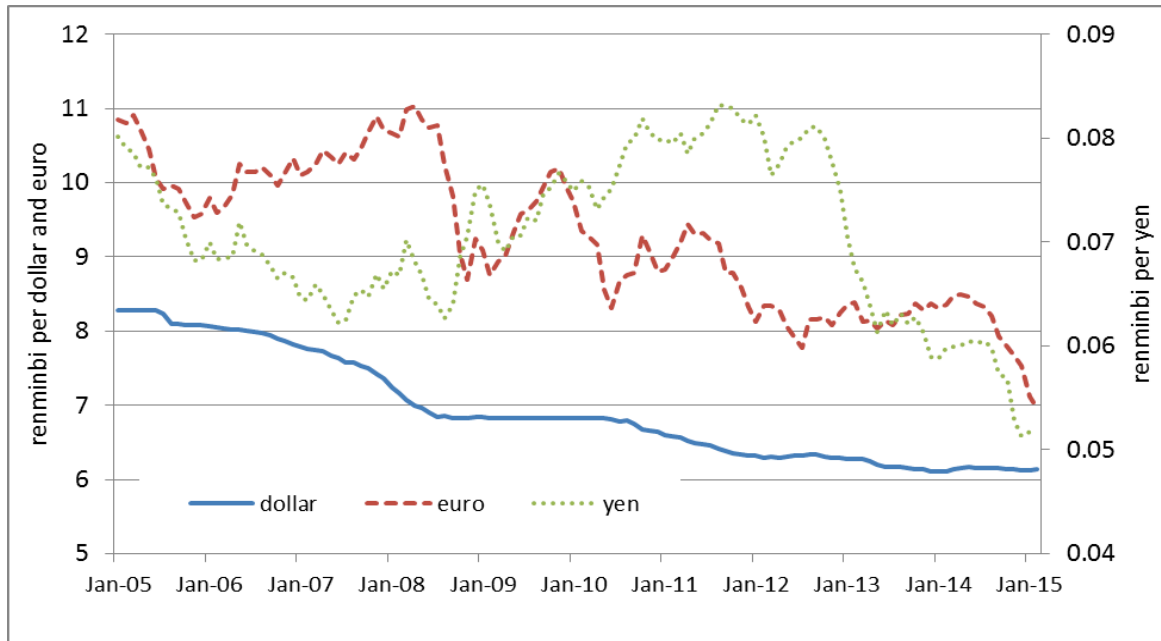
Figure 8. China: Current Account and Trade Balance
(in percent of GDP)



Data sources: State Administration of Foreign Exchange and National Bureau of Statistics.

Notes: Current account balance and trade (goods and services) balance are shown as ratios to nominal GDP. The figure shows four-quarter trailing moving averages for both variables.

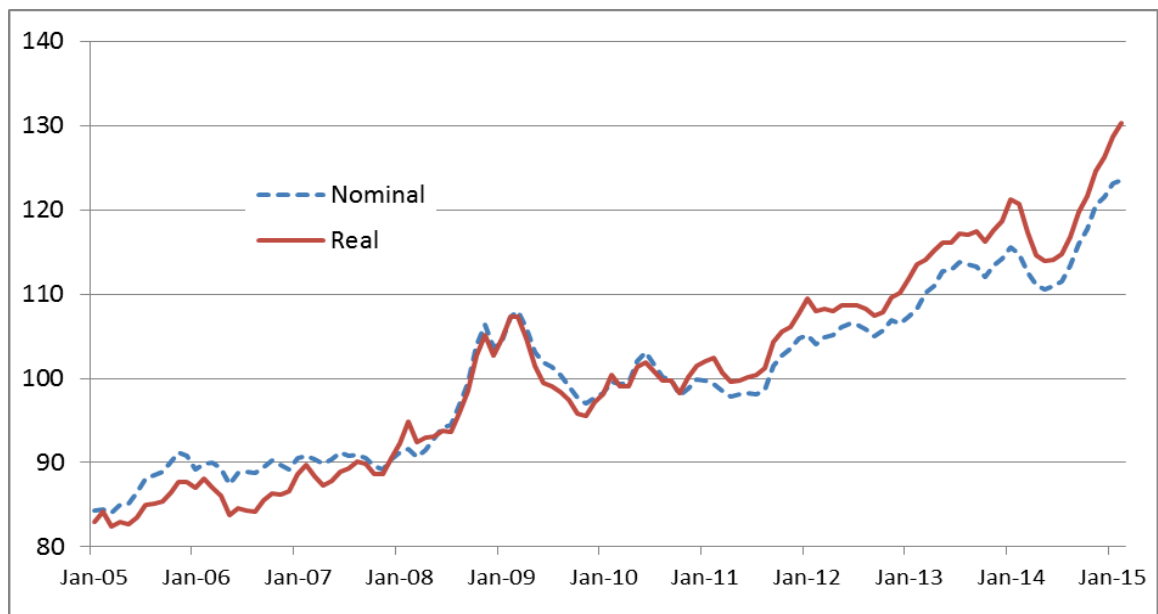
Figure 9. China: Bilateral Exchange Rates
(renminbi per unit of foreign currency)



Data source: State Administration of Foreign Exchange.

Note: A decrease denotes appreciation of the renminbi. An increase denotes depreciation.

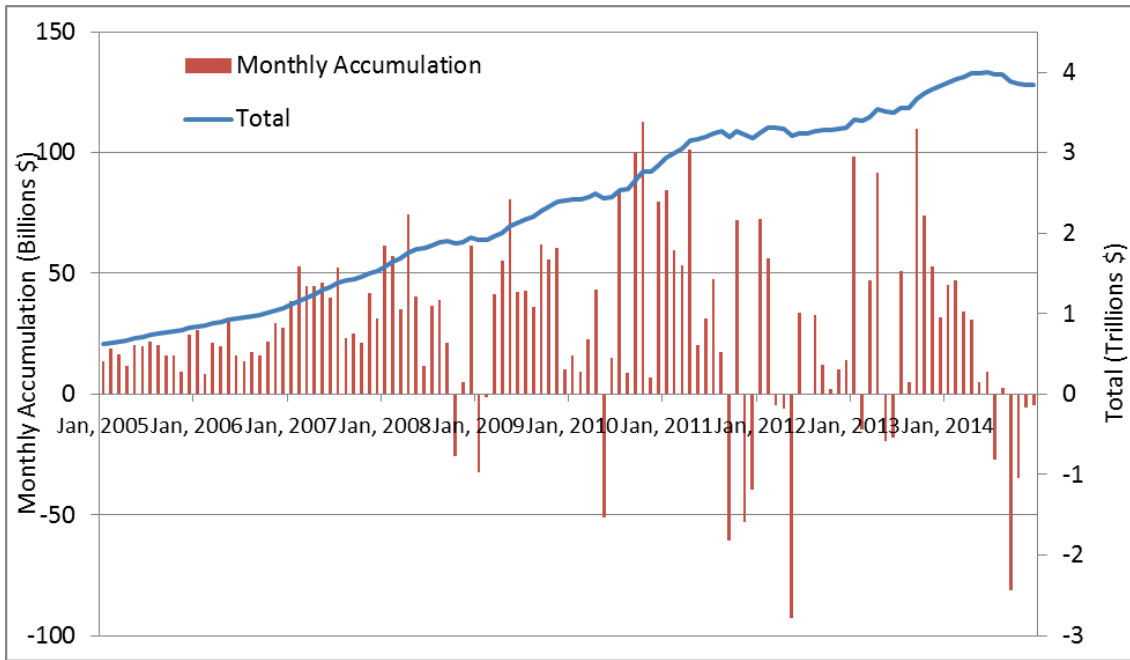
Figure 10. China: Effective Exchange Rates
(indexes)



Data source: Bank for International Settlements.

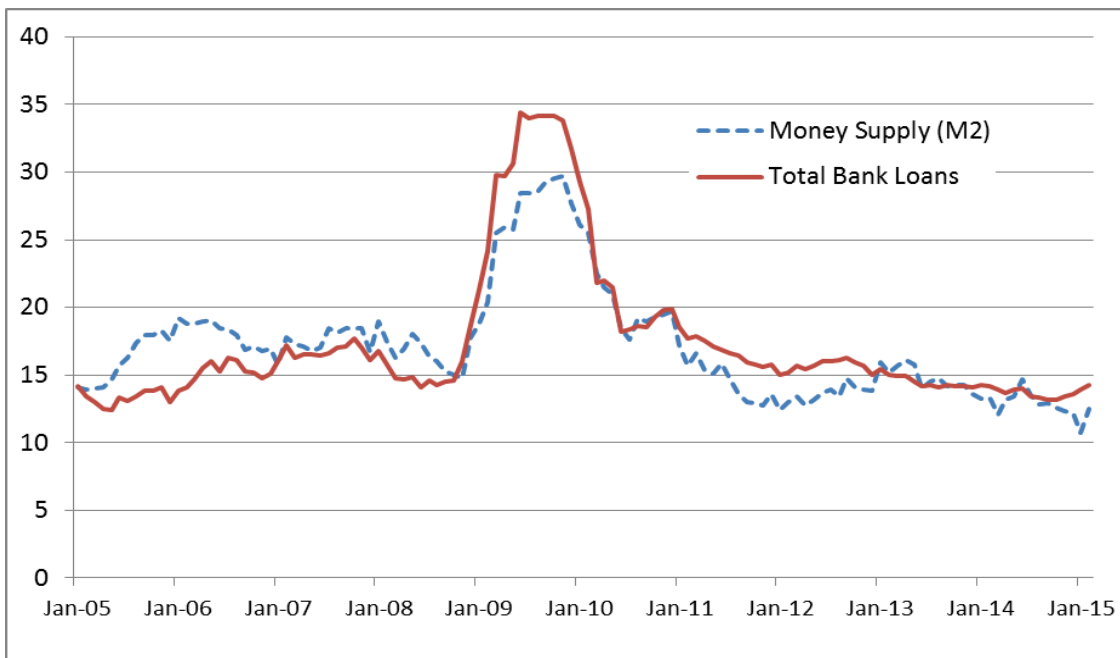
Note: A decrease denotes depreciation of the renminbi. An increase denotes appreciation.

Figure 11. China: Foreign Exchange Reserves
 (monthly accumulation in billions of dollars; total level in trillions of dollars)



Data source: People's Bank of China.

Figure 12. China: Bank Loans and Money Supply
 (year over year growth; in percent)



Data source: People's Bank of China.