FT Alphaville **Global Economy**

Rumours of China's economic demise may be greatly exaggerated

From 'miracle to malady' — but how bad is it really?

Robin Wigglesworth 14 HOURS AGO

Eswar Prasad has been thinking about China's economy longer than most. The Cornell professor's new paper — which examines whether the Chinese economy has gone from "miracle to malady" — makes for timely reading amid fears the Asian superpower has fallen into a classic middle-income trap that could morph into something more dangerous.

Prasad's basic argument is that Beijing has actually managed an "inefficient and risky growth model" surprisingly well, and while "unbalanced reforms, a schizophrenic approach to the role of the market versus the state, and strains in financial and property markets could result in significant volatility… a financial or economic collapse is not in the cards".

Here's his conclusion:

> China has found a way to get results — generating sustained growth over a long period, improving the living standards of its people, avoiding a financial crisis, and pulling its economy through a number of perilous periods for the world economy. It has done all of this without a well-functioning financial system, a strong institutional framework, a market-oriented economy, or a democratic and open system of government. There is certainly cause for humility for anyone attempting to explain the China phenomenon based on the historical record and experiences of other countries.

> China's growth model and approach to reforms have not hewed to conventional norms and arguably tensions are building up in the system, with a possibly explosive meltdown at some point. But so far the government has proved adept at navigating around such perils. There have undoubtedly been mishaps, often with significant consequences, but the government has left itself room for maneuver. And there have been many resources wasted over time, with a big bill left to pay at some point in the future.
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> If the government's goal is to sustain growth, it needs to find ways to improve the allocation of resources within the economy and enhance productivity growth. This will require a better financial system. Indeed, while there are legitimate concerns about China's high rates of investment in physical capital, the capital-labor ratio is much lower than in advanced economies such as the United States and China still has vast needs for infrastructure in its interior provinces. The challenge is the efficient intermediation of domestic savings into domestic investment, so capital is allocated to its most productive uses.
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> China would benefit from a financial system that does a better job of allocating resources to more productive uses and to dynamic parts of the economy, especially the services sector and small and medium enterprises. This requires fixing the banking system, improving depth and liquidity in bond markets, and tightening regulation to mitigate institution-specific and system-wide risks. Such reforms, in tandem with institutional and supply-side reforms, will help reduce unproductive investment, improve employment and household income growth, and promote more regionally balanced development.
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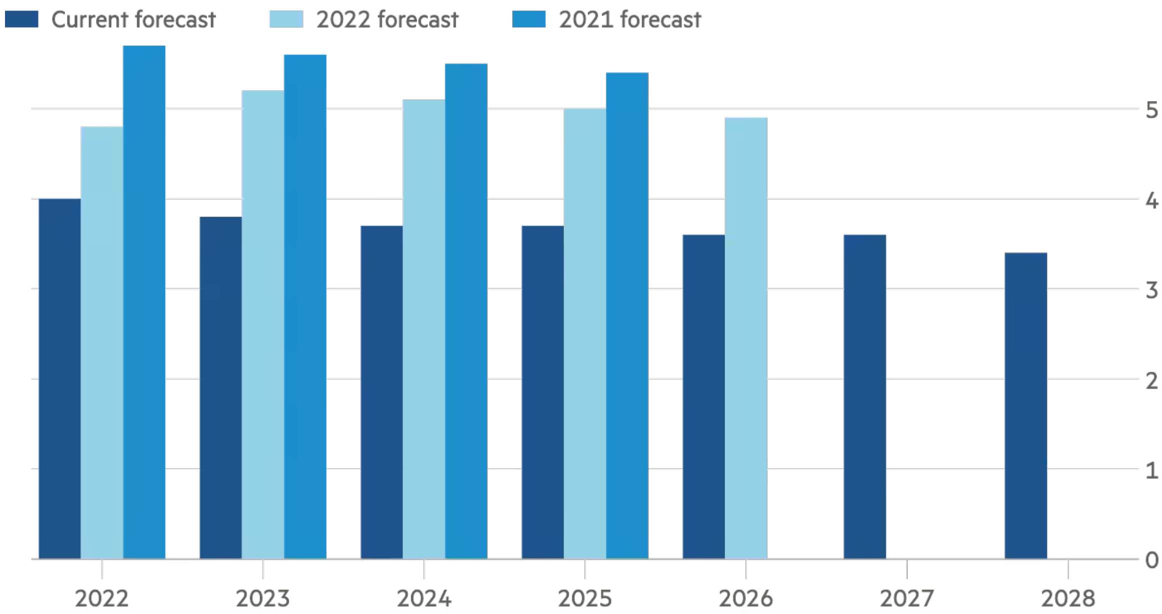
> The underpinnings of China's growth seem fragile from historical and analytical perspectives. Things that must end do often end suddenly and in unpredictable ways. Yet, if the government plays its cards right, one could equally well envision a more benign future for the Chinese economy — with growth that is more moderate by its own standards, but that is more sustainable from economic, social, and environmental perspectives.

The problem is that China's worsening demographics (coupled with the past decade's debt binge and a rickety domestic financial system) mean growth is going to be harder to eke out in the coming decades — even if it avoids the kind of financial collapses that have often ended similar growth miracles.

In response to these challenges, as Alphaville noted in February, the IMF recently took a chainsaw to its longer-term Chinese growth forecasts.

Mid-income trap ahoi

The IMF has chainsawed its longer-term Chinese economic forecasts (%)



Source: IMF
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On the other hand, Prasad notes, even though “speculating about China’s medium- and long-term growth prospects has been a growth industry in itself”, it has consistently done better than feared (with all the usual caveats around the accuracy of Chinese data).

Maybe this current bout of concerns will also prove overdone?