Chinese Economy

China’s fixation on stability creates economic risks

President Xi would increase control over the economy by letting markets operate

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Workers inspect LED light bulbs at a factory in Sichuan province, China. The country has lowered its annual economic growth target to 'around' 6.5 per cent, as Beijing emphasises 'risk control' in the final year of President Xi Jinping’s first term. © AP

27 MINUTES AGO by: **Eswar Prasad**

As China (https://www.ft.com/china) gears up for a high-level leadership transition at its party congress in November, stability has become the main watchword in Beijing, dictating everything from economic policies to reform efforts.

Minimising volatility (http://next.ft.com/content/d85e9d4e-054e-11e7-ace0-1ce02ef0def9)from economic liberalisation is seen as important for a smooth political transition. As they jockey for promotions (http://next.ft.com/content/0b742054-000f-11e7-8d8e-a5e3738f9ae4), even reform-minded officials are loath to take risks, partly to avoid creating enemies at a time when they need every ally they can corral.

Paradoxically, by trying to enforce stability through tighter control and limited reforms, the government is raising the risk of longer-term economic instability. It is a good bet that China's gross domestic product growth (http://next.ft.com/content/253fbc78-014a-11e7-ace0-1ce02ef0def9)will come in like clockwork in the government's target range of about 6.5 per cent over the next 12 months.

For all its lip service to more balanced and less environmentally destructive growth, the government has been constrained by its own narrative that fast GDP growth is a sign of successful economic management. This narrative locks in the imperative of rock-steady growth as President Xi Jinping (http://next.ft.com/content/b7683e1a-feff-11e6-96f8-3700c5664d30)manoeuvres to consolidate power ahead of his second term.

The goal of stable growth has resulted in a set of policies, including continued rapid credit expansion on top of a mountain of debt, that heighten longer-term risks and economic stability. Critical reforms, such as restructuring state enterprises, have fallen prey to the prerogative of maintaining output and employment growth at all costs.

Even when it comes to prices, the Chinese government seems convinced that stability is an end in itself. Since last year's sharp volatility in equity and currency markets, the government has done everything in its power to keep stock prices and the exchange rate stable.

This is an upside-down approach to stability. It is far more important to have policies that are predictable and markets with a good supporting infrastructure. This means, for instance, that stock markets should allow efficient price discovery, which in turn requires that companies be subject to high standards of corporate governance, accounting procedures and transparency.

Instead, the government has made it a practice of stepping in to support financial markets on their way down (and cheerleading them on their way up), through both words and actions. If anything, this heightens market uncertainty and volatility.

The knee-jerk response this year to the surge in capital outflows followed a similar trajectory. Even as the government was ostensibly lifting restrictions on capital inflows and outflows, it clamped down on certain channels of capital flight.

While defensible on the grounds of limiting flows of illegal funds, such actions have spooked foreign investors who interpret it as a sign the government is once again trying directly to control capital flows. This has reduced inflows and increased outflows, exactly the opposite of what the government hoped to accomplish.

Markets are inherently volatile, reflecting the unpredictability of economic fundamentals that determine asset prices. Such volatility is not to be feared. Of course, markets sometimes become unhinged from fundamentals. Yet, direct government intervention typically makes things worse.

A better approach is for the government to promote financial and macroeconomic stability through a predictable policy and regulatory environment. Beyond that, it would be more productive to reduce direct government intervention and free up markets. The government's best role is to ensure that markets are supported by effective regulation and supervision, a good flow of reliable information, and disciplined monetary and fiscal policies.

It may go against his instincts of command and control. But by giving up some control over markets, Mr Xi could in fact strengthen his control of China's economy.

The writer is author of 'Gaining Currency: The Rise of the Renminbi'
