Opinion Chinese economy

# China needs a new growth model, but that requires serious reform

The government must clearly define its role in the economy and financial markets

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Shoppers pass a map of Evergrande's commercial estates outside a mall in Beijing © Feature China/Barcroft Media/Getty

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The Chinese economy has held up remarkably well through the pandemic but now faces a combination of waning growth and financial market volatility. This reflects a number of dilemmas that Beijing is grappling with, some of which are of its own making.

China's government seems willing to tolerate lower short-term growth in the interest of securing long-term prosperity. This approach is well-intentioned, but the specific policies adopted risk creating more uncertainty and volatility, in turn eroding public support for the reforms needed to bolster long-term productivity and growth.

Yet there is a way to improve this trade-off: adopting forceful measures that better define the government's role in the economy and financial markets.

The real estate sector encapsulates the challenges Beijing faces. Some property developers such as Evergrande recklessly undertook debt-financed development while many households have borrowed to finance purchases of multiple properties for speculative purposes. The property sector symbolises many of the excesses in the Chinese economy and the government clearly saw no choice but to rein it in to forestall growing economic and financial imbalances.

The attempt simultaneously to reduce the build-up of debt in the economy and tamp down on property speculation has set the housing market on a downward spiral. The government is now discovering the huge costs of rectifying imbalances in a sector that it had long relied upon for propping up growth, boosting local government revenues and contributing to household wealth. The property sector's influence over practically every aspect of the economy, financial markets

The property sector's influence over practically every aspect of the economy, financial markets and society makes it a thorny issue to fix.

Beijing has set out two frameworks to guide its policymaking. The first, "dual circulation", implies continued engagement with global trade and finance but seeks a greater reliance on domestic demand as well as technological self-sufficiency and homegrown innovation. The "common prosperity" agenda aims at a more equitable distribution of the fruits of growth. These are laudable frameworks but come up against some difficult realities.

The government wants to persist with its deleveraging campaign and has rightly limited the use of debt-financed investment, fuelled by lax monetary policy, to support growth. Similarly, it wants to reduce energy-intensive production and the economy's reliance on heavy industry and low-wage manufacturing. But the banking system, which continues to direct finance toward large state-owned industrial enterprises, has made it harder for smaller and nimbler private enterprises — including service sector firms — to secure credit.

Beijing's willingness to let Evergrande default shows it is ready to encourage market discipline by eliminating implicit state guarantees backing up financial firms and major corporations. However, the concomitant desire to increase state control of the economy and financial system, including the central bank's measures to direct credit by fiat rather than through market mechanisms, adds more confusion than clarity.

Xi Jinping's government is clearly conflicted about the role of the private sector. Relying on it for innovation rubs up against Beijing's steps to curb companies, particularly in the technology sector, that are seen as having accrued excessive economic and political influence. It is also not easy to square the objective of restraining wealth inequality with the reliance on the private sector to generate more wealth.

Balancing these conflicting objectives is not impossible, but it will take a different approach. First, the government must commit to reducing its influence in financial markets. Second, it must tackle legacy problems, such as the large pile of implicit bad debts in the banking system, that have thwarted a restructuring. Third, a broader set of reforms is needed to reorient the economy in the direction that Beijing wants. This includes more decisive reforms to state-owned enterprises and measures to strengthen the social safety net. These steps must be complemented by institutional reforms that improve legal frameworks, including for the better protection of intellectual property rights, as well as corporate governance and transparency.

These measures will help improve the trade-off between short-term pain and better economic outcomes over the longer term. Beijing might still have to accept lower growth as a price for trying to have it all, but it would be more palatable, both for China and the world economy, if that growth were more stable and balanced.