

OPINION

Beijing's Steady Progress Toward Rebalancing

By ESWAR PRASAD

While the world's attention has been focused on the political and economic dramas in Europe, Japan and the U.S., one country has been quietly chipping away at some of its own economic problems. Recent data suggest a gradual but remarkable transformation in China's growth model. It is far too early to declare victory, however, and the new leadership has its work cut out for itself.

New data suggest that it is time to revise the view that China's growth is driven largely by exports and investment. Private and government consumption together accounted for more than half of China's output growth in 2011-12, signaling a big shift in the composition of domestic demand. Physical capital investment, the main driver of growth over the previous decade, is no longer the dominant contributor to growth. As for exports, a shrinking trade balance has in fact dragged down growth these past two years.

China has made substantial progress in reducing its external imbalances. Its trade and current account surpluses have shrunk steadily and markedly relative to their peaks in 2007, when they hit 7.6% and 10.1% of gross domestic product, respectively. In 2012, both of these surpluses were below 3% of GDP.

One reason for this shift is that China's strong growth, combined with economic weaknesses in its

key export markets, has brought down the trade deficit. Another is that the government has eased restrictions on capital inflows and outflows, allowing Chinese investors and corporations to look to foreign investments for diversification purposes.

Capital outflows exceeded inflows in 2012, something not seen for over a decade. This has raised concerns about capital flight. But the reversal might simply reflect a maturing, richer economy with more open financial markets that allow investors to take advantage

China is less dependent on exports and investment. The next step toward economic maturity? Real reform.

of diversification opportunities.

There are other signs of progress on domestic rebalancing as well. The decline in the share of private consumption in GDP has been halted. The share even went up slightly in the last two years, although it still remains well below that of every other major economy, advanced or emerging. Consistent with the government's objective of promoting the services sector, employment in this sector grew faster in 2012 than in the industrial sector. The shares of these two sectors in GDP are now equal.

This is not to say that all is well

with the Chinese economy. There are problems lurking on the books of the big state-owned banks which have continued lending mainly to state enterprises. The shift away from state-owned to private enterprises has ground to a halt. Provincial governments have large levels of debt. Overall employment growth remains meager, and the environmental consequences of the growth model are painfully obvious. For all of these and other problems, however, the fact that the government has been able to gently steer the large and fast-moving economic ship in the right direction is a notable achievement.

Growth is the magic tonic that has helped China cope with the myriad of economic problems it faces. A declining labor force and limits to investment growth suggest that China will have to rely on faster productivity growth to keep up its GDP growth.

The big challenge now is to speed up 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. This will require more disciplined banks, broader financial markets, a stronger social safety net and other reforms that were clearly laid out in China's 12th five-year plan two years ago.

Earlier this month the government announced a plan to reduce



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A Shanghai Volkswagen dealership. China's trade surplus has shrunk since 2011.

inequality that incorporates some of these reforms. Trying to reduce inequality through government intervention is usually not a good idea, as it puts the focus on redistributive policies rather than ones that promote growth.

But this plan seems to use the goal of reducing inequality more as a framework for a broad set of reforms that will secure growth and improve income distribution. The proposed reforms include liberalization of interest rates to boost competition in the banking system, removal of restrictions on labor mobility to promote urbanization, and increased spending on social programs to reduce household savings and raise private con-

sumption. Beijing has hit upon a clever strategy, as it will be a lot harder for vested interests to block reforms that are sold as being for the benefit of the masses.

China has a golden opportunity—with growth recovering and inflation low—to look beyond short-term demand management and focus instead on improving the balance, quality and sustainability of growth. While its new leaders have sung the appropriate paeans to reforms, now is the time to pick up the playbook from two years ago and act on it.

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An Open Letter to Shinzo Abe

By MICHAEL AUSLIN

Dear Prime Minister Abe:
This week you come to Washington as prime minister of Japan for the second time. Many things have changed since your last visit in 2007. The world economy cratered, as did Japan's. China surpassed Japan as the world's second-largest economy. America elected a president intent on ending the policies of his predecessor and expanding the role of government. Your party lost power after

Dear Prime Minister: Please inform the U.S. that Japan under your watch will be open, bold and well-armed.

half a century and watched its successor fail to deliver.

You now have a "do over," as we say in America. You have been given a second chance by Japan's voters to restore their country to economic health and international prestige. You started off by making bold, controversial decisions to devalue Japan's currency to help Japan become an export powerhouse again.

You also have a new chance to restore true health to Japan's relationship with the U.S. Your predecessors, the Democratic Party of Japan, wasted their first year in power in 2009 by picking unnecessary fights with Washington

over relocating U.S. Marines inside Okinawa. Near the conclusion of their short tenure, they raised fresh concerns for the alliance by enraging China after nationalizing some of the disputed Senkaku Islands in the East China Sea.

You have started your second term by returning to the themes of your first, including ideas about revising restrictions on Japan's ability to engage in collective self-defense with its partners. You have reached out to Southeast Asia and talked about a larger role for Japan in the world. You have also been given some gifts by the DPJ, including their decision to purchase the F-35 stealth fighter and relax an arms-export ban that isolated Japan's defense industry from the world.

In Washington, I hope you will seize the attention of Barack Obama—and his country—by demonstrating how Japan will continue to be a global leader and why Japan's success is a crucial element in global stability. In particular, I hope you stress two initiatives that you are already engaged in and that matter much to the U.S.

First, stress that you plan to increase Japan's defense budget. Explain that the uncertain environment in Asia has convinced you to end a decade of gradual reduction in defense spending. Given China's continuing military modernization and North Korea's ongoing nuclear testing and bal-



Associated Press

Shinzo Abe with George W. Bush in Washington, D.C., April 2007.

listic missile program, you have decided to allocate more than \$1 billion in additional defense spending this year. This makes Japan one of America's only major allies not cutting its defenses this year.

Your spending decision is important, because cuts to the U.S. defense budget are inevitable and it therefore needs reliable partners. The U.S. and Japan face the same threats and uncertainties, and you can tell Mr. Obama that Japan is committed to contributing more to its own defense and helping maintain peace in its neighborhood. In addition, you can emphasize that you are renewing attempts to change those Japanese laws that prevent collective self-defense.

Second, emphasize that you are drawing a line in the sea re-

garding the Senkaku Islands. Tell Mr. Obama that Japan will never fire the first shot, nor endanger civilian life. But neither will it allow China to upend the balance of power in the East China Sea. Make clear that even though you understand that the nationalization of the islands caused unrest in China, you understand equally that Beijing cannot be allowed to use its newfound strength to ignore international law and create a crisis.

Let Mr. Obama know that, while you recognize that both the U.S. and Japan need China as an economic partner, economic growth cannot continue unaffected as Beijing becomes more reckless and unpredictable. Yes, your actions to defend Japan's claims in the Senkakus carry risk, but they will leave Asia a more

stable place because Beijing will have to rethink its policy in the East and South China Seas.

Finally, I hope you will promise quietly to move forward on a decision to join the Trans-Pacific Partnership trade talks as well as to resolve the stalled plan to move U.S. Marines to a new base in Okinawa. Besides the economic benefits of the first, both these moves will leave Japan more integrated with America.

This is what you should say to Mr. Obama. You should be speaking to the people of Japan as much as to the President of the United States when you say it, for your actions in Washington will signal to your citizens how you intend to keep them safe as you work to rebuild Japan's economy. If you speak in concrete terms, the White House will get the message, too.

Mr. Obama will realize that, for all of Japan's problems, it retains enormous strengths that benefit not only itself but the U.S. as well. He will understand that while political dysfunction and budget cutting in Washington raises questions about America's future role in Asia, Japan stands ready to help preserve the liberal system that has made the Asia-Pacific region the most dynamic on earth.

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