

## Review – Sustaining China's Economic Growth

Written by Shiran Shen

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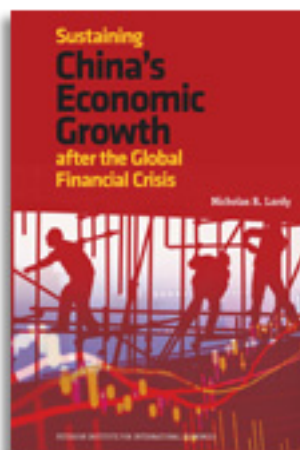
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Sustaining China's Economic Growth: After the Global Financial Crisis

By: Nicholas R. Lardy

Washington DC: Peterson Institute for International Economics, 2011



Since market reforms championed by Deng Xiaoping began underway in the late 1970s, China has made impressive strides in economic development, sustaining double-digit growth for an extended period of time. While the world economy suffered the most severe decline in 60 years during the 2007-09 global financial crisis, China's economic growth only ticked down slightly to 9.2 percent in 2009. China was the fastest growing emerging market both during and immediately after the crisis, and has thus emerged as a critical engine for the entire global economy.

Despite China's economic success in the past three decades, Nicholas Lardy, renowned expert on the Chinese economy at the Peterson's Institute for International Economics, articulates China's economic challenges ahead and offers suggestions in his book *Sustaining China's Economic Growth: After the Global Financial Crisis*. Lardy seeks to explain China's economic policy during the global financial crisis and analyze challenges facing the Chinese leadership in sustaining growth rates in the coming decades. He suggests that China's economic imbalances will require fundamental market-oriented reforms; modest, marginal, and incremental reforms only provide lip service that cannot bring China onto a new growth path. Lardy examines the technical and political challenges that these comprehensive reforms entail.

Given the Chinese economy's heavy reliance on exports to foreign market, Lardy describes China's policy response to the global financial crisis as "early, large, and well designed" (5). Lardy points out that quite contrary to common belief, the stimulus package in 2009-10 did not privilege state-owned enterprises at the expense of the private sector; in fact, private firms and family businesses experienced significant improvement in access to bank loans, as did the state-owned enterprises. In 2009-10, private firms became the most crucial source of China's growth of exports for the first time ever.

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Although the stimulus packages were able to sustain the Chinese economy during the global financial crisis, Lardy argues that they do not address the structural problems that are looming large on the horizon. In a 2007 speech at the National People’s Congress, Chinese Premier Wen Jiabao described China’s economic growth as “unsteady, imbalanced, uncoordinated, and unsustainable” (44). According to Lardy, China’s most outstanding economic imbalances include: 1) low private consumption expenditure, 2) highly elevated share of investment in GDP, 3) an outsized manufacturing sector and a tiny service sector, 4) gigantic official holdings of foreign exchange, and 5) increasingly outsized and potentially unsustainable rate of investment in residential property.

In order to make China’s economic growth more sustainable, the Chinese government has implemented a series of policies to correct the imbalances; however, their effects to date have not been very promising. Since 2003, the government policy has kept the renminbi undervalued by having the central bank intervening massively in the foreign exchange market. To prevent the expansion of the ensuing expansion of the domestic money supply, the central bank has engaged in two types of large-scale and continued monetary actions, referred to as sterilization: 1) issuing bills to commercial banks, and 2) raising the required reserve ratio, the share of deposits that commercial banks place at the central bank (97). Several signs indicate that China’s financial system has become more repressed since 2004, when the government abandoned its policy of interest rate liberalization. These signs include, but are not limited to, negative real interest rate on household savings, an augmenting required reserve ratio, an emerging and significant informal credit market, and a sharp drop in public holding of government bonds share.

To more effectively amend these imbalances, Lardy presents measures to ameliorate the situation and analyzes both technical and political challenges posed by the much-needed reforms. According to Lardy, China needs to pursue liberalization policies so that the market will play a greater role in setting the value of the Chinese currency and interest rates. In the meantime, the government should facilitate building a stronger social safety net to encourage household spending; the social goods include, but are not limited to, health care, education, welfare, and pensions.

In addition to liberalizing the country’s fiscal policies and improving social benefits, Lardy analyzes the weak possibility of an endogenous rebalancing despite continuous increments in real wages. Even though real wages have been growing in recent years, Lardy writes that China’s unit labor costs vis-à-vis those of its trading partners have not been increasing as a result of a comparable increase in labor productivity in the trading goods sector.

Internationally speaking, Lardy argues that it is unclear whether China will initiate sustained rebalancing efforts even when China’s stated national and international economic policy objectives align. The current impediments include financial repression, undervaluation of the exchange rate for renminbi, and provision of subsidies in production. A renewed interest in rebalancing efforts surfaced at the National People’s Congress in the spring of 2011, but whether the government has the political will and capital to implement the rebalancing policies have yet to be seen.

Despite Lardy’s quite holistic dissection of China’s economic and fiscal challenges, the book could have included a more in-depth analysis of the impact of China’s political organization on economic policies that may be at odds with rebalancing efforts. Lardy hints that powerful interest groups may have kept policies at its status quo for their personal benefits. He could have gone further to analyze two things that constrain the initiation and implementation of more liberal economic policies: 1) the shrinking power of China’s top leader and 2) protracted and often difficult consensus building among several powerful political factions. From Deng Xiaoping, to Jiang Zemin, to Hu Jintao, and to Xi Jinping, the top leader is endowed with less and less power to direct and implement reforms. As a result and at the same time, the top leader is increasingly facing powerful political factions vying for influence. For Xi Jinping, any reform plan will come out of the negotiation and comprise among different factions. The Chinese leadership recognizes these political challenges. During the Anhui delegation’s meeting at the 12th National People’s Congress meeting on March 5, Wang Yang, who is likely to become China’s new vice premier with the responsibility for reforms, described reform as cutting off one’s own flesh; that is, China must be determined to break through vested interests.

By and large, *Sustaining China’s Economic Growth* is a timely work that provides a comprehensive and persuasive analysis of China’s economic challenges in the wake of the global financial crisis. Author Nicholas Lardy has a decades-long background in studying about and writing on China’s economy; this book is a new addition to his series

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of best writings on the Chinese economy. The economics part is beyond reproach, though Lardy could have factored more political analysis into his argument. The subject matter is technical, but Lardy explains it well enough to make it understandable to an educated audience who may not have a deep background in global finance and economy.

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**Shiran Shen** is a fervent observer of and writer on Chinese domestic politics and foreign relations. Her works have been featured in outlets such as *Foreign Policy In Focus*, *The Asia Times*, *International Policy Digest*, *Reference News (Cankao Xiaoxi)*, and *Lianhe Zaobao*. She is a member of the Young Leaders Program at Pacific Forum CSIS and a Phi Beta Kappa graduate of Swarthmore College. You can follow her on Twitter @ShiranShen.