China on a Tightrope

March 30, 2010

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Economic reform requires political reform, says James Dorn. China's leaders must loosen control if they want harmony.

Chinese acrobats are among the best in the world. So are Chinese illusionists, and Beijing will need both their skills to convince markets that last year's rapid growth of money and credit can be tamed without sacrificing long-run growth.

After achieving real GDP growth of 8.7 percent last year, China's economy is expected to grow by 9–10 percent this year. Some of that growth is due to sleight-of-hand accounting—for example, counting disbursements for investment projects as part of GDP, even if those projects haven't started yet.

Meanwhile, the real inflation rate may be higher than official price indexes, therefore overstating real growth. Such a lack of transparency, coupled with the grip government officials still have on the allocation of investment funds, offers ample opportunities for meeting growth targets. Indeed, it seems clear that China has slid back toward central planning and away from market liberalism since the beginning of the global financial crisis.

The large, multiyear, fiscal stimulus package announced in November 2008, which came to Rmb 4 trillion (about 14 percent of GDP), was followed by massive increases in bank loans in 2009. Bank lending grew by more than 30 percent, with new loans reaching about Rmb 10 trillion, while the dollar carry trade added fuel to the fire with speculators borrowing at low US interest rates and investing in Chinese assets.

This year, the People's Bank of China (PBC) has slowed money and credit growth, but monetary policy is still described as 'moderately loose' and bank lending is expected to grow by about 18 percent. The problem is that local authorities want to complete investment projects and are using implicit guarantees to obtain credit via special investment vehicles. Bank loans are being collateralized by land and other assets 'owned' by local governments.

Although the PBC has increased reserve requirements to sterilize excess liquidity, the demand for new credit is still strong. If interest rates are increased, capital inflows will fuel the monetary base. There's a limit to the PBC's ability to sell bills into the market and as long as the PBC must accumulate dollar assets to peg the renminbi (also known as the yuan) to the dollar at an artificially low level, there can be no independent monetary policy. Flexibility is provided not by a free-market interest rate mechanism but by administrative measures and capital controls.

Financial repression is a hallmark of China's market socialism, with one control spawning others. Without market price signals—in the form of competitively determined interest rates and exchange rates—and the free flow of capital, China can't become a world-class financial center.

In addition to this, it should be borne in mind that markets without private property rights are an illusion. Inherent in property rights is the free flow of information, yet the absence of the rule of law to protect the rights of individuals and their property means China cannot have real capital markets, only pseudo markets. With the huge increase in money and credit during 2009, poor risk management, and the difficulty of disciplining state-owned banks and state-owned enterprises, China now faces a major challenge—namely, how to avoid a sizable increase in nonperforming loans and improve the allocation of capital.

The too-big-to-fail problem is endemic in China's state-directed financial sector, while moral hazard is rampant with the underpricing of risk. Errors are accumulating, and the longer Beijing waits to address them, the more costly it will become to fix them.

Foremost is the issue of the undervalued yuan. Foreign exchange reserves now total $2.5 trillion. It makes no sense for a capital-poor country like China to be a net exporter of capital and China needs to normalize its balance of payments by increasing domestic consumption and allowing capital freedom. Making the renminbi convertible on the capital account and allowing greater exchange-rate flexibility would help China achieve a more balanced growth path. More importantly, it would widen the range of choices open to the Chinese people and increase their wealth.

In addition to liberalizing capital markets, China needs to reform the rigid hukou (internal passport) system that harms migrants and impedes the efficient allocation of labor. Allowing migrants to establish individual retirement accounts would facilitate such changes. Land reform, meanwhile, would also enable many migrants to achieve a higher standard of living if they had full ownership rights to what is now collective ownership of rural land. Lease rights have been extended, but that reform isn't sufficient to create a robust market in land rights, which depends on the right to sell. Capitalizing China's 'dead capital' would immediately create new wealth for millions of rural households.

Economic reform, however, depends on political reform. The most basic change would be to continue to improve the protection of private property rights, not just by constitutional changes but also by a system of justice that's based on individual rights. Limited government, not majoritarian democracy, is the primary requirement for a free society.

Article 13 of the Chinese Constitution, as amended in 2004, states: 'The lawful property of citizens is inviolable.' That reform expanded freedom, but the state still decides what is 'lawful property'. And there's no independent judiciary to protect property rights. Collective property rights, state ownership of banks and enterprises, and the lack of fully transferable land rights make China a socialist, not a market economy.

Depending on the power of government to 'balance' a complex modern economy is a risky venture, as was seen in the failure of central planning. China's transition to a market system is still a work in progress. Reforms since 1978 have allowed millions of people to lift themselves out of poverty, but it is clear it is increased economic freedom that has produced the 'Chinese miracle,' not state intervention. Yet the danger now is that China is reverting to greater control over the 'commanding heights' of the economy, believing that fine-tuning is possible without destroying the spontaneous market process.

Wu Jinglian, a leading reformer, has warned, 'Only by matching the rule of law with the market economy can we achieve total success.' Harmonious development requires that people be free to make their own choices. Chinese consumers have benefited from trade liberalization, but are harmed by the politicization of economic life, especially the lack of free markets in labor, land, and capital.

Premier Wen Jiabao has stated, 'The society that we desire...is one in which people can achieve all round development in a free and equal environment. That is why I like Adam Smith's Theory of Moral Sentiments very much.' But long before Smith, the great Chinese sage Lao Tzu, emphasized the benefits of non-intervention (wu wei): When the ruler leaves people alone, they are 'spontaneously transformed' and 'increase their wealth.'

Likewise, the 'Great Historian' Sima Qian stated: When all work willingly at their trade...things will appear unsought and people will produce them without being asked.'

The idea of spontaneous order doesn't sit well with those in power. The challenge for China is to limit the scope of government—to the protection of life, liberty, and property—and let people be free to choose. Market Taoism, not market socialism, is what China needs for a harmonious society.