In the darkest hours of the recent global financial crisis, the swift and dramatic actions taken by the Chinese government to buffer its economy from the worst effects of the crisis represented for many one of the few bright spots of the period.

But those actions have created a fresh set of challenges for Chinese authorities, argues Barry Naughton, one of the world’s leading experts on the Chinese economy.

MAINTAINING ECONOMIC growth is the most important domestic challenge that China faces today. Without economic growth, China is unlikely to have the resources and policy flexibility to address its other challenges. At first, it might seem that growth is a non-issue. After all, China’s response to the global financial crisis was remarkable decisive, quick, and big enough to make a difference so that China resumed growth rapidly. Indeed, it is only a modest exaggeration to say that China led the world out of recession in early 2009. By creating demand for global commodities, China put a floor under global deflation and provided the first “green shoots” in the global economy. Gross domestic product growth accelerated throughout 2009, and in the first quarter of 2010 reached a searing 11.9 percent over the previous year. However, that growth was purchased at a price, and the first task confronting Chinese policy-makers is to get growth onto a more stable and sustainable path.

There is no optimum speed for China’s growth. There is no need to maintain a minimum growth rate of 8 percent (as some Chinese policy-makers believe), and it is possible that, even with very successful policymaking over the next several years, growth rates will inch downward. After all, China is beginning the shift from growth under conditions of nearly inexhaustible cheap la-
bor to growth with slower labor force increases, rising wages and a greater need for productivity improvements. No doubt it is also true that in order to make this historic shift, China will have to make profound changes in its growth model, in its ability to innovate and in its support for domestic consumption and services. These long-term challenges are important, but they are not the focus of this article. Rather, this article discusses the immediate and medium-term challenge of weaning the economy from the short-term stimulus that sustained China through the global crisis. Only if this challenge is successfully overcome can China address its long-term future.

SUCCESS BREEDS NEW WORRIES
China’s success in responding to the global crisis has created a new set of challenges. China used two very particular instruments in overcoming the global crisis, and each has its distinctive costs and pitfalls; each requires new thinking to ensure that policies that were essential at the time do not end up creating new obstacles to China’s development. China’s response to the crisis was a massive investment stimulus that relied on two organizations. The first was the Communist Party, whose political hierarchy was used to mobilize local governments to quickly ramp up investment projects; the second was the financial system — especially the state-owned banks — which was ordered to provide credit to finance these investment projects. Both responded with enthusiasm. The stimulus program was adopted on Nov. 10, 2008. Within days, local governments across China were meeting to draw-up lists of “shovel-ready” investment projects.

The result was a flood of proposals. In fact, within a month, provinces had proposed to the central government projects with a combined budget of 25 trillion yuan ($3.6 trillion) — over 80 percent of annual GDP, and that was with only just over half of provinces reporting! Credit flooded out from the banking system to fund those projects, especially during the first quarter of 2009. For the whole year, bank credit increased by 9.6 trillion yuan, about triple what would be expected in a normal year. It was this massive credit expansion, combined with local government investment projects, which formed the main pillar of the Chinese stimulus plan.

The success of the plan — far from assured at the outset — came as this massive injection of demand spilled over into the rest of the economy. Initially, money poured into investment projects ranging from small-scale village clinics and electrification to a major acceleration of the high-speed rail program already on the books. But gradually, an effort was made to steer lending towards mortgages and housing development in order to revive the housing market; and to resume lending to small-scale businesses, which had been neglected in the early stages of the crisis response. In addition, preferential policies for purchases of automobiles and consumer durables in the countryside, as well as housing units in the city, were used to jump-start demand. Overall, the program worked. Employment began to turn up again in the last half of 2009. Migrant workers returned to city worksites and employment was once again growing. The recovery gained footing, and by year-end 2009 it was obvious that growth had returned.

With renewed growth came fears that the rapid credit expansion would lead to overheating and inflation if sustained into the recovery. Since late 2009, China has been trying to tamp down the growth of credit. The challenge has been to gradually wind down stimulus, without moving too abruptly toward tightening measures that would derail the still-fragile recovery. In these broad terms, China is just like all the other recovering economies struggling with the after-shocks and consequences of the crisis. However, since each country used a different mix of instruments, each country faces different challenges in withdrawing stimulus. Many countries — most critically those of southern Europe — face startlingly large budget deficits. China’s fiscal position is enviable, but it has to deal with the economic consequences of its highly expansionary credit policy, and the political-economic issues brought up by the way political power was used in the recovery. Just as the two huge organizations — party and finance — were used in the stimulus effort, they must be repositioned to transition to a post-stimulus economy.
HOUSING BUBBLE
All of the difficulties that China faces are currently on vivid display in urban housing markets. As the economy recovered, abundant credit found its way into urban real estate markets. The housing recovery quickly transformed into a housing bubble. Land and housing prices in Beijing and Shanghai soared past previous highs during the first part of 2010. In mid-April the Chinese government finally cracked down on speculators, restricting bank credit for anybody with more than one home, while ordering local governments to increase the supply of affordable housing. Government oversight and taxes on the property sector were increased, and it was signaled that Shanghai would pioneer a trial implementation of a property tax by the end of the year. Market participants have been very uncertain about how thoroughly these policies will be implemented. As buyers and sellers both took a “wait and see” attitude, housing transactions plummeted in May.

These policies face substantial passive resistance from local governments, which are deeply enmeshed in the finances and politics of property development. Local governments’ revenue from land sales in 2009 accounted for 44 percent of the total amount of tax revenue they received. Moreover, the strategies of local officials to leave their mark on cities for posterity, and to assemble coalitions of supporting businessmen, rely on property development schemes. In general, local governments would prefer less central government interference, and robust housing markets. Right now, local governments have a special interest in the health of land and housing markets. In order to get the local government investment projects off the ground — the main pillar of the stimulus program — local governments set up corporations that could borrow money and invest in infrastructure projects. These “funding platforms” ran up a whopping 7.4 trillion yuan in debt as of the end of 2009, or 22 percent of GDP, and growing. But only 10 percent of these funding platforms have stable revenues in the form of service fees (such as toll roads). The remainder expect to repay loans by selling land at higher prices because of its proximity to value-enhanc-
ing infrastructure. In principle this can be done, but it leaves local governments exposed to any serious downturn in property markets.

China’s macroeconomic managers thus face a formidable policy challenge. They need to gradually ratchet down the total amount of lending, without pushing the economy into a “double-dip” recession. They need to cool down the housing sector and stabilize prices, without pushing it into a slump. They need to wind down the credit going to local governments, without causing a financial crisis for those governments. Moreover, they need to do this while strengthening the financial system. Regulators are pushing the banks to raise additional capital and set aside additional provisions in case large numbers of loans go bad. Indeed, the banking system has clearly been set back by the slipshod way in which loans were approved during the peak of the stimulus moment. This is quite damaging, because banks were just beginning to shift over to a new model as commercial firms. Now banks must once again assess the riskiness of loans more critically, and start to recover their nascent credit culture. Both the banks and local governments were severely politicized during the stimulus program. Both need to be brought back to better governance systems.

THE ANSWER? MORE GOVERNMENT
How are these challenges to be faced? Central government leaders have concluded that they must exert more detailed and differentiated control over economic decision-making. For example, banks are to be monitored more closely, their loans reported more regularly and the share of their loans going to housing controlled more carefully. Without doubt, they are also preparing to enforce their will on potentially recalcitrant local governments. In fact, this is the primary lesson China’s leaders took from their successful response to the crisis. Midway through Premier Wen Jiabao’s Government Work Report, given at the National
People’s Congress meeting in March, he expressed the leadership's official view of the lessons learned from the economic crisis: The micro-economic advantages of markets, he said, must be combined with the advantages of macro-control. Those advantages, Wen said, are: “efficient decision-making, a powerful organization and concentrated power to accomplish big things.” Wen’s formulation marks a small but significant shift in official rhetoric. The Chinese government is laying out a future path in which economic growth is to be steered by a strong and intrusive government.

In all countries, the economic crisis led to a large increase in the role of government in the economy. In most developed countries, this increase has been followed by a strong backlash, a politically driven determination to roll back the advance of the government. Such a backlash, evident in Germany, the UK and the US, whatever its intrinsic merits, raises the economic risk by suggesting that government will reduce the degree of its stimulus as governments reduce budget deficits and liquidate investments. This backlash is the opposite of the lesson the top Chinese political leaders have learned. In China, the government is determined to do more. In the short run, this will give some benefit, because it means that the Chinese government is less likely to sharply reduce its stimulus policy. The slowing of credit creation will continue to be a moderate process. Chinese local governments are well represented in the top political spheres, and no one wants to set off a political dogfight over their pet projects. Nor does the central government have the stomach for a prolonged downturn in urban housing prices. Indeed, it is quite probable that the government will launch a massive affordable housing campaign, keeping up investment by pushing China into a new era of public housing authorities and subsidized construction.

This prospect also has positive international repercussions, since China’s continuing expansionary policies will generate further increases in imports. Since late 2009, China’s imports have been growing much more rapidly than exports. In April 2010, China’s cumulative export surplus over the previous twelve months was $139 billion, down
more than half from the $300 billion-plus surpluses run in early 2009. These trade trends are likely to gradually reduce tensions between China and its trading partners, particularly the US. In turn, this is important to the world recovery, because the recovery in most developed countries is likely to be anemic at best. In contrast, the more rapid growth of China — and other developing countries such as India and Brazil — is fundamentally changing the dynamics of world economic growth.

But this preference for short-run economic growth will mean that Chinese policy-makers must walk a tightrope. If the effort to cool the housing market, strengthen banks and restructure local government budgets is too weak, or is abandoned too soon, the economy will face greater dangers down the road. On the other side, too harsh a contraction could tip China into an unanticipated and unwanted economic slowdown. In a world that looks to China for growth momentum, such a slowdown could have dire consequences for global economic sentiment and ultimately demand for Chinese exports. Despite remarkable success over the past two years, China is not yet on a smooth path to healthy economic growth.

Barry Naughton is the So Kwanlok Chair Professor of Chinese International Affairs at the Graduate School of International Relations and Pacific Studies at the University of California, San Diego, and one of the world’s leading authorities on the Chinese economy.