China and Asia have replaced North America, Europe and Japan as the engine of global growth. China alone accounts for 25 per cent of the world's economic growth. iStock photo

The Rebalancing of Chinese Growth

Kevin Lynch

In its latest annual assessment of the Chinese economy, the International Monetary Fund advised Beijing to shift its focus away from the fixation of the past two decades—both domestically and internationally—on the country's totemic GDP targets. As BMO Financial Group Vice Chair Kevin Lynch writes, such a shift would, ideally, mean a pivot from the "what" of GDP target prioritization to the "how" of China's growth trajectory.

There is renewed Canadian interest, by the new federal government and the public, in stronger economic ties with China. Prime Minister Justin Trudeau's September visit to China was a success on many levels, and not unrelated to recent polling that has surfaced a significant uptick in public willingness to strengthen commercial relationships with China balanced by continuing concerns about the state of human rights in the country.

So, given this interest in growing our

commercial links with China, where is the world's second largest economy headed? China is undertaking a massive rebalancing of its economy as it attempts to transition to a more balanced and sustainable growth path. While the challenge of more balanced growth in the new global normal is not unique to China—many economies, including Canada, are experiencing persistently lower growth—the scale and the scope of its challenge are unprecedented in the modern era.

The starting point in examining the rebalancing of China's growth is the global context, something policy makers in any country, regardless of size, ignore today at their peril in a hyper-connected world.

And, the global context is changing, dramatically. The engines of world growth, previously North America, Europe and Japan, are now China and emerging Asia. China alone accounts for over 25 per cent of global growth, with emerging Asia in total driving over 60 per cent of it. This is a huge structural shift in a short period of time.

While the engines of growth are shifting, most—in the emerging world as well as the West—are in need of a tune-up. The global reality is a weaker and more volatile world economy with most economies experiencing lower-than-expected growth on a sustained basis. The U.S. is wrestling with sub 2 ½ per cent growth, Canada with sub 2 per cent growth, the Eurozone with even weaker growth, and double-digit Chinese growth led by trade and investment is a memory. Chinese growth is trending towards 6 per cent, according to the IMF, with a surprising degree of regional variation: some provinces are in high single-digit growth while others are in recession.

The pivotal question is whether this is a prolonged and unique cycle, due to the unprecedented after-effects of the global financial crisis, or a structural change in potential growth.

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Experience increasingly supports the latter interpretation. Structural drivers of growth are losing steam, calling into question the appropriateness of the policy mix in many countries. Whether it is: aging demographics in the West, China and Japan; slowing productivity growth; growth impediments across many emerging economies such as peak urbanization, worsening environments, congestion, regulatory inefficiencies and lack of competition; high debt and rising leverage; and, a plateauing of connectivity growth—the net result is lower global potential growth.

All of these global growth impeders apply in some measure to China. Consider the growth risk from rising leverage. China is on a debt treadmill: corporate debt in China has skyrocketed from 68 per cent of GDP in 2007 to 145 per cent of GDP today. In its most recent review of China, the IMF focused on the high and accelerating Chinese corporate debt (growing at twice nominal GDP) as a key risk to sustainable growth and productivity, and an impediment to broader structural reforms.

A central aspect of structural reform in China is the need for economic rebalancing—a singular objective with many complex elements. In this context, it is useful to deconstruct the rebalancing policy objective into these elements.

There is external rebalancing, which refers to shifting from export-led growth in China, a pillar of its economic strategy for decades, to domestic-demand led growth.

There is domestic rebalancing, which in China is equally challenging and takes a number of forms. These include: shifting from industry to services; shifting from investment to consumption; shifting from government-owned production to the private sector; shifting from low-productivity production to higher value-added activities; and shifting from excessive corporate leverage to sustainable levels. None is easy, and vested interests in the status quo are many.

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There is also environmental rebalancing in a world concerned about climate change and the environment, and China needs to worry seriously about both.

And then there is income distribution rebalancing, where high and growing income inequality of the sort China is experiencing may affect confidence, entrepreneurship and the social contract.

The complexity of the rebalancing challenge in China highlights the requirement to have on hand an adequate array of structural policy instruments to match the diverse policy objectives.

How is China doing? The first observation is that considerable progress has been achieved. Reforms have progressed across a broad domain including fiscal reforms, external sector reforms, financial sector reforms and structural reforms. The rebalancing to services is particularly striking, and China is emerging as a world leader in e-commerce, mobile payments and commercial internet usage.

The second observation is that there is still much to do to achieve balanced and sustainable growth in China. In the next phase, rather than a series of often seemingly unconnected reforms, it would be useful to consider a suite of integrated and mutually reinforcing structural reforms combined with complementary financial sector renewal.

Simply put, it is challenging to see how significant progress can be achieved on a number of core and interrelated structural rebalancing reforms—tackling excessive corporate debt and leverage; facilitating corporate restructuring; encouraging more corporate competition; incenting greater corporate innovation; shifting to more energy-efficient production and usage; and, increasing the digitization of corporate operations—without further reforms to the financial sector.

At the same time, it is difficult to see how further financial sector changes will have the maximum impacts on generating more balanced and sustainable long-term growth in the absence of complementary supply-side structural reforms.

Consider the financial sector imperative. Strengthening the links between the financial system and the real economy is a central concern for policy makers and financial market participants around the globe, not just China. Many worry that the "lending channel" is not working as it should, for different reasons in different economies, and this renders monetary policy less effective than it otherwise would be. China is no exception.

Indeed, it would benefit significantly from broader and deeper capital markets, where market forces play a greater role in the efficient allocation of capital. This will require deeper and more liquid corporate bond markets, better functioning equity markets and less reliance on bank and near-bank financing of corporations, both SOEs and private enterprises.

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It will also need greater access to financing for SMEs if the government's objective of a larger, more diversified and more innovative private sector is to be realized. This would be facilitated by a more diverse array of investors, including institutional and overseas players, and from greater differentiation and innovation among institutions within the financial sector, both domestic and foreign banks.

Fintech firms, and interestingly China has the potential to be a key global Fintech player, increase financial sector efficiency and service under-served sectors such as SMEs and entrepreneurs, provided there is an appropriate regulatory environment for such firms.

New categories of lending should be encouraged, such as "green bonds", municipal bonds and venture capital, as these would facilitate clean tech, innovative start-ups and public infrastructure objectives, provided they are market-based.

But the effectiveness of such financial sector reforms will be substantially influenced by what is done to tackle the challenge of excessive corporate debt and leverage, to facilitate corporate restructurings, to shift more production from the state sector to private hands and to foster more corporate competition. These are highly interrelated. The more comprehensive the scope, the more clarity in the signalling, and the more integrated the approach by China to structural rebalancing, the better the outcomes will be.

In short, an efficient, innovative, and trusted financial sector—one that allocates capital to the most productive uses—is crucial for successful supply-side reforms to bolster balanced and sustainable Chinese growth. The opportunity for China from well-integrated, well-communicated and well-executed structural reforms, according to the McKinsey Global Institute, could be in the order of $5 trillion. Not a bad return from a government investment in reform. P

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