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China has room for policy reform

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China has a choice. It can have higher growth now or higher growth later, but not both.

That's the assessment of many commentators as they watch an investment and industrial output-led economy move towards one led by consumption and services.

China's leaders can temporarily pump up economic activity by running bigger budget deficits and making credit cheaper and more easily available.

But as long as there is an obsession with this year's growth rate, the tough structural reforms needed for the economy to expand sustainably will be put off. This includes cutting back on overcapacity in heavy industry and closing down loss-making state-owned enterprises (SOEs).

Last weekend at the National People's Congress meeting in Beijing, Premier Li Keqiang said that China would target growth of between 6.5 and 7 per cent this year and an average annual growth rate of "at least 6.5 per cent" until 2020.
This is higher than the International Monetary Fund expectations of 6.3 per cent this year and an average annual rate of 6.2 per cent until 2020.

That China has set an ambitious near-term growth target is not usually viewed positively. Instead, it is taken as a sign that the can of serious reforms has been kicked further down the road.

REGIONAL CLOUD

If true, that would be bad news not only for China but the region as a whole. China ranks as the number one trading partner for Japan, Korea, ASEAN and New Zealand.

For Australia, China is not only our biggest trading partner. It is simply the best prospect on our economic horizon. A brief respite would be little compensation for putting at risk a growth story that has at its heart 850 million more middle-class Chinese by 2030, according to the Brookings Institution.

On the streets of Sydney and Melbourne, and the beaches of the Gold Coast, the early impact of China's rising middle class is already being felt. In 2015 more than 1 million Chinese tourists visited, spending $7.7 billion, an extraordinary 35 per cent jump on a year earlier.

And then there's booming Chinese demand for our beef, wine, education and financial services.

Yet as Guonan Ma, a former senior economist at the Bank of International Settlements noted last year, the idea that China faces an inevitable trade-off between short and long run growth "looks odd".

After all, since the global financial crisis the consensus in OECD countries has been that policies intended to boost demand in the short run go hand in hand with structural reforms that lift productivity in the long run.

Another consideration that makes a trade-off appear off the mark is China's own past experience.

PUBLIC SUPPORT CRUCIAL

China's leaders were able to keep the public on the side of deepening reform by waiting nearly two decades to lay off 36 million state sector employees between 1995 and 2002. By then the private sector had grown large enough to absorb these surplus workers.

The need to maintain public support is greater than ever.Interest groups such as SOEs are openly resistant to having more of their privileges withdrawn.

And spending by households is keeping the economy afloat during a difficult period. In 2015, consumption accounted for two-thirds of GDP growth, up from one-half the year before.

Last weekend Premier Li said that the problem of state-owned "zombie firms" would be dealt with "proactively yet prudently".

That's not code for stalling indefinitely.

Last month, Chinese officials announced their intention to trim 1.8 million workers from the beleaguered coal and steel sectors. This will be easier since the economy created 13 million new jobs in 2015, more than 90 per cent of which were in the private sector.

China's authorities have resisted using strong stimulus measures to date.

This may come as a surprise to those accustomed to reading that China's debt levels have reached nearly 250 per cent of GDP.

But this has more to do with China's exceptionally high savings rate and banks being awash with deposits than the People's Bank of China adopting a loose monetary stance.

In February, the Reserve Bank of Australia observed that China experienced mild deflation last year and average lending rates are now up to seven percentage points higher in real terms than in 2010.

That China's stimulus package in response to the global financial crisis in 2009 led to a misallocation of credit is also not an argument against supporting growth in the future. Rather, the lesson is that if another shot in the arm is required then the beneficiaries need to be concentrated in the more efficient private sector.

China still has policy space to buffer a further growth slowdown. That's good news, in both the short and long run.