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China's Bumpy New Normal

SHANGHAI – China's shift from export-driven growth to a model based on domestic services and household consumption has been much bumpier than some anticipated, with stock-market gyrations and exchange-rate volatility inciting fears about the country's economic stability. Yet by historical standards, China's economy is still performing well – at near 7% annual GDP growth, some might say *very well* – but success on the scale that China has seen over the past three decades breeds high expectations.

There is a basic lesson: “Markets with Chinese characteristics” are as volatile and hard to control as markets with American characteristics. Markets invariably take on a life of their own; they cannot be easily ordered around. To the extent that markets can be controlled, it is through setting the rules of the game in a transparent way.

All markets need rules and regulations. Good rules can help stabilize markets. Badly designed rules, no matter how well intentioned, can have the opposite effect.

For example, since the 1987 stock-market crash in the United States, the importance of having circuit breakers has been recognized; but if improperly designed, such reforms can

increase volatility. If there are two levels of circuit breaker – a short-term and a long-term suspension of trading – and they are set too close to each other, once the first is triggered, market participants, realizing the second is likely to kick in as well, could stampede out of the market.

Moreover, what happens in markets may be only loosely coupled with the real economy. The recent Great Recession illustrates this. While the US stock market has had a robust recovery, the real economy has remained in the doldrums. Still, stock-market and exchange-rate volatility can have *real* effects. Uncertainty may lead to lower consumption and investment (which is why governments should aim for rules that buttress stability).

What matters more, though, are the rules governing the real economy. In China today, as in the US 35 years ago, there is a debate about whether supply-side or demand-side measures are most likely to restore growth. The US experience and many other cases provide some answers.

For starters, supply-side measures can best be undertaken when there is full employment. In the absence of sufficient demand, improving supply-side efficiency simply leads to more underutilization of resources. Moving labor from low-productivity uses to zero-productivity unemployment does not increase output. Today, deficient global aggregate demand requires governments to undertake measures that boost spending.

Such spending can be put to many good uses. China's critical needs today include reducing inequality, stemming environmental degradation, creating livable cities, and investments in public health, education, infrastructure, and technology. The authorities also need to strengthen regulatory capacity to ensure the safety of food, buildings, medicines and much else. Social returns from such investments far exceed the costs of capital.

China's mistake in the past has been to rely too heavily on debt financing. But China also has ample room to increase its tax base in ways that would increase overall efficiency and/or equity. Environmental taxes could lead to better air and water quality, even as they raise substantial revenues; congestion taxes would improve quality of life in cities; property and capital-gains taxes would encourage higher investment in productive activities, promoting growth. In short, if designed correctly, balanced-budget measures – increasing taxes in tandem with expenditures – could provide a large stimulus to the economy.

Nor should China fall into the trap of emphasizing backward-looking supply-side measures. In the US, resources were wasted when shoddy homes were built in the middle of the Nevada desert. But the first priority is not to knock down those homes (in an effort to consolidate the housing market); it is to ensure that resources are allocated efficiently in the future.

Indeed, the basic principle taught in the first weeks of any elementary economics course is to let bygones be bygones – don't cry over spilt milk. Low-cost steel (provided at prices below the long-term average cost of production but at or above the marginal cost) may be a distinct advantage for other industries.

It would have been a mistake, for example, to destroy America's excess capacity in fiber optics, from which US firms gained enormously in the 1990s. The "option" value associated with potential future uses should always be contrasted with the minimal cost of maintenance.

The challenge facing China as it confronts the problem of excess capacity is that those who would otherwise lose their jobs will require some form of support; firms will argue for a robust bailout to minimize their losses. But if the government accompanied effective demand-side measures with active labor-market policies, at least the employment problem could be effectively addressed, and optimal – or at least reasonable – policies for economic restructuring could be designed.

There is also a macro-deflationary problem. Excess capacity fuels downward pressure on prices, with negative externalities on indebted firms, which experience an increase in their real (inflation-adjusted) leverage. But a far better approach than supply-side consolidation is aggressive demand-side expansion, which would counter deflationary pressures.

The economic principles and political factors are thus well known. But too often the debate about China's economy has been dominated by naive proposals for supply-side reform – accompanied by criticism of the demand-side measures adopted after the 2008 global financial crisis. Those measures were far from perfect; they had to be formulated on the fly, in the context of an unexpected emergency. But they were far better than nothing.

That is because using resources in suboptimal ways is always better than not using them at all; in the absence of the post-2008 stimulus, China would have suffered substantial unemployment. If the authorities embrace better-designed demand-side reforms, they will

have greater scope for more comprehensive supply-side reforms. Moreover, the magnitude of some of the necessary supply-side reforms will be markedly diminished, precisely because the demand-side measures will reduce excess supply.

This is not just an academic debate between Western Keynesian and supply-side economists, now being played out on the other side of the world. The policy approach China adopts will strongly influence economic performance and prospects worldwide.

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