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Policy Options for China: Reorienting Fiscal Policy to Reduce Financial Fragility

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Since adopting a policy of gradually opening its economy more than three decades ago, China has enjoyed rapid economic growth and rising living standards for much of its population. While some argue that China might fall into the middle-income "trap," they are underestimating the country's ability to continue to grow at a rapid pace. It is likely that China's growth will eventually slow, but the nation will continue on its path to join the developed high-income group—so long as the central government recognizes and uses the policy space available to it.

Policy options open to a nation that issues its own fiat, or sovereign, currency are much greater than the narrow policy space available to nations that do not. As a sovereign currency issuer, China has the fiscal capacity to continue to pursue economic growth at a pace consistent with its development objectives. Recognizing this, we recommend that China gradually relax constraints on central government spending while tightening corporate and local government budgets.

While holding total government spending constant, it is desirable to shift spending away from local governments, which have limited fiscal capacity, and toward the sovereign central government, which has more fiscal policy space. China's central government spending is very small in comparison to both developed and upper-middle-income developing nations. At 23 percent of GDP, China's government debt ratio remains well below ratios that are common in the West. Further, its budget deficits are small, typically between 1 and 2 percent of GDP. By contrast, debt service absorbs, on average, about 30 percent of local government revenue. And the reported data actually understate local government liabilities, much of which are in off-balance-sheet special investment vehicles—because, until very recently, local governments had very restricted ability to issue debt directly.

The policy stances of local governments and of the central government appear to be the opposite of prudent policy. In a sovereign nation, it is better to run tighter fiscal policy at the local level and looser fiscal policy at the national level. A sovereign government faces no solvency risk. As the currency issuer, it can make all payments as they come due. By contrast, local governments can and sometimes do default on obligations because they cannot generate enough revenue to service debt.

Similarly, China's corporate debt as a percentage of GDP is high (151 percent) compared to that of other Asian nations—and much higher than the ratio in the United States (75 percent). If China does enter a phase of slower growth, it will become more difficult to continue to service private debt undertaken on the expectation that growth would remain high. If, indeed, firms are already facing some financing problems, with total corporate debt service close to 30 percent of GDP, slower growth would make matters worse.

Financial fragility will be compounded by reports suggesting that rolling over loans has become widespread, as loans extended under the massive economic stimulus package introduced during the financial crisis came due but could not be paid back on time. Bankers appear to support the practice of rolling over mature loans, so long as interest can be paid. In the classification scheme developed by Hyman Minsky, this would be called speculative finance, where income flows can only service interest. He warned that a speculative position could become a Ponzi position, where interest has to be capitalized (borrowing just to pay the interest due). This is the danger an indebted corporate sector faces when growth rates fall (or interest rates rise). The issue of how China might be able to transition to slower growth is certainly complicated by heavy corporate debt. For that reason, the transition to slower growth needs to be carefully managed. One way of doing this is to have central government spending lead growth in a manner that strengthens corporate portfolios—effectively, by replacing corporate debt with central government debt. A slow transition to relying less on corporate debt to finance economic growth would reduce the danger of financial fragility.

These results do not depend on internationalization of the sovereign currency, nor do they require the liberalization of capital flows. Managing exchange rates and capital flows helps protect the economy from externally induced financial instability. Eventually, China will want to move toward greater flexibility of its exchange rate in order to maintain domestic policy space. Tight control of the exchange rate can be maintained only in the presence of sufficient foreign currency reserves. With a current account surplus as well as managed capital flows, China has ample policy space even with managed exchange rates. However, as the current account balance moves toward deficit and capital controls are relaxed, greater flexibility of the exchange rate will be needed.

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