China's Stuck *in the* "Muddled Middle"

How to find growth in a fractured world.

BY MOHAMED A. EL-ERIAN

For decades, China set a shining example of how to capitalize on globalization to accelerate domestic economic growth and development. These days, however, the country risks becoming a cautionary tale about mishandling globalization's shift from a beneficial tailwind to a disruptive headwind.

Although the Chinese economy's recent travails have some unique characteristics, they illustrate the growth challenges facing many developed and developing countries. They also show that while economic growth is not everything, you cannot solve much of anything without it.

This year was supposed to mark a robust economic recovery for China. Instead, many analysts have been forced in recent days to again revise down their projections for Chinese growth, and more are likely to follow suit. This increasingly pessimistic outlook can be attributed to three main factors.

First, as the most recent trade data show, the global economy no longer supports China's domestic growth dynamics. In June, Chinese exports fell by 12.4 percent (in dollar terms), and imports declined by 6.8 percent, far worse than the consensus forecast of a 10 percent decline in exports and a 4.1 percent decrease in imports. These disappointing figures are the result of sluggish demand growth in Europe and elsewhere, and enhanced restrictions against China, particularly those imposed by the United States, which created a self-reinforcing cycle that further dampened the country's growth prospects.

Second, the Chinese authorities appear to be torn between two distinct approaches to stimulating the economy, resulting in a rather indecisive policy response. While the government seems inclined to revert to the top-down stimulus measures it employed in the past, actual implementation has been limited, owing to concerns

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about exacerbating inefficiencies and impeding the ongoing and generally orderly deflation of debt bubbles in certain sectors. Conversely, the much-needed alternative of unleashing bottom-up economic dynamism is constrained by domestic political considerations, leaving China stuck in the muddled middle. Meanwhile, domestic policy challenges are compounded by structural factors, including the aging population, high youth unemployment, and remaining pockets of excessive leverage.

Third, the removal of the long-standing zero-covid restrictions has not led to a uniform sharp increase in household, business, and property demand. Instead, the process has been uneven and weaker than consensus forecasts. While GDP bounced back by 6.3 percent in the second quarter, growth fell short of the 7.1 percent pace that analysts expected.

Given that growth in Europe and the United States is likely to remain subdued for the foreseeable future, and with the global economy still reeling from the impact of the most aggressive wave of interest-rate hikes by central banks in advanced economies in several decades, China cannot count on globalization to rescue its faltering growth model. As companies seek to diversify supply chains away from China, inflows of foreign direct investment have also been constrained. Moreover, geopolitically driven trade and investment restrictions are more likely to increase in response to U.S. national-security concerns.

Rather than seeking salvation from external demand, China needs to sharpen its focus on domestic sources of robust and sustainable economic growth. Here, policy implementation has lagged, failing to match political leaders' rhetoric. Similarly, the country's industrial policy framework has yet to strike the right balance between macro-level directives and providing sufficient operational autonomy at the micro level.

To avoid the middle-income trap that has repeatedly ensnared emerging economies, China must avoid policy inconsistency. That said, and with only a small handful of exceptions, it is difficult to point to any sizable economy that has managed to evade this trap over the past few decades.

While China represents a special example of "muddled-middle" growth strategies, it is not the only country in danger of falling into a growth trap. Both developed and developing countries face a similar risk of economic stagnation or, worse, regression.

With the exception of the United States, few systemically important economies have recognized the significance of comprehensively reinvigorating their growth strategies. And even in the United States, where recent government actions have focused on generating higher and more sustainable growth, the process is still susceptible to disruption by another Federal Reserve policy error.

Over the past two years, Gordon Brown, Michael Spence, Reid Lidow, and I have been discussing strategies that would enable governments to deliver the inclusive, durable, and sustainable growth needed to meet their citizens' needs and aspirations. The results of these deliberations are outlined in our forthcoming book *Permacrisis: A Plan to Fix a Fractured World,* which will be published in September.

Our vision is simple. By adopting a "reduced form" approach, we have identified a manageable set of actions focused on three key areas: reengineering stagnant and increasingly ineffective growth models, improving domestic economic management, and enhancing global policy coordination and responses. We firmly believe that a detailed set of realistic and actionable measures could reverse worrisome secular developments, including declining growth and productivity, rising inequality, and heightened financial fragility.

Our findings could apply not only to China and other developing countries, but also to the world's major developed countries, whose domestic malaise and weak global engagement undermine their economic and social well-being and the stability of the international system. Despite the policy mistakes that have put our world on its current course, we now have an opportunity to heed the lessons of the past and present and chart a more promising path for future generations. ◆

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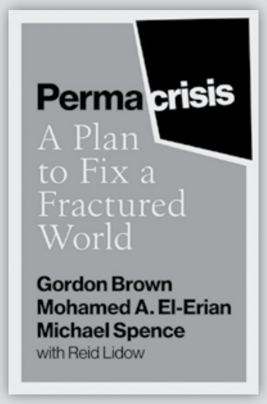
—M. El-Erian



Permacrisis: A Plan to Fix a Fractured World
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