Much of the media coverage of China’s economy suggests that the country is headed for a financial crisis. China’s mountain of debt is decried, local government finances are labeled menacing, and a property bubble is called disastrous. But this picture is misleading. While China has serious debt problems, with prudent macroeconomic policies and productivity-enhancing structural reforms, the challenges should be manageable if underlying fiscal issues and growth-related reforms are addressed.

Real but Overstated Financial Risks

• China’s level of debt has grown rapidly since 2009, but this credit boom fundamentally differs from others. The debt surge is the result of a deliberate state-driven stimulus program to stave off economic collapse in the aftermath of the global financial crisis. It has not been accompanied by the usual external imbalances, fiscal deficits, or overleveraged housing market that triggered financial crises in other countries.

• While corporate debt has skyrocketed, there is no evidence of widespread distress: risks remain concentrated in particular sectors with excess capacity and large state-owned enterprises. These pockets of distress will see mounting losses, but rising default rates appear to be anticipated and incorporated in the prices of the relevant stocks and bonds.

• The Chinese government’s balance sheet remains relatively healthy compared to that of its peer countries. The central government has the resources to rescue systemically important firms and banks, limiting the potential damage from mounting financial stress in the corporate sector. But those resources will not last indefinitely.

• Shadow banking in China is diverse and many forms generate marginal risks or are too disconnected from the banking system to threaten financial stability. The truly risky types of shadow banking account for a relatively small share of financial assets, and their impact on the formal banking system is being scaled back.

• A property market correction is beginning and will act as a drag on short-term growth, which could fall as low as 6 percent over the next two years. However, while the property correction will affect construction-related activity and production indicators, it will not have a seriously debilitating impact on the financial position of households or the banking system.

• Altogether, credit losses from the current economic stresses are unlikely to exceed 20 percent of GDP. Dealing with these losses will be costly and complex, but, after a period of consolidation, the country should be able to maintain relatively robust economic growth in spite of the financial upheaval.

• Still, reforms are needed to ensure China’s long-term financial stability and reestablish rapid but more sustainable growth. Many of the key actions lie in strengthening the fiscal system since the country’s debt problems are merely symptoms of underlying weaknesses in the way that resources are being raised and allocated. China’s leaders demonstrated that they realize change is needed in November 2013 at the Third Plenum meeting, when they laid out a comprehensive plan for reforming the economy.
**Implications for China’s Future**

The financial sector and the government will have to share the burden of credit losses. Such losses will be incurred as firms default on loans and bond payments and banks need to recapitalize to meet required financial standards. Forcing the financial sector to absorb the brunt of these losses is necessary to make it more risk conscious, but the government will need to periodically step in with bailouts and bank recapitalizations to maintain financial stability.

The government should not resort to financial stimulus to stave off the property market correction. China’s property sector is entering a period of structural oversupply that cannot be sustainably remedied by a stimulus package. This would only exacerbate existing debt problems by encouraging continued construction of housing in excess of long-term needs. At some point, the excess stock would lead to much sharper price decline that could destabilize the financial system. The only sustainable solution is to allow excessive housing construction to be scaled back.

China’s medium- to long-term growth outlook depends on the government’s success in implementing its Third Plenum reform agenda. If China enacts major fiscal and financial reforms alongside productivity-enhancing measures to facilitate a more efficient urbanization process, curb the role of state-owned enterprises, and rationalize regional investment patterns, it could see growth of around 7.5 percent in the years following an unavoidable property correction.