The world's two largest economies, the United States and China, seem to be enduring secular slowdowns. But there remains considerable uncertainty about their growth trajectory, with significant implications for asset prices, risk, and economic policy.

The US seems to be settling into annual real (inflation-adjusted) growth rates of around 2%, though whether this is at or below the economy's potential remains a source of heated debate. Meanwhile, China seems to be headed for the 6-7% growth rate that the government pinpointed last year as the economy's "new normal." Some observers agree that such a rate can be sustained for the next decade or so, provided that the government implements a comprehensive set of reforms in the coming few years. Others, however, expect China's GDP growth to continue to trend downward, with the possibility of a hard landing.

There is certainly cause for concern. Slow and uncertain growth in Europe – a major trading partner for both the US and China – is creating headwinds for the US and China.

Moreover, the US and China – indeed, the entire global economy – are suffering from weak aggregate demand, which is creating deflationary pressures. As central banks attempt to combat these pressures by lowering interest rates, they are inadvertently causing releveraging (an unsustainable growth pattern), elevated asset prices (with some risk of a downward correction, given slow growth), and devaluations (which merely move demand around the global economy, without increasing it).

For China, which to some extent still depends on external markets to drive economic growth, this environment is particularly challenging – especially as currency depreciation in Europe and Japan erode export demand further. Even without the crisis in major external markets, however, a large and complex middle-income economy like China's could not realistically expect growth rates above 6-7%.

Yet, in the aftermath of the global economic crisis, China insisted on maintaining extremely high growth rates of 9% for two years, by relying on fiscal stimulus, huge liquidity injections, and a temporary halt in the renminbi's appreciation. Had the government signaled the "new normal" earlier, expectations would have been conditioned differently. This would have discouraged undue investment in some sectors, reduced non-performing loans, and contained excessive leverage in the corporate sector, while avoiding the mispricing of commodities. Growth would still have slowed, but with far less risk.

In the current situation, however, China faces serious challenges. Given weak growth in external demand and an already-large market share for many goods, China cannot count on export growth to sustain economic performance in the short run. And, though support for infrastructure investment by China's trading partners – especially through the "one belt, one road" policy – may help to strengthen external markets in the longer term, this is no substitute for domestic aggregate demand.

Investment can sustainably drive growth only up to the point when returns decline dramatically. In the case of public-sector investment, that means that the present value of the increment to the future GDP path (using a social discount rate) is greater than the investment itself.

The good news is that growing discipline seems to be pushing out low-return investment. And there is every reason to believe that investment will remain high as the economy's capital base expands.

But, in order to boost demand, China will also need increased household consumption and improved delivery of higher-value services. Recent data suggest that, notwithstanding recent wage increases, consumption amounts to only about 35% of GDP. With a high household savings rate of around 30% of disposable income, per capita disposable income amounts to roughly half of per capita GDP. Expanded social-security programs and a richer menu of saving and investment options could go a long way toward reducing precautionary saving and boosting consumption. But what is really needed is a shift in the distribution of income toward households.

Without a concerted effort to increase households' share of total income and raise consumption's share of aggregate demand, growth of consumer products and services on the supply side will remain inadequate. Given that services are a significant source of incremental employment, their expansion, in particular, would help to sustain inclusive growth.

Another key challenge concerns China's slumping property sector, in which construction and prices dropped rapidly last year. If highly leveraged developers are under stress, they could produce non-performing loans – and thus considerable risk – in both the traditional and shadow banking sectors.

Fortunately, Chinese households' relatively low leverage means that the kind of balance-sheet damage that occurred in some advanced countries during the crisis, leading to a huge drop in demand, is unlikely, even if real-estate prices continue to decline. It also means that there remains some space for expanding consumer credit to boost demand.

That is not the only source of hope. Wages are rising, deposit insurance will be introduced, and deposit rates are being liberalized. Internet investment vehicles are growing. New businesses in the services sector – 3.6 million of which were started just last year – are generating incremental employment, thanks partly to a new streamlined licensing framework. And online platforms are facilitating increased consumption, while expanding market access and financing for smaller businesses.

China's leaders should aim to accelerate and build upon these trends, rather than pursuing additional fiscal and monetary stimulus. Public investment is high enough; expanding it now would shift the composition of aggregate demand in the wrong direction. And, with the corporate sector already overleveraged, a broad-based expansion of credit is not safe.

Any fiscal stimulus now should focus on improving public services, encouraging consumption, and increasing household income. Accelerating the expansion of state-funded social security could bring down household savings over time. More generally, China must deploy its large balance sheet to deliver income or benefits that expand what households view as safely consumable income. Given that private investment responds mainly to demand, such measures would likely reverse its current downward path.

A further slowdown in China is a distinct possibility. China's leaders must do what it takes to ensure that such a slowdown is not viewed as secular trend – a perception that could undermine the consumption and investment that the economy so badly needs.