

# Financial and Fiscal Reforms in Support of China's Rebalancing

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China has continued to grow well in recent years, but there are reasons to be concerned about the sustainability of its growth model. Before the global crisis China's growth relied to a considerable extent on net exports, as well as on a high investment rate. When the crisis hit, China responded forcefully with fiscal and monetary stimulus, but the stimulus was aimed largely at investment. So, the already high investment rate rose further, to about half of GDP. At that rate, China doubled its capital stock in the six years, 2005 to 2011. This has led to over-capacity in many sectors and a declining return to capital. There is widespread agreement within policy circles in China that the pattern of growth needs to shift to rely more on consumption and less on investment. China's household consumption is very low by international standards so that there is plenty of scope for increase.

Structural reforms will be an important part of the rebalancing, measures such as opening up the oligopolized service sectors to competition from private investors, including foreign investors. Or, easing up on the restrictions that prevent rural families from moving to cities, where they find significantly higher income and naturally have higher consumption. At the key third plenum meeting, the China Communist Party is likely to endorse in general moving towards a more market-oriented economy. But it is unlikely to roll out a large number of specific measures. Progress in many of the structural reform areas will be gradual.

Where there is more likely to be substantial movement is in the areas of financial and fiscal reforms. The authorities know that they need to slow down the rate of investment, but they want to do it very gradually so that the effect on aggregate growth is not too great. They had some modest success in 2012: Consumption's contribution to growth was actually slightly higher than investment's for the first time in years. However, in the first three quarters of 2013 China was back to the old pattern of investment growing faster than consumption. There are reforms in the financial and fiscal arenas that could accelerate a smooth transition to a more sustainable growth model.

In the financial arena, a key issue is the controlled deposit interest rate. This has been held close to the inflation rate over the past decade so that households get no real return on their financial wealth. It supports relatively low lending rates that encourage investment. Until recently households have had few options outside of the banks for their savings, as the stock and bond markets are underdeveloped. Firms that want to issue stocks or bonds need a number of different approvals, and there is a long line of firms waiting to go to the capital markets. The lack of good financial products encourages households to overinvest in real estate, and that is one of the foundations of the ongoing run-up in housing prices.

Reforming a repressed financial system is a tricky business. The central bank has already allowed banks a little bit of discretion on the deposit interest rate by permitting banks to offer up to 1.1 times the set rate. Banks quickly moved to take advantage of the extra flexibility. A natural next move would be to widen this band considerably. While bank interest rates have remained controlled, an important development in the past few years is the rapid expansion of a shadow banking system that offers trust products at higher interest rates. This has been a good development in terms of giving savers more market-oriented options. However, this is a lightly regulated sector and its development carries lots of risks. In the past few years there has been a very significant run-up in credit to GDP, and the authorities are trying to slow down the credit coming from the nonbank sector. Liberalization of interest rates, streamlining processes for stock and bond issuance, and bringing the shadow banking sector back into the regulated system—these are the natural next steps for financial reform. Well-designed deposit insurance could help contain the risks as China liberalizes the financial system. Financial reforms should support both macroeconomic stability and the transition towards more consumption-driven growth.

On the fiscal side, the key problem is a mismatch between local government expenditure responsibilities and their secure revenue base. Simply put, most taxes go to the center while most spending is at the local level. This mismatch requires ad hoc fiscal transfers each year. It also encourages local governments to pursue unsustainable revenue sources, notably the taking of land (which it is allowed to do with below-market compensation) and the sale of land to industry and developers. This process generates much social conflict, and is also a major source of corruption. An obvious reform under discussion is to introduce a property tax. This would provide a secure basis for local finance and also an incentive to stop hoarding empty apartments. Clearly this would have to be introduced carefully to avoid a sudden disruption of the housing market. Aside

from creating new sources of revenue for local government, there is also talk in Beijing of recentralizing certain expenditure responsibilities.

Another important aspect of local finance reform would be to allow local governments to issue bonds. In theory local governments cannot borrow. In practice they have set up thousands of infrastructure companies that float bonds and borrow from banks in order to finance infrastructure. Estimates of the total local government debt that has been accumulated are around 30 to 40 percent of GDP. One problem with this system is that much of the borrowing is short-term, to finance long gestation infrastructure projects, putting local finance on a risky foundation. Furthermore, the system is not transparent. There are widely differing estimates of the total local debt. Citizens do not have a good picture of all of the expenditures, including investment, by their local government. Moving to a system in which local governments have to disclose more about their overall finances and in which rating companies investigate and rate different local governments should lead to more efficient investment and avoid wasteful projects. A better informed populace is likely to lobby for more spending on education, health, and the environment, and less investment in prestige projects. There is a risk, however, that a move to allow local governments to issue bonds would simply lead to more total financing and hence more wasteful investment. So, it is likely that reform will be introduced gradually.

The extent to which China successfully introduces these and other structural reforms will have a major effect on Asia and the world economy. In the wake of the global crisis China's current account surplus has come down significantly, but it is still large, at about 2 percent of GDP. The overinvestment in China is likely to correct itself one way or another in the next few years—either smoothly with healthy growth and a shift towards more consumption, or in a more disruptive manner with market-oriented investment falling off as overcapacity and low returns become more prevalent. With a smooth transition, China will continue to be an important source of demand for the rest of the region and the world. A rebalancing towards more sustainable growth in China would benefit globally, even though China's growth may slow in the near term. The alternative is that savings remain elevated in China while investment falls off, and in that case there will be a tendency for China's external surplus to rise—at a time when demand is still weak globally. This would be a bad scenario for China and for the region. So, we wish our policymaking colleagues in Beijing well!