GENERAL DISCUSSION
Policymaker Panel

Chair: Mark Spiegel

Mr. Spiegel: We will use the time we have left for fielding some questions from the general audience. So let me make a list, I'll start with Ric.

Mr. Mishkin: David, the paper by Pritchett and Summers earlier on looked statistically at what would happen to China. The statistical analysis suggested that China is likely to have a very sharp slowing sometime in the future. So I'd be interested to hear your view about the probability that China will not slow and will be able to progress from low to middle income status and actually break through to the top tier?

Mr. Dollar: First I want to be clear that I don't believe anyone thinks China can continue to grow at 10 percent, right? So let's just take that off the table. Seven to eight percent over the next five years or so would be an outstanding performance. So as I say, I like Lant Pritchett's paper a lot because it's a good way of thinking about it. But what is missing from it is the policy side. The economies that avoided the kind of sharp slowdown he was talking about are basically South Korea and Taiwan. Depending on how you date it, you could also count Japan, if you think of Japan having some kind of a miracle up to about 1970 and then gradually slowing down before the stagnation. I have a paper on this arguing that China has a lot of important institutional differences from Japan, South Korea, and Taiwan in particular. The distinctive thing is that all three continued catching up to the U.S. total factor productivity (TFP) growth, getting up to 80 percent of U.S. TFP on average. China is now stagnating at about 40 percent, far behind the others. It also has a much higher capital output ratio and seems to have a much lower return to capital compared with the other countries at the same stage of development. So my serious answer to you is, I think China needs a very bold reform program to avoid a sharp slowdown, and I'm not going to put a probability on that. However, a really interesting question is, if China doesn't reform fast enough and there's a sharp slowdown sometime in the next five years, how will they respond? Will they pursue an aggressive agenda, so when you look out 20 years from now it'll be just a nasty blip? Or is there something that really is going to make it difficult? And the last thing I'll say is, higher income helps to foster democratic political institutions, which in turn contribute to innovation and productivity growth. So among those other economies, Japan had democratic institutions in place at the beginning of its growth path. South Korea and Taiwan transitioned to democracy at about the stage where China is now. It will be really interesting to watch how China's political institutions evolve over the next 10 to 20 years.

Mr. Spiegel: Martin Wolf next.

Mr. Wolf: A comment and a question. The comment is this. You can go a bit further on your point, David. I increasingly believe the choice they're going to face is, what are they more committed to? The preservation of the political system as it is now, or the growth and success of China? I don't know the answer, so I wonder what you think. My question is about the future of foreign currency reserve accumulation. This is addressed particularly to you, Deputy Governors Choi and John Murray. As we all know, and as Carmen Reinhart has discussed, reserve accumulation has been large and unexpected, and it has reshaped the world financial and monetary system in important ways. That's the past. As you show very clearly, there's no break in the trend through the crisis. The question is, is there a good reason to expect those policies to change profoundly over the next 10 years? There are several arguments why they might or might not. The argument that they might is, many countries have enough reserves now. How much does China need, 10 trillion? They've got enough. The other reason why they might think it's enough is, it's very expensive. There are real costs, particularly if you're buying low interest-yielding U.S. Treasuries. On the other hand, they may still want to hold more reserves for other reasons. So the future of reserve accumulation really does affect your rebalancing story in a very big way. Then there's a subquestion, which seems to me absolutely decisive in this regard, which is, is China serious about turning the renminbi into a reserve currency over a reasonably short time horizon, the next decade or so, or not? Because in that case they won't be accumulating reserves, they'll be producing them, and that changes everything.

Mr. Dollar: I can very briefly answer the first part. The way you just framed it about the political institutions and democracy, there's some debate among intellectuals in China along those lines, Martin, but I don't think the people in power are really having this debate. I don't think they're taking it very seriously. If not and you're right about your presumption, then it's likely that you will get a sharp growth slowdown in the medium term. And then, as I said, the interesting question is how things respond. I would like to be optimistic about China, that in the longer 20-year time horizon there are a lot of positives about Chinese society that could lead to a political transformation, but I wouldn't predict it in the near term.

Mr. Murray: I'm glad you went first David, you know much more about China than I'd ever pretend to. I guess the answer I'd give to you, Martin, does have an optimistic flavor, partly because I don't think there's any choice. As I tried to indicate in my remarks, they've sort of run out of runway. Trying to continue with the export-led growth just isn't going to work. For the advanced economies, the cupboard's bare. There's this need to consolidate and save on the fiscal side. In a way, they've run out of foreign customers, so they're forced by default to turn to their own domestic customers. That may be a delayed realization that rebalancing is the only way to preserve some growth. With regard to the renminbi, what I've seen and heard from the authorities is a fairly serious attempt to move towards broader, deeper financial markets and a more flexible internationalized renminbi. This is part of a package that uses price signals increasingly to help guide rebalancing and reform. So for these reasons I'm fairly hopeful. I shouldn't say optimistic, but there is no other alternative.

Mr. Spiegel: Deputy Governor Choi, would you like to comment?

Mr. Choi: Yes. Korea is one of the most interesting cases of reserve accumulation. Korea now holds $343 billion in its reserve silo. Although we have displayed financial market resilience to global financial turmoil over time, we still are very concerned about the big waves ahead associated with the Federal Reserve's QE tapering and normalization of its monetary policy stance over time. So we are trying to strengthen our financial sector further. In addition, we have lengthened the average maturity of our foreign borrowing. We are moving in the right direction, but still we have memories of the 1997–98 Asian financial crisis. So we are looking forward to strengthening Asian financial integration, and reaching some kind of new arrangement between countries in the region that will lessen the need for reserve accumulation. Our government authorities are aware that accumulating too much reserves will hinder investment for future growth. So the new government is trying to push higher domestic demand, which will be conducive to global rebalancing over time. Thank you.

Mr. Spiegel: Thank you. Peter, next question.

Mr. Hooper: A question for John on Canada. You get much well-deserved praise for having a well-run, well-regulated banking system and for having avoided the excesses during the bubble period in the United States. But now the housing market does appear to be reaching bubble territory in Canada, judging from movement in price-to-rent ratios and price-to-income. How has this happened, and does this increase Canada's vulnerability to a possible run-up in global bond yields in the event of tapering?

Mr. Murray: Good question. Certainly we've identified household debt and house prices as our primary domestic risk. It has been one result of low interest rates, and this idea of using domestic demand as a bridge until we rebalance so that exports are carrying more of the load. We discussed this in our most recent monetary policy report. We see a soft landing, in which house prices, at least in real terms, actually declined slightly. And we've seen a sharp deceleration in household credit recently. We see things moving in the right direction. I don't think we ever talk about a housing bubble, but we have acknowledged in our financial system review that house prices are stretched in Canada. They no doubt have risen to quite high levels, as has the level of household debt to income. And that's now a consideration in our monetary policy process; we definitely regard this as one for risk management.

Mr. Spiegel: And the last question is from Michael Hutchinson.

Mr. Hutchinson: A question for David. In many respects the remarkable growth of China is associated with how quickly they can invest efficiently. What I mean by that is, if you speak to Americans engaged in foreign direct investment, it's truly remarkable how quickly they set up production facilities, those are approved, and they move forward with infrastructure projects. But the downside is that there are very serious environmental issues, as you pointed out, expropriations, and low real wages up until fairly recently. There are severe restrictions on mobility, that is, workers can come but not families. So in some sense the optimism you're suggesting about moving towards a more democratic system could put a brake on all of those things. Doesn't that suggest that if you have a more participatory process, that the very features of Chinese economic growth would in fact be severely slowed down, at least in the short run? So the scenario mentioned yesterday of a sharp growth slowdown in China seems to me very plausible in a political economy setting. Now to Deputy Governor Choi, we've seen a remarkable transformation in Korea away from a much more centrally controlled, credit controlled system, with the chaebols at the center of the system. Would you have any advice from the Korean experience for Chinese policymakers?

Mr. Spiegel: David, do you want to take the question first?

Mr. Dollar: Yes. I really think the current growth model in China is unsustainable, so I basically agree with the thrust of where you're going.

Democratization and more political participation would undermine a lot of features of the old growth model. I consider that a good thing because I really think the old model is unsustainable. You're right that it's very impressive the way local government can dispossess peasants with far below market compensation, and then they can put a job out to bid and put a metro through my neighborhood in Beijing in an extraordinarily short time during the crisis. But they're building up capital stock first to export, and now they've been so successful that they're the biggest exporter in the world. It's hard to see how that can grow faster than the world market. They invest to build a lot of infrastructure, but now they're at risk of overbuilding, because you've got major airports in small cities that you've never heard of. You've got metros in small cities. And the evidence is that the return to this capital is now dropping very sharply. Also, a lot of it is backed by debt, so to keep growth going I believe the old model will end in some kind of overinvestment crisis or financial crisis. Their best hope is to transform the model and, as you say, more popular participation would help. Because if people knew what their local government was doing, they would want more environmental protection, and more health and education and safety nets, and they would want a lot fewer prestige projects and industrial zones now that the future prospects do not look super.

Mr. Spiegel: And Deputy Governor Choi, you get the last word.

Mr. Choi: I pretty much agree with David's response, but I have some other suggestions for Chinese development strategy. Recently I heard that Chinese investment is mainly focused on boosting aggregate demand without contributing to future growth. Say, suppose, that the depreciation rate of Chinese capital is more than 20 percent, rather than 5 percent or 8 percent per year. Then what is the purpose of investment? If investment is mainly replacing depreciating capital, China must change its development strategy, boost demand that leads to income growth, which in turn leads to demand for investment. Now as regards the liberalization process in the financial sector and the foreign exchange market, I believe China is headed in the right direction in its plans to liberalize domestic interest rates and the foreign exchange market. But I think this process could speed up a little. After that, I believe China should think about overhauling its social infrastructure by improving its regulatory systems and encouraging more social mobility. Korea has moved in that direction very fast, but we still have a lot of regulations and restrictions in various sectors, especially the service sector. So maybe the next decade's challenge for Korea is reforming the service sector and the labor market. Thank you.

Mr. Spiegel: Thank you. Please join me in thanking the panel for a very interesting discussion.