

GENERAL DISCUSSION

Sustaining China's Economic Growth after the Global Financial Crisis

Mr. Goodfriend: I'd like to ask you to follow up on something you said. It's well-known that China has an advantage in development, relative to India or other countries, because it has a more centralized government and can internalize problems in the country and undo interest group paralysis to make things work. Your discussion suggests that advantage, which China has exploited for the last 30 years, again relative to India, appears to be a problem at the moment. I'd like you to go into this a little bit: Why is it that a country that's set up to internalize problems at the very top is facing a problem now in overcoming interest group politics as you described?

Mr. Lardy: That's a very good question. Certainly, many people argue that one of the difficulties the government has in implementing policies is the inability to get local governments to comply with their directives. I don't think that really applies in this case because the interest rate is set at the central level. Local governments cannot have their own interest rate policy. So once this decision is made at the central level, it will have a dramatic effect throughout China. If you allow interest rate liberalization, this huge nexus of interests would remain in favor of current policy. Obviously that includes property developers and construction companies. The rich list published by Hurun shows that about 90 of the top 100 richest people in China have made their money in property, and they're a very powerful interest group. Local governments like the money that they can earn from leasing land that goes with property development. But once the central government undoes this distortion, all that will peel away. People cannot be forced to buy more property than they want, and once demand subsides, the property developers will have to adjust fairly rapidly. So the question is, What's the holdup at the central level on interest rate liberalization?

I've already indicated that one of the challenges is that the Ministry of Finance has a very strong vested interest in propping up the profitability of the banks. If you look at just the raw numbers on their rate of return on assets, it is world class, but that's not hard when you have a guaranteed interest

rate spread. Now, why is the Ministry of Finance in favor of this? You have to look at the history, for example, of the creation of their sovereign wealth fund, which they started by giving \$200 billion worth of foreign currency assets to the China Investment Corporation (CIC) in 2007. Ted Truman has worked a great deal on this subject. So to raise the money to do this, the Ministry of Finance had to issue 1.55 trillion in renminbi-denominated bonds, and when the assets were transferred to the CIC, they also transferred the liability. So, the CIC has to pay the interest and amortize this rather large bond issuance. This is done by having Central Huijin, which is the domestic arm of the CIC that invests primarily in domestic commercial Chinese banks, use dividend payments from the banks to service the debt. The standard complaint, which is completely valid and which I have made many times and continue to make, is that most state-owned companies pay out very low dividends, but the commercial banks are a complete exception. In recent years, some banks are paying out 70 to 80 percent of their after-tax profits in dividends, which goes directly to the CIC. Zhou Xiaochuan, the Chairman of the Bank of China, which is their third largest bank, said if interest rate liberalization was instituted then bank earning spreads would fall by half and the ability of banks to pay huge dividends would be eroded. So the Ministry of Finance is terrified that if Central Huijin doesn't service the CIC's debt the burden will fall back on the Ministry of Finance, which will have to pay it from tax revenues, something they're very loathe to do. Thus, they're campaigning as hard as they can against any interest rate liberalization.

Then there is the central bank, which promoted the early stages of market-oriented interest rate liberalization in China in the late 1990s. China was then on the path toward a market-determined interest rate structure, but in 2003 and 2004, the currency became increasingly undervalued and the central bank had to recapitalize all of the banks and issue a lot of bonds. At that time, a decision was made to ensure the profits of commercial banks. That's the most important obstacle at the central level.

I think that the burden of CIC should be handled by taking the hit and paying the interest on the CIC's bonds from fiscal revenues. There are a lot of advantages to moving toward interest rate liberalization beyond the ones I've already described. If you have floors on lending rates and ceilings on deposit rates, it's not a very good environment for developing a truly commercial banking system, which is one of their most important long-term goals of development.

Mr. Wei: Two comments. One, when you juxtapose a picture of the current account surplus and a picture of a foreign exchange reserve accumulation, a

common interpretation is that the foreign exchange reserve picture shows evidence of massive intervention to induce exchange rate undervaluation. According to common wisdom, that would lead to a current account surplus, though that's not the only way to interpret the data. The alternative is the central bank may have a dual mandate of maintaining inflation by the use of monetary policy and undervaluing the exchange rate through capital controls on currency usage for imports. Suppose this undervalued exchange rate causes high savings and a current account surplus, which requires mandatory surrender of foreign exchange earnings by firms and households. This would also give you the appearance of accumulation of foreign exchange reserves. So, that is a matter of logic.

Second, I understand you want to argue that the negative real interest rate on bank deposits, combined with the implicit assumption that the income effect dominates the substitution effect, will give you less wealth and therefore less consumption. However, I'm confused because a few seconds later you said that more and more household wealth in China now takes the form of residential housing, an asset whose price has been appreciating at an unusually fast rate. Given that by 2010 housing assets were as large as bank deposits, if not more so, wouldn't that effect go in the opposite direction? That is, if the lower wealth coming from lower interest rates on bank deposits induces people to consume less, wouldn't higher wealth and expectations of appreciating housing value induce people to consume more?

Mr. Lardy: Thank you, Shang-Jin, for two very good comments. On the first point, I agree with you in theory that the mandate of low inflation plus enforcing capital controls could lead to a buildup of foreign exchange reserves of the same type as we've seen. I have two reservations about that interpretation. First of all, most of the requirements for surrender have completely disappeared in the last five years. Firms that earn foreign exchange can keep very large balances in their foreign currency denominated bank accounts. Since the surrender requirement is gone, the central bank hopes that firms would retain foreign exchange rather than selling it on the market so that it wouldn't have to intervene in the market so much. But firms, with an expectation of appreciation, have voluntarily sold most of their foreign exchange earnings on the market rather than holding onto them. Export earnings are substantially ahead of imports. The demand for foreign exchange to finance imports has led to the buildup of foreign exchange reserves. So the surrender requirements are basically no longer in effect. I think this is laid out in Eswar Prasad's paper about the extent to which capital controls have eased somewhat over time. The other thing to

look at, of course, is what's the source of China's overall balance of payments surplus? Until 2011, the overwhelming source of the foreign exchange surplus was the current account rather than the capital account, which reinforces the argument.

I agree with you on the second point. In theory, if house price appreciation persists for a long time and influences expectations, then you would expect a very positive wealth effect and people might reduce their saving rate. I don't know any studies that deal with the formation of price expectations and whether that's now enough ingrained that we should expect to see the saving rate come down. I don't think there's much evidence that it has come down yet, but it is an empirical question that's worth investigating because I agree, it should be pushing the other direction. But remember, in the diagram, even though the share of household assets in property has roughly doubled, the share of household assets in bank deposits is still fairly high at more than 40 percent. It's now roughly equal to housing, so you still have a big exposure to bank deposits based on the data at the end of 2010.—Eyeballing it, it looks to be somewhere between 40 and 43 percent.

Ms. Forbes: Two comments. First, for the organizers, thank you for giving us two very different views on China. I thought this was a nice contrast from the luncheon speaker. But a suggestion: Next time why don't you put the more negative one at lunch and then we can end on a positive note? [laughter]

Second comment for Nick. Thanks for a very nice presentation. I'm going to give you a chance to redeem yourself and say something positive. A basic question: If the situation in Europe deteriorates substantially, say the euro breaks up, how will that affect China, and do you see any major changes in China's policy mix?

Mr. Lardy: That's a very good question, a challenging one, and one to which I'll give a not totally satisfactory answer. My basic view is that China is in a very different position today than it was when the global economy was heading south, particularly in the fourth quarter of 2008. If you think of my diagram on household leverage, it was 30 percent of disposable income, very low. Now it's 50 percent; it may be a little bit higher by the time we get to the end of 2011. So the ability of the household sector to engage in a big further ramp-up of borrowing to finance housing investment to stimulate GDP growth is obviously more constrained. The same is true on the government side. Going into the crisis, central government debt was about 20 percent of GDP and local government debt was basically almost nonexistent. Now, central government debt hasn't changed very much, but local government debt is 20 percent of GDP. The

government debt-to-GDP ratio is roughly doubled what it was in 2008. It seems to me that the government's degrees of freedom today are substantially less than they were three years ago. A big European slowdown that's persistent over many quarters will have a very substantial effect on GDP growth. Also, it looks like it's hitting about the time that we may be heading into a significant change in the property market. Property sales now are falling month over month by close to 20 percent, and prices are coming down for the first time ever. This happened in 2000 and in 2008, when they had a correction in property and they took off a lot of restrictions that were designed to discourage speculative investment in housing. They got this big housing boom in 2009 and 2010, but then investment in housing was about 6 or 7 percent of GDP. Did they want to try to do that again when they were already north of 10 percent of GDP in residential housing? I don't know. It seems like a very risky strategy. So, I think they face substantial challenges over the next several quarters as they try to deal both with this emerging indigenous correction in terms of declining housing investment and a potential further decline in external demand because of a slowdown or worse in Europe.