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China's challenge: Balancing state and market

James A Dorn | August 25, 2012

The slowing of the global economy is forcing China as the world's largest exporter to confront the issue of rebalancing, which at heart is a problem of striking the right balance between state and market. State-owned banks still dominate the financial sector and are kept profitable by a positive spread between loan and deposit rates dictated by government policy.

Financial repression has penalized savers while rewarding banks. The recent decision of the People's Bank of China (PBOC) to allow greater flexibility in interest rates is a welcome sign.

In June, the PBOC announced that banks will be allowed to offer loans at interest rates up to 20% below the benchmark rate and be free to pay savers a rate up to 10% above the ceiling rate. With CPI inflation at about 2%, real rates on saving deposits are now positive. Wang Tao, chief China economist at UBS in Hong Kong, calls the deposit rate reform "unprecedented" and a "milestone for interest-rate liberalization."

The influence of the state in controlling key prices - notably interest rates, the exchange rate, and prices for refined energy products, water, and electricity - politicizes investment decisions, artificially spurs export-led growth, and favors manufacturing. China's challenge is to expand the scope of private markets and use competitive pricing to allocate resources efficiently. Once prices are right, China's growth path can be rebalanced toward greater domestic consumption.

President Hu Jintao wants to build a "harmonious society" by creating a more extensive growth model that spreads growth to less developed regions and by decreasing income inequality. Yet, as Nicholas R Lardy, one of the world's leading China scholars, notes in his new book, *Sustaining China's Economic Growth after the Global Financial Crisis* (Peterson Institute for International Economics), present leaders have not done much to extend liberalization in the post-Deng Xiaoping era. Modest reforms are not sufficient to free interest rates and other key prices from the hand of the state. The new leadership team that is soon to take over will need to take bolder steps if China is to end financial repression and extend prosperity.

China's 4 trillion yuan (US$586 billion) stimulus program was launched in 2008 to counter the global financial crisis. Monetary easing and infrastructure investment, financed primarily by loans from state-owned banks, helped keep real gross domestic product (GDP) growing by more than 9% in 2009 and more than 10% in 2010, while the United States, Europe, and Japan languished.

Critics of that program, such as MIT economist Huang Yasheng, argue that state intervention during the crisis has set back the reform effort and harmed the private sector. In particular, it is claimed that the bulk of bank loans went to state-owned enterprises.

Lardy does not accept that verdict. Relying on official data, he concludes that "the stimulus program did not lead to a wholesale advance of the state at the expense of either private firms or individual businesses." In particular, "state-owned firms did not increase their share of bank lending." Nevertheless, he recognizes that the state continues to retain control over the so-called pillar industries such as banking, finance, telecommunications, and petroleum. And he acknowledges the "stepped-up level of state industrial policy", although he thinks it is premature to predict the impact on "the balance between state and market".

The question about the proper balance between state and market should be at the center of any debate regarding China's future. Promoting capital freedom - that is, the right to acquire and exchange titles to capital assets - would allow private individuals a wider range of investment choices and limit the power of state officials.

Lardy and others argue that one way to increase consumption in China is to extend the social safety net to include rural residents, who now have to pay most of the costs of education, health, and retirement. What is neglected, however, is that reliance on private savings reduces one's dependence on government and thus fosters civil society. In contrast, expanding state welfare would tilt the balance between state and market toward more government power and less individual responsibility.

Private firms, many of which are foreign-funded, have been the most important contributors to growth in manufacturing, primarily in tradable goods. Exporters and import-competing industries have benefited greatly from China's opening to the outside world, beginning in 1978. The existence of widespread shadow banking serving the private sector, however, indicates that state-owned enterprises have much easier access to credit.

The recent Wenzhou experiment (based on a town in eastern China noted for its entrepreneurial activity), which officially recognizes and sanctions the informal banking sector, is an explicit admission of past discrimination. Also, the use of investment platforms (special investment vehicles) to fund local governments steers funds to SOEs involved in development projects, thereby affecting the balance between state and market.
There is also the problem of identifying recipients of loans from state-owned banks by type of ownership. No official data exists on bank credit by ownership type. Thus, Lardy looks at bank loans by firm size, assuming private firms are mostly small enterprises, and finds that their share of new loans made under the stimulus program exceeded credit going to larger enterprises. He also finds that

the share of industrial output produced by SOEs has continued to decline - from more than 80% in 1978 to less than 28% today.

Nevertheless, Lardy is critical of the lack of any significant progress in reforming the state sector by liberalizing factor prices, especially interest rates, during the stimulus program. The government continues to set a ceiling on deposit rates and a floor on lending rates. The positive net interest spread enhances bank profitability and gives state-owned banks an incentive to favor financial repression.

Low or negative real interest rates on deposits, including saving accounts, provides a low-cost source of funding for state-owned banks. Households appear to have a target rate of saving in order to meet expected expenditures for housing, education, healthcare, and retirement. Thus, Lardy finds that when interest rates decline, households tend to save more. Meanwhile, relatively low lending rates encourage investment, including in residential housing.

The sources of the imbalances in China's economy are due to the distortions in the price system and the politicization of investment decisions. Unless those distortions are removed by ending financial repression and allowing a greater scope for private markets, China will face increasing disharmony.

The most fruitful reform, notes Lardy, would be to end financial repression by liberalizing interest rates, which would increase real rates on deposits, thereby decreasing saving if the income effect is strong, and increasing consumption. That process now appears to have begun.

Of course, if interest rates are to be market-determined, there must be fully competitive private capital markets, which would require privatizing state-owned banks and bringing shadow banking into the daylight not just in Wenzhou. In addition, the renminbi (also referred to as the yuan) needs to be convertible for all transactions, not only for trade in goods and services. Investors need to be free to choose both domestic and international assets for their portfolios. Using credit quotas and interest rate controls to allocate scare capital leads to corruption and inefficiency.

The essential condition to normalize China's balance of payments, shift to a more service-oriented economy, slow investment growth, and increase consumption is to get relative prices right - especially interest rates and the exchange rate. Economists at the central bank and elsewhere have called for faster liberalization and restructuring, but the pace of reform will depend on political factors in a one-party state.

The United States and others can put pressure on China for further reform, but such pressure is limited and could backfire. It would be better for Western debtor countries to get their own fiscal houses in order than to attack China for an undervalued exchange rate and threaten protectionist measures that would reduce world trade and wealth.

A capital-poor country like China should not be a net exporter of capital. By holding trillions of dollars of low-yielding foreign debt, China deprives its citizens of the wealth that could be created by relaxing capital controls and encouraging imports by allowing market-determined exchange rates and freely determined interest rates.

China's challenge is to undertake institutional reforms that protect individual rights, strengthen the private sector, get prices right, and thus tilt the balance between state and market toward more freedom and less coercion.

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