Some 'tips' from the Conference on China, January 10 and 11 2013, Hong Kong Monetary Research Institute

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I. GROWTH

- Interest rates liberalization? Big issue for the immediate future. Some commercial banks have already began. Benchmark rates already adopted.

- Other banks: opening channels of capital flows for residents. In capital markets right to issue bonds in domestic market through the stock exchange.

- As capital controls is concerned, progressing towards the IMF new vision. (See IMF Ostry 2010 and 2012).

- Price liberalization in the financial sector, probably more rapidly than most people think.

- Is it going inevitably to 6%-7% growth? Is a trend or a cycle? The answer: the latter.

- At current growth rate, per capita GDP doubling every 9 years, with 20% of the world population, today 1/5 of per capita GDP of US and the same as Brazil.

- The main driving force has been productivity, much more than investment or simple demography. No doubt, there is much more room for sustaining actual growth, at least for the next two decades.

- Investment growth almost the same as GDP growth. Labour now growing less than 1%. Investment on GDP near 50%.

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- Productivity and investment in human capital, the key. TFP (total factor productivity) grew the last decade (1998-2009) 9,17% annual. Much more than in previous decades. 1988-2009, 7,02%. The inflection point was reached around 1978 (the first big agricultural reform by Den). Growth 1978-2009 was 8,04%. Growth 1952-1978 was only 2,97% and TFP growth was negative.

- Technological progress, policy and institutional reforms, structural transformations (from agriculture to manufacturing and services, from state to non-state business). The first step forward was agriculture to free labor for other sectors. TFP in non-state sector well above the state sector.

- Labor productivity average annual growth 1978-2009: agriculture 7,13%, non-agriculture 5,56%, aggregate 7,86%.

- Conclusion: productivity in non-agriculture, non-state sectors, the main source of growth. Could be sustained? The answer: still plenty of room to catch up US productivity.

- Restriction: still capital market distortions, which should be removed. Need for a more decentralized banking system and entry of small private financial institutions. Need for reducing monopoly control of the state in key industries and services and barriers to labour mobility.

- Only during the recent crisis (2007-2009) the growth rates of investment were higher for the state sector than for the non-state, as a counter-cyclical strategy. Plus RMB (renminbi) 4 trillion stimulus by the Chinese government.

II. STATE-OWNED BANKING: A VERY STRONG WEAKNESS

- During periods of crisis private banks tend to be pro-cyclical: the truth.

- The four biggest banks of China control 32% of total credit.

- Monetary policy mainly controlling loan supply and "suggesting" (but not forcing) where credits should go. In other words, "window guidance", the Japanese style of the postwar surging age.

- Loans discrimination against non-state sectors. No blame for loans if defaulted? Not obvious. The credit still misallocated. Surging credit for local governments, probable defaults.

- Still political influence remains.

- Strong regulation, especially for deposits, still remains.

- Career concerns among bank officials.

III. CHINA SECONDARY PRIVATIZATION

- Refers to the stock exchange. Initial shares reform (partial) was performed in the early nineties. A spilt-share system was established: non-tradable and tradable shares coexistence.

- Early privatization failed because: legislation, methodology, fall out of share prices during privatization of 10% of the first big ten state-owned companies.

- The lesson: the market negotiation mechanism predicts positively success of privatization, rather than top-down administrative privatization process.

- The trend toward privatization of share structure will go ahead, but speed is uncertain.

IV. DE-MONOPOLIZATION

- Low productivity associated to state-protected monopoly rights. Deters entry of firms with better work practices.

- Switching from monopoly rights to free enterprise: need to speed up the process to gain efficiency. Post-WTO (World Trade Organization): impressive efficiency gains in competitive tradable sector in China: state-owned plants run 40% TFP bellow the non-state.

- Monopoly rights still predominates in the capitalism state-led system of China.

- Energy, telecommunications, banking, health, transport, construction, among the most protected monopolies.

- From de-monopolization, GDP major gains come mainly through TFP. Additionally, it is one of the optimal ways to expand internal consumption through lower prices.

- The China-US per capita differences are explained mainly by the monopoly rights system in China. The inspiration comes from the very positive experience of policy reforms adopted so far in China, which have multiplied by 3,5 times TFP in those sectors that have been liberalized.

- Of course, there must be some natural monopolies like oil, utilities, communications, etc. which, accordingly, should be excluded from de-monopolization policy. Difficulty in drawing the line between those activities where monopoly rights must be preserved and the rest. The debate is open.

V. TRADE POLICY DOMINANCE OF MONETARY POLICY

- Is the "window guidance" coherent with capital market liberalization? However, capital market liberalization still dubious, even in the medium term, not only for economic reasons (currency appreciation), but also for overwhelming geopolitical reasons (absorption of rural outmigrants in urban industrializing areas).

- The present interest rates structure (lending rate floors and deposit rate ceilings and annual loan quotas) represents, in practice, a tax on deposits and a subsidy for industry. Nevertheless, the floors and ceilings and annual loan quotas, theoretically, are not necessarily binding.

- The system of loan quotas work as a ceiling, not as a floor, resulting in a restriction on loans (which are cheap because of the deposit rate ceilings), at higher margins.

- The financial sector still dominated by banks. While the four biggest Chinese banks are the most profitable of the world.

- Monetary policy making in China continues to be complex and distorted by a wide set of non-market instruments, as well as by the mix of deposit ceilings and loan quotas. China's monetary policy constrained by trade policy. Or, which is the same, trade policy dominance of monetary policy: exchange rate peg regime, undervalued currency, persistent trade surpluses, capital controls (private agents restricted from holding foreign assets), Chinese interest rates lower than foreign rates.

- "The dollar is our currency, but your problem" (John Conally, Secretary of the Treasury 1973). Continues to be so in our time, believe (rightly) the Chinese. Remember the "exorbitant privilege".

- China started rising interest rates after the crisis.

- When foreign interest rates fell, sterilization costs go up.

- True, open capital account, in theory, would help reducing the need of sterilization, and letting exchange rate float would also help by facilitating restoration of current account balance. But the priorities for the pragmatic Chinese leadership seem to be different for the time being.

- FED going to the 4th round of QE (according to Mark Spiegel from the Federal Reserve Bank of San Francisco).

- Credit channel is a very important (probably the most) transmission mechanism for China.

- Most exporters are extremely credit dependent.

- Credit channel plays a dominant role in monetary policy transmission, while private export firms face restrictions in their access to credit. But interest rate channel is very weak, while policy mainly relies in quantitative credit instruments as quotas and regional distribution. Exports are more external credit dependent.

VI. THE RENMINBI (RMB) IN THE TRADE OF THE ASIAN-PACIFIC REGION

- RMB becoming a major *"invoicing"* currency in the region. Remember the euro's and yen's experiences.

- Whenever a country becomes the mayor trade and investment partner in a region, its currency will predominate on it. Remember especially the history of the yen after the second world war.

- In outside the region, it will depend on the openness of the capital market and the development of the financial sector. In my opinion, it will take an extended period of time.

VII. A PROVINCIAL VIEW OF GLOBAL IMBALANCES

- Expected variation in real exchange rates is probably the main driver of capital flows in China, especially in provinces more financially developed, more open to foreign capital, and richer in minerals.

- The primary objective of capital controls policy clearly consists in preserving (defending) the competitiveness of the real sector of the economy, especially industry and agriculture, by avoiding excessive appreciation of the currency.

VIII. LABOUR MARKET

- In general terms, neither labour market tightness nor migration have significantly affected wages yet.

- There is no shortage of labour at the aggregate level yet, but sectoral shortage of labour and skill mismatches do exist, particularly in East China.

- Superior and university education has advanced substantially in China, but vocational education lags behind.

IX. SLOWDOWN: CYCLICAL OR TREND?

- 10% average annual growth rate so far (last two decades) due to both investment and productivity: infrastructure; human capital; rapid adoption of foreign technologies.

- Labour has not been growing very much.

- Productivity has surged especially in the manufacturing sector, the driving force of the TFP growth.

- Capital stock has been growing 10%-12%, but will slowdown in the coming years.

- Labour market has been quite tight. Surplus labour is being reduced.

- Surplus labour was very important driving force, but not anymore.

- Ample room for continue growing fast (8%?) during long time. Differences with former tigers (Thailand, South Korea, Indonesia, Malaysia, Singapore, Hong Kong, Taiwan): second largest economy of the world; natural and strategic resources endowment, including raw materials and energy; size (one fifth of global population)..., etc.

- Of course, the investment surplus (or excess?) is a problem. But gives additional room for stimulating internal demand without major inflation risks.

- Manufacturing sector, the strength in the short term. In the medium and the long terms, of course, services.

- Working population (15-64 years) declining. Labour market in agriculture also declining, while growing in non-agriculture.

- The supposed slowdown is, definitively, cyclical.

- Unstable growth in China is part of reality.

X. THE NEAR AND FAR FUTURE: GRADUALISM

- The first reform in agriculture in 1978 exhausted very soon: only four years. Later, new reforms to keep pace. Now, stimulating internal demand successfully. Gradual opening of the economy. Gradual de-monopolization. Further gradual reforms of markets coming. More ways to generate jobs. The Chinese pathway of doing the right things is gradualism.

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