Macroeconomic Implications of China's Trade and Investment Liberalisation

Good afternoon. I am honored to have the opportunity to discuss the OECD study in the company of Mr. Liu and the other distinguished experts who are here, including many of our friends who have contributed to the study.

My task in this last session to summarise the implications of the structural conditions we have been talking about for China's macroeconomic policies. We have departed from usual practice in dealing with this topic last, because when structural problems are as extensive as they are in China, the interdependencies among those problems and their effects on aggregate performance largely shape the priorities and constraints for macroeconomic policies. Dealing with macroeconomic issues at the end is a useful way to highlight the implications for the overall economy of the structural issues that are the subject of most of our study.

I will focus on two areas in the remainder of my remarks. These issues are discussed in more detail in the last main section of the synthesis report and in several of the chapters [Slide 1]

- The key challenges that macroeconomic policies will have to address over the next five to ten years, to ensure a successful adjustment to trade and investment liberalisation and to realise the development potential of the economy.
- Some specific implications of these for reforms that will be needed to macroeconomic policies and policy instruments

Key challenges for macroeconomic policy

China has had an excellent macroeconomic performance in many respects. It came through both the 1987 Asian financial crisis and the recent world economic downturn rather well; the external accounts have remained very healthy, with ample international reserves, a comfortable current account surplus, and an exchange rate that has remained both stable and competitive. These successes are substantially attributable to skillful and prudent macroeconomic policies.

Nevertheless there have been increasing signs in recent years of strains in macroeconomic performance, particularly in two areas:

- Economic growth has slowed noticeably since the mid-1980s, and growth in employment has slowed even more, to the point that it has led to even more slack in labour markets;

- Inflation in the early 1990s has given rise to deflation, which reflects large-scale excess supply in many markets.

These problems do not reflect the natural slowdown in potential growth that comes as development matures, but rather from large-scale structural problems. These include, notably: the decline in profits and investment of a large portion of enterprises; the waning of the dynamism of rural enterprises and falling agricultural prices that have held back growth in rural income and consumption.

Looking over the next five to ten years, the basic challenge to macroeconomic policy is to sustain a 'virtuous circle' in which macroeconomic performance creates conditions that facilitate necessary structural adjustments and reforms, which in turn provide a further positive impetus to macroeconomic performance. The biggest risk is a vicious circle in which enterprise, banking, unemployment, and other structural problems either do not improve or get worse, and generate further deflationary pressures on real growth, which in turn make it all the more difficult to make progress on the structural problems. China came dangerously close to falling into such a vicious circle several years ago. While performance has improved since then, it is fair to say that the risks have not disappeared and that more will need to be done to firmly establish a virtuous circle.

In sustaining a virtuous circle, there are two longer-term considerations, and three more immediate ones, that we believe will be important in shaping the priorities for macroeconomic policies and reforms. Let me begin with the longer-term considerations [Slide 2].

- First is the need to improve resource utilisation over time so as to better realise China's productive potential. [Slide 3] Messrs Kwiecinski and Reutersward have talked about the large amount of under-employed and unemployed labour in the economy, especially from rural areas. In recent years, though, employment growth has been at best sufficient to maintain existing slack in labour markets-- but not to reduce it. To improve the utilisation of labour will *at some future point* require faster growth in both employment and real GDP than has been experienced in the past several years. I hasten to add, however, that this faster growth will not be achievable until more progress is made in dealing with current structural problems. To try to do so through more monetary or budget stimulus in the near-term would pose unacceptable risks of inflation and other problems.

- Second is the importance over the longer term of better balance in the growth and development of China's regions. [Slide 4] This is sometimes viewed as a matter of equity, 'sharing' in China's overall development, but it is very important for macroeconomic performance beyond the near-term. As the discussion by Messrs Kwiecinski and Reutersward indicate, the lack of integration has led to substantial waste in resource use and allocation. Correcting these distortions can provide a powerful and sustained boost to growth by raising productivity over time. The European community has been pursuing internal integration of its markets for many years in the realisation that it is critical to the success of the community and its members in competing with the largest integrated economy in the world-- the United States. On the other hand, failure to take advantage of the resources and comparative advantages of China's interior regions and rural areas risks at some point that coastal provinces will become overburdened by migration, pollution, and other problems that would jeopordise their dynamism.

I now turn to the three more immediate considerations we see for macroeconomic policy over the next several years, and which some of you in this room will be dealing with directly. The three considerations are: [Slide 5]

- The need to put public finances on a more sound and sustainable basis, so that China's government can provide the support that will be needed as the economy becomes more exposed to the international economy, and to support development over the longer term;
- The need to improve the flexibility of macroeconomic demand management instruments, particularly monetary policy;
- And the need to lay the foundation for the move to a more flexible exchange rate and capital control regime over time.

Specific implications for macroeconomic policies and reforms

I would like now to say more about each of these, beginning with the first.

As Andrew Dean indicated at the beginning, our study implies that public finances need to be bolstered soon so that essential reforms can go forward. China's government probably will need to raise spending further on technology, education -- especially in rural areas-- and possibly even more than now on infrastructure. More funds are likely to be needed to support laid off workers, to facilitate restructuring of viable state owned enterprises, and other adjustments that will come with the opening to the international economy, and, over the longer term, to extend pension and other social benefits to those not covered. But the biggest near-term demand on public finances will come from measures to restore the financial health of ailing financial institutions. Their non-performing loans in large part are due to the past use of lending to achieve goals that the government mandated objectives but which the government was unable to pay for out its revenues. In that sense, the NPL are a bill on the government that is outstanding but has yet to be acknowledged. For the reasons given by John Thompson, this bill needs to be paid sooner rather than later if the financial system is to play the role in will need to play in supporting the restructuring of the real economy.

These burdens are large, and to some observers they are so large that China's government cannot afford to pay them without risking a fiscal crisis. Our conclusion, however, is that the costs can be met while sound public finances are sustained—provided that three key conditions are met. [Slide 6].

- The first is that tax revenues continue to rise further in relation to GDP, by at least 2-3 percentage points in the medium-term. This may be the easiest to achieve: tax revenues have been rising rapidly relative to GDP over the past several years, due in substantial part to improved collection. Further improvements in collection along with changes in tax provisions—a higher income tax rate and phased elimination of preferential taxes for foreign firms should be accomplish this.

- The second condition is that government liabilities for pension and other social benefit programmes can be contained within affordable limits. As Mr. Reutersward has discussed, the foundation for achieving this has been laid. So this goal also seems achievable, although far from easy, especially in political terms.

- The third and most critical condition is that new non-performing loans are contained. As scenarios such as those developed by Nicolas Lardy graphically demonstrate, failure to contain NPL poses the most serious risk of fiscal crisis.

We have done some rough, illustrative calculations based on these conditions. While differing in details, they are broadly consistent with scenarios developed by others. As with the others, these suggest that that China's debt will rise sharply initially, to at least 50 percent of GDP and quite possibly much higher depending on how much the clean-up of the financial system costs. However, provided the above conditions are met, the debt ratio should at least level off and is likely to decline relative to GDP if the historical pattern, whereby the real interest rate paid on government debt is significantly below the real growth rate of the economy, continues to hold. This leads to a relatively favourable 'debt dynamic'.

The scenarios only indicate that it is possible to have sustainable public finances while bearing the costs of necessary reforms. But this is unlikely to be possible without reforms to achieve the above conditions, and these conditions are necessary but not sufficient to create healthy public finances that can adequately support China's development. [Slide 7]. A key further priority is to reform central-local government fiscal relations, to bring expenditure responsibilities more in line with tax and other legally sanctioned fiscal resources. This is important also to reduce incentives for distorting ad-hoc taxation and regional protectionism. Other important reforms are needed to improve the efficiency of the tax system and to improve the efficiency with which government revenues are used through reforms to budgeting and expenditure implementation.

The second nearer-term challenge is to improve the overall effectiveness and flexibility of macroeconomic demand management instruments. This is likely to be especially necessary for two reasons [Slide 8]. First, macro policy will confront a shifting balance of pressures on aggregate demand as structural adjustments to WTO and internal reforms proceed. While deflation, weaknesses in demand growth from key sectors of the economy, are the pattern now, China could face inflationary pressures at some future point, if, for example, the influx of FDI were to lead to a bubble in coastal property markets, or enterprise efforts to keep up with increased foreign competition were to spark an investment boom. Second, there needs to be less reliance on fiscal policy, in large part because of the constraints that will come as debt levels rise for the reasons noted earlier.

The implication is that monetary policy needs to become more effective. The transmission mechanism of monetary policy is now seriously impaired. A major reason is that, as in other countries that have suffered serious banking stress, a ‘credit crunch’ has developed for much of the business sector our of the reluctance of banks to lend for fear of creating new NPL. This problem clearly will not be solved over night. However there are other steps that could be taken in the next year or two which would help improve the effectiveness of monetary policy. A key step is to liberalise bank loan rates, and perhaps rates on large deposits. This would allow banks to charge a more reasonable rate to cover their lending costs and to improve the transmission of changes in central bank monetary policy instruments into the costs paid by borrowers in the business and household sector. Measures to liberalise and broaden the domestic money markets would also help to strengthen the transmission mechanism.

The third nearer-term challenge is to lay the foundation for moving toward more flexible exchange rate and capital account regimes. [Slide 9] The beginning and the end of this process are reasonably clear. In the longer-term, China will need to liberalise the capital account if it is to complete and fully benefit from its integration in the world economy. It is also likely to find, as have other large, comparably open, economies, that a flexible exchange rate ultimately best suits its economic needs. But for now, a fixed exchange rate and capital controls in many areas have served China fairly well and are necessary given the underdeveloped state of domestic financial markets and extensive distortions that create incentives for financial abuse.

The big question, of course, is how and over what time period China should move from the current fixed exchange rate/capital control regimes exchange rate and capital controls to the longer-term objectives. The only thing that seems clear is the need to move, starting in the near-term, toward greater flexibility in these regimes over time. Our study does not pretend to any specific answers for this ‘sequencing’ but does suggest several considerations that should be taken into account: [Slide 10]

- The probability that the current exchange rate parity will need to be changed is likely to rise as adjustment to WTO proceeds, since China will be increasingly exposed to real shocks. Adjusting to those real shocks via domestic prices and wages is likely to be difficult until reforms to improve the efficiency of the economy progress further.

- Greater flexibility in the exchange rate will require a more liberalised capital control regime to ensure adequate efficiency in the foreign exchange market so that a market-determined exchange rate reflects underlying fundamentals.

- Capital controls tend to become increasingly difficult to enforce and potentially counter-productive as the international integration of the domestic economy proceeds. The large unreported outflows in China suggest widespread evasion now and this is likely to get worse if current controls are maintained while the economy opens further to international markets.

- More liberal capital flows can contribute significantly to domestic financial system development. Conversely, undue delay in liberalisation can impose significant costs, in limiting the range of financial options for domestic businesses and others and by denying domestic financial markets the benefits of greater breadth, diversity, and sophistication that opening to international markets can bring.

Thank you.