China’s Structural Reforms and Growth Prospects

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The views expressed herein do not necessarily reflect the views of the Federal Reserve Bank of San Francisco or the Federal Reserve System.
China appears to have followed the growth paths of Japan and Korea.
Structural reforms needed to sustain further growth

• State-owned enterprises (SOEs):
  – Useful for public goods provision and industrial policy
  – But a source of inefficiency and drag on growth

• Financial repression:
  – Facilitates credit access for SOEs
  – But hurts productive non-SOEs and households

• Capital controls:
  – Support financial repression by restricting cross-border capital flows
SOEs remain inefficient and subsidized

![Bar chart showing productivity and effective SOE subsidy over years 1998 to 2007. The chart indicates that SOEs have been inefficient and subsidized over the years. The source of the data is Liu, Wang, and Xu (2019) and the author's calculation.](image-url)
SOEs sustained by financial repression...

China deposit and lending rates
1980-present

percent per year

Lending rate

Deposit rate

Source: CEIC; IMF
...and also by capital controls
Financial reform should precede capital account liberalization

- Financial repression:
  - SOEs borrow at subsidized interest rates
  - POEs face higher market rates
  - Households receive lower deposit rates

- Capital controls support financial repression
  - Households restricted from investing abroad
  - Foreign investors restricted from Chinese markets

- Optimal policy: liberalize financial repression before opening capital account
  - Tradeoff: cross-sector allocation efficiency vs. consumption-saving efficiency

- See Liu, Spiegel and Zhang (2019) for analysis
SOE reform should precede financial liberalization

- Multiple distortions under existing regime:
  - SOEs subsidized and have easy access to credit
  - POEs more productive but face tight credit constraints
  - Interest rate controls

- Interest-rate liberalization faces tradeoff
  - Improves productivity within each sector
  - But exacerbates over-investment in SOEs

- Reducing SOE subsidies alleviates such tradeoff

- See Liu, Wang and Xu (2019) for analysis
China’s growth prospects

• As income rises, slowdown is expected

• Structural reforms needed to sustain growth

• Sequencing of reforms
  – Targeting root causes of distortions
  – SOE reforms should precede financial liberalization
  – Financial reform should precede capital account liberalization