FEDERAL RESERVE BANK OF SAN FRANCISCO

China's Structural Reforms and Growth Prospects

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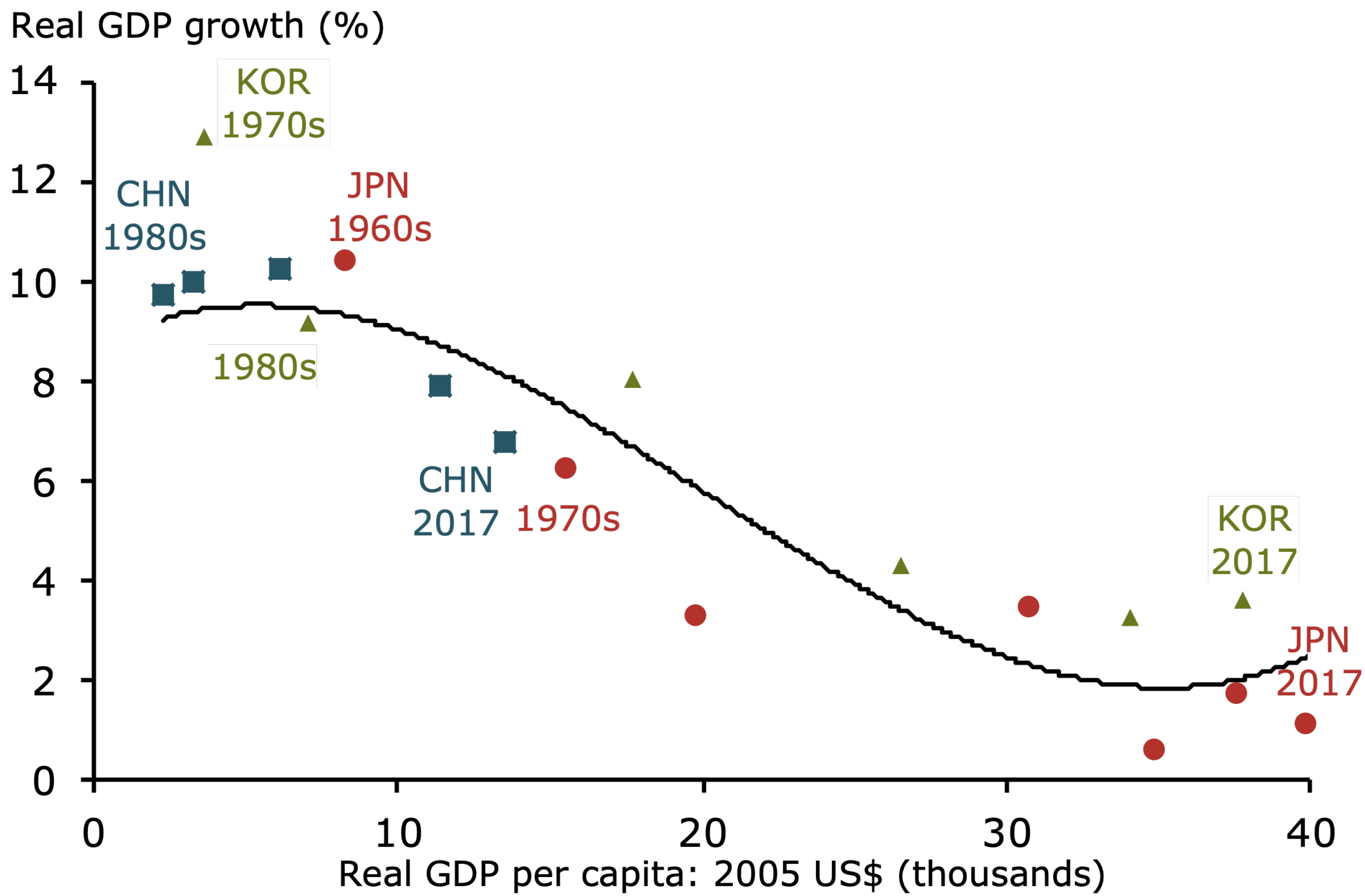
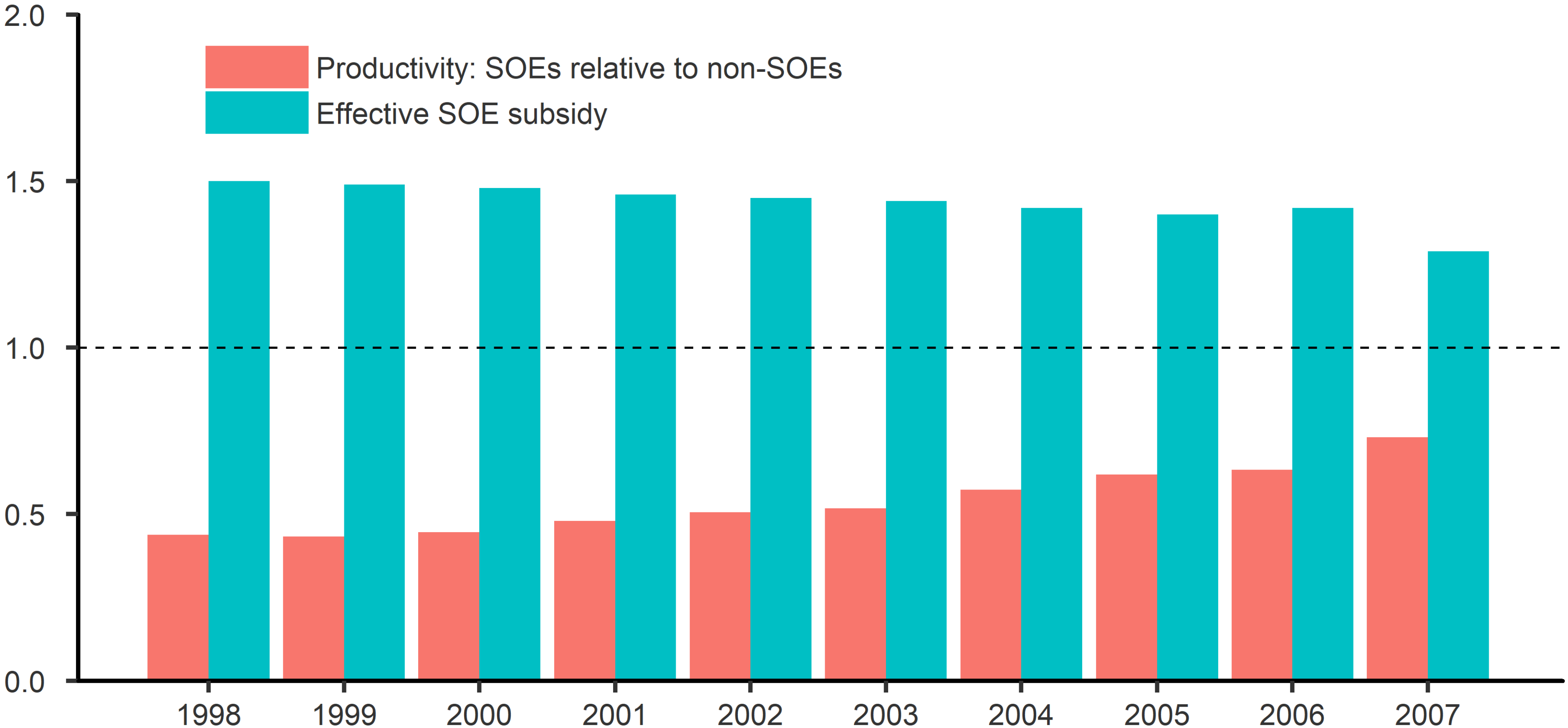
China appears to have followed the growth paths of Japan and Korea



Structural reforms needed to sustain further growth

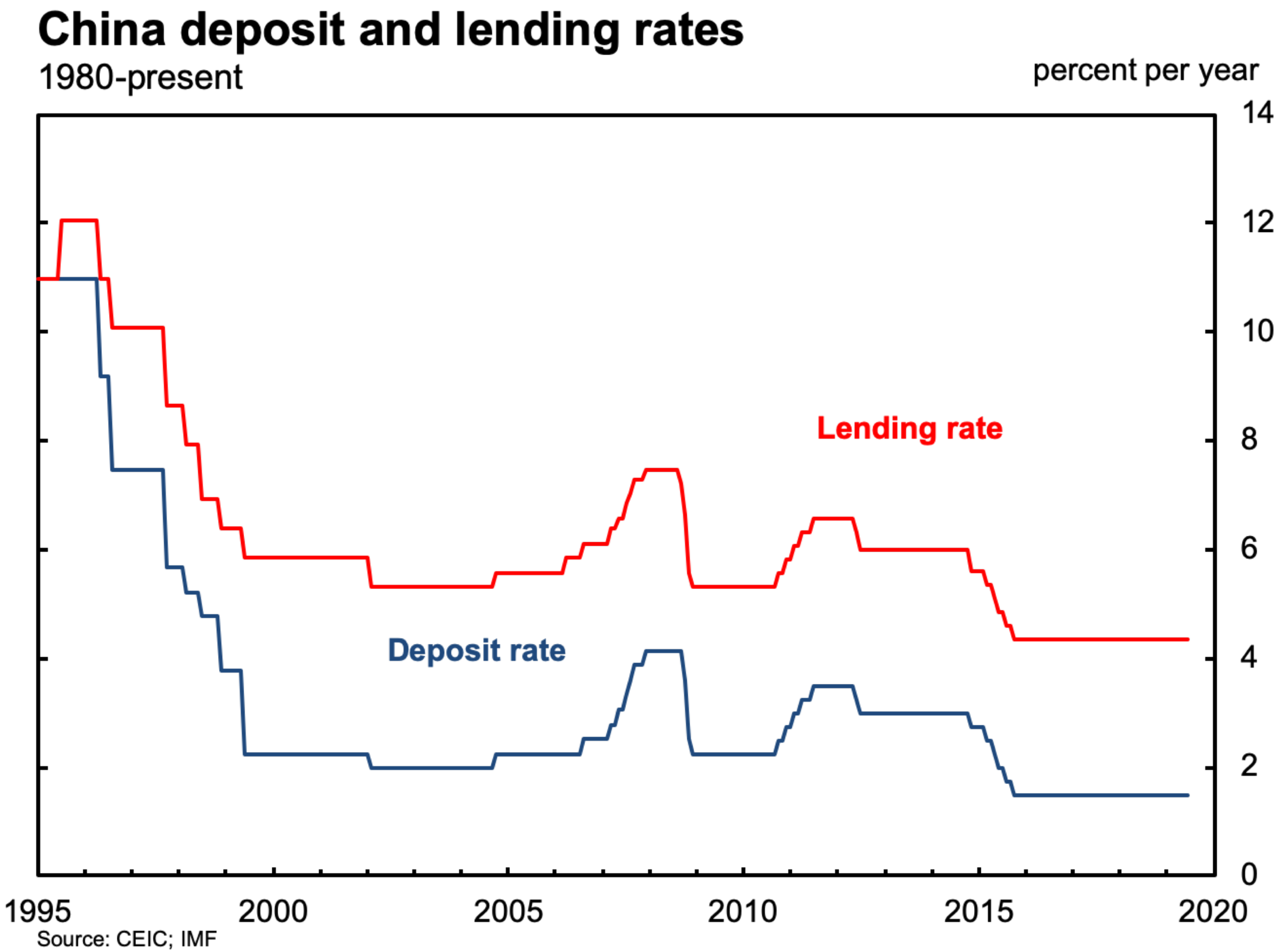
- State-owned enterprises (SOEs):
  - Useful for public goods provision and industrial policy
  - But a source of inefficiency and drag on growth
- Financial repression:
  - Facilitates credit access for SOEs
  - But hurts productive non-SOEs and households
- Capital controls:
  - Support financial repression by restricting cross-border capital flows

SOEs remain inefficient and subsidized

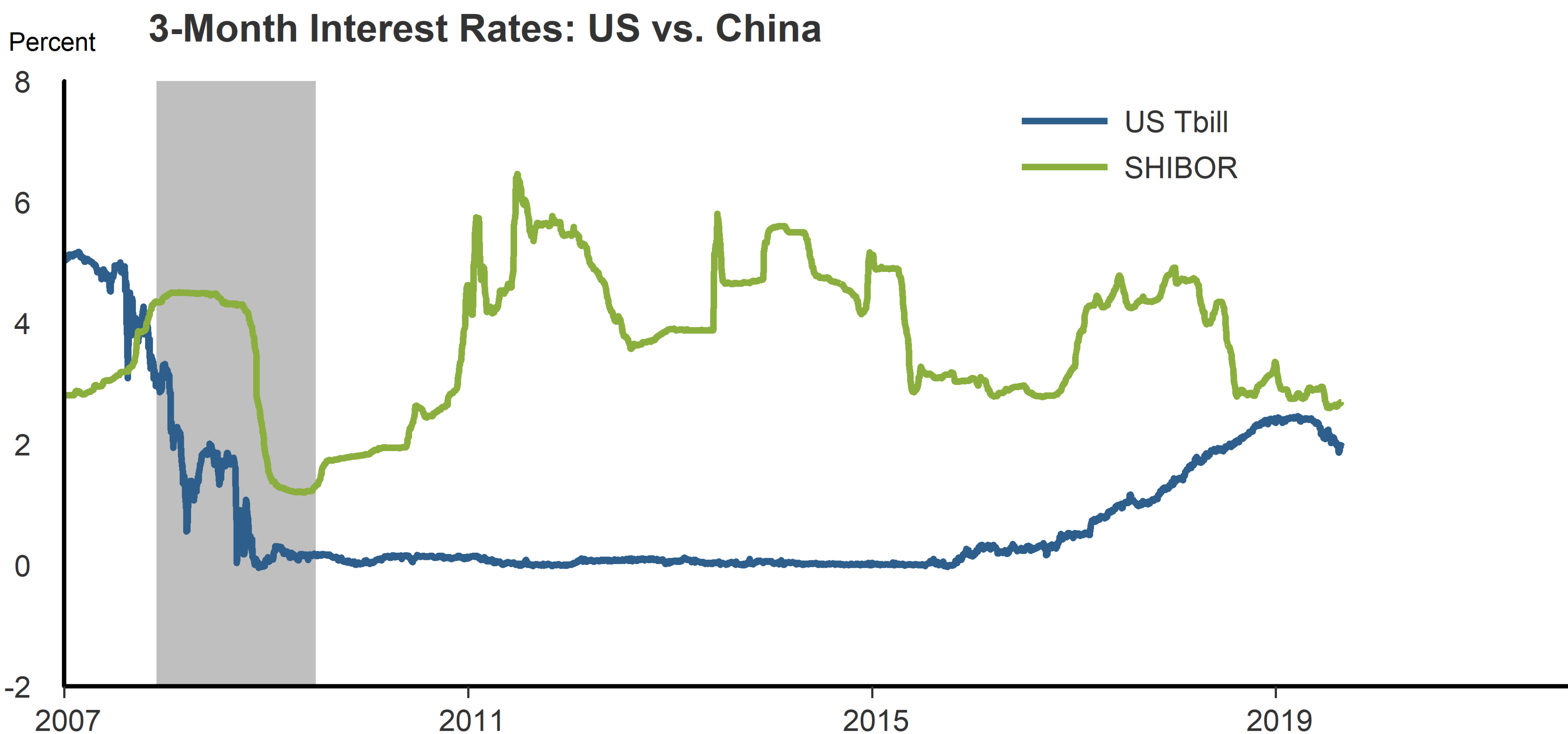


Source: Liu, Wang and Xu (2019) and author's calculation

SOEs sustained by financial repression…



…and also by capital controls



Source: Bloomberg

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