CEPS COMMENTARY

Thinking ahead for Europe

What direction for reforms in China?

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The task for reformers in China today seems to be straightforward: liberalising and opening the economy. The most recent 'third plenum' did continue this approach, pledging that the market should be given a decisive role in guiding the Chinese economy. This is indeed what economic theory and all the evidence suggests: allowing the market to play a greater role in the production of goods and services, and opening this market to the outside world should foster growth and productivity.

However, China has already achieved astonishing progress on this road in recent decades and might now have reached a level of income at which the problem is no longer simply to let the market operate. On the contrary, some of the key problems China faces today require a stronger role for the government in regulating the market.

The need for a stronger role of the government is starkest if one considers pollution. This is obviously a problem that will not be resolved by the market. On the contrary, combating pollution requires more state intervention, both at the central and the local level. The central level of government must set the general rules on air and water quality, but these general rules must be implemented at the local level in order to become effective. There might be resistance at the local level because improving the environment is costly. But the pressure for change from local people who cannot breathe the air over their cities or whose water is undrinkable will provide a strong spur to local officials to act.

Once the local and central government begin pushing in the same direction, there can be little doubt that China has the resources to improve the quality of its air and water in much the same way that it created the world's biggest manufacturing sector. Reducing smog requires essentially more investment: more investment in filters for steel plants, more investment in public transport (such as subways) to reduce people's dependence on automobiles and more investment in canalisation and water purification plants. The fight against smog and water pollution plays to the strength of the country: its huge availability of domestic savings to finance all this investment.

However, the need for more investment to combat local pollution has a side effect: it makes the rebalancing of the economy more difficult. The official aim of economic policy is to shift growth from investment and exports towards consumption. But here is the catch: more consumption today would just lead to a further aggravation of the pollution problem. However, investing more in pollution control and infrastructure makes it more difficult to achieve the rebalancing goal. As economists say, you cannot have your cake and eat it too. Rebalancing is likely to be pushed into the background because the environment is more urgent today.

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But there are also other areas of the economy that cannot be left to market forces alone. For example, network industries like telecoms, gas, electricity and water tend to become monopolistic or oligopolistic if left to the market. These sectors have to be regulated and supervised. Well-run economies achieve higher levels of welfare not because there is less regulation, but because they have more efficient regulation. The best regulation of network industries lets market forces operate as far as possible, but prevents the emergence of monopolies and even regulates prices where necessary to prevent an exploitation of consumers.

Eliminating subsidies for producers and consumers of coal or oil is certainly also needed. But this is straightforward compared to the task of creating and implementing an efficient regulation for the energy market as a whole.

The biggest area in need of reform is finance. This sector also requires a much more subtle approach than just liberalising market forces and opening to the outside world. The global financial crisis has confirmed once more that the financial market requires tight supervision if it is to work well.

It is difficult to overstate the importance of financial markets for China and the global economy.

In most of the advanced world, investment amounts to little more than 15% of GDP, compared to close to 45% for China. This implies that the financial market is in a certain sense almost three times more important for China than it is for the US or Europe because it has the task of intermediating resources that are three times larger as a share of GDP.

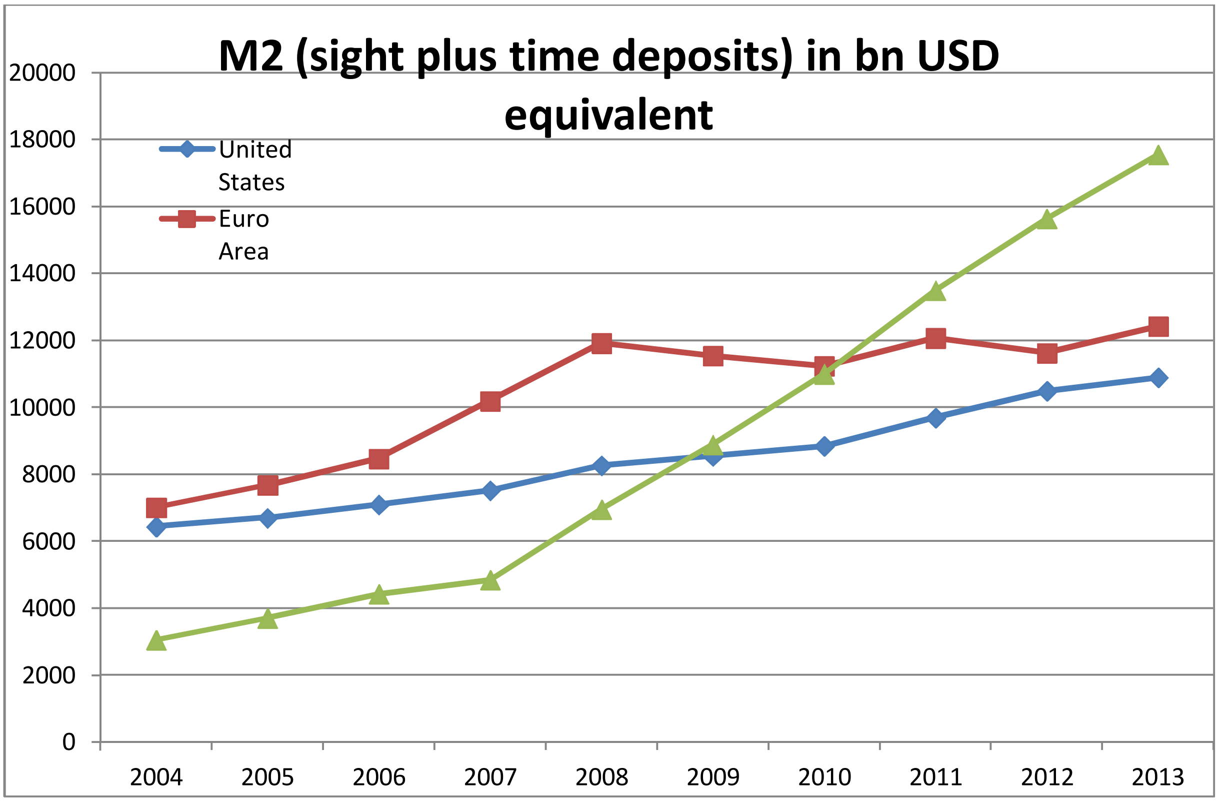
The rest of the world has a vital interest that the reform of financial markets in China succeeds because the country is now the biggest source of savings in the world economy. The GDP of China is still lower than that of the US or the EU (about $10 trillion for China, compared to about $14 trillion for the US and a similar value for the EU). But given that China's savings rate is so much higher, the supply of savings from China alone is larger than that of the US and the EU *combined*.

It is vital for the global economy that its biggest source of savings is channelled towards productive investment.

Today China's financial system is dominated by its banks. The deposits at the Chinese banking system, which economists call M2, now amount to slightly more than 100 trillion yuan, which is much larger than the country's GDP. The banking sector is thus much larger in China than in other countries of a similar level of development. But around the banking sector, which is still in the hands of the state, a large 'shadow-banking' sector has also evolved. Variants of such shadow-banking sectors have led to unhealthy forms of finance in many countries. This is a sector that also requires more state intervention in the form of regulation and oversight, not less.

A strong Chinese banking sector is also vital for the global financial system because in absolute terms the deposits at the country's banks (M2) are already now much larger than those in the US or the euro area. China now also has the world's largest financial system. If this system, which is still growing strongly, as shown in the figure below, were to be opened quickly to the rest of the world, the consequences for global financial markets could be severe. When the financial crisis erupted on both sides of the North Atlantic, the Chinese financial system was still much smaller, but it has outgrown both the US and the euro area by a wide margin since. This combination of size and growth could soon constitute a major risk factor for the global financial system if the system is not very tightly regulated.

Interest rates need to remain much higher in China than in the US or the EU simply because China will continue to grow much more quickly than the developed world. Experience has shown that large interest rate differentials can lead to large flows of 'hot money', which add little to the proper allocation of savings, but can create huge macroeconomic distortions, both when the money flows in, and when it suddenly flows out again.



In principle, it should be easy for the government to control the banking system, given that most banks are owned by the state. In reality, however, state-owned banks are de facto often not controlled by the state, but by their managers and the particular economic interest groups that have the most influence on the selection of the managers and the policy choices of the banks. The experience in Europe and elsewhere has shown that merely privatising state-owned banks often does not improve the situation. The key to creating an efficient banking system is, in any event, the ability to evaluate credit risk, a skill that can only be learned through experience.

So privatising banks is not an urgent issue. The one measure that is certainly needed is to increase interest rates. Paying savers 3% when nominal GDP is growing at 10% or more is not sufficient. Much higher interest rates would be required to ensure that households that save do not see their savings continue to be devalued relative to wages and other income. This would also encourage them not to invest in the shadow banking system and spend a bit more instead on accumulating ever-higher deposits in the hope of achieving a nest egg that could support them during retirement.

Higher interest rates on lending would also help to reduce overinvestment. But just liberalising lending rates would not be appropriate. In a system with lots of, often implicit, government guarantees, it is not always the most efficient enterprises that will be willing to pay higher interest rates. Liberalising lending rates might just lead those with government guarantees (or those simply too big to fail) to outbid smaller and more efficient enterprises, thus resulting in more waste of capital and achieving the opposite of what an efficient financial system should do.

Even more important than liberalising the banking system would be to set up the infrastructure for wider securities markets so that enterprises have an alternative source of financing, and savers have alternative reliable investment vehicles. A financial market of the size of China's should not be so completely dominated by banks. But developing market-based financing (via bonds and equity) requires a number of deep reforms of accounting standards and reliable financial indicators, especially for smaller enterprises. All these measures would require a strengthening of state capacity to enforce rules.

China finds itself at a difficult crossroads for the reforms: continuing in the direction that so far has been followed with astounding success, namely giving the market a greater role and opening to the rest of the world, might no longer be sufficient: combating pollution requires more state intervention, not less. Strengthening a huge, potentially unstable, financial system requires stronger oversight and some continuing separation from the global financial system. Navigating this change in the right direction will be crucial not only for China, but also for the global economy.