

Comments on “Rebalancing to Invigorate Growth Potential in China”

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Strengthening Growth Potential in the Aftermath of the Global Financial Crisis

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Summary of the Paper

- While a number of economists point out the possibility of a credit crisis in China, the likelihood is low.
 - All of the credit is domestic in origin
 - China's bank credit boom is largely financed by deposits rather than through the wholesale market
 - China has a national saving rate of around 50 percent
 - Very strong external position

Summary of the Paper (cont.)

- The adoption of market-oriented liberalization of deposit rates and the elimination of state monopolies will be even growth enhancing.
 - More bank lending will flow to the private sector where return on assets is higher
 - The pace of growth of private consumption relative to GDP growth will increase

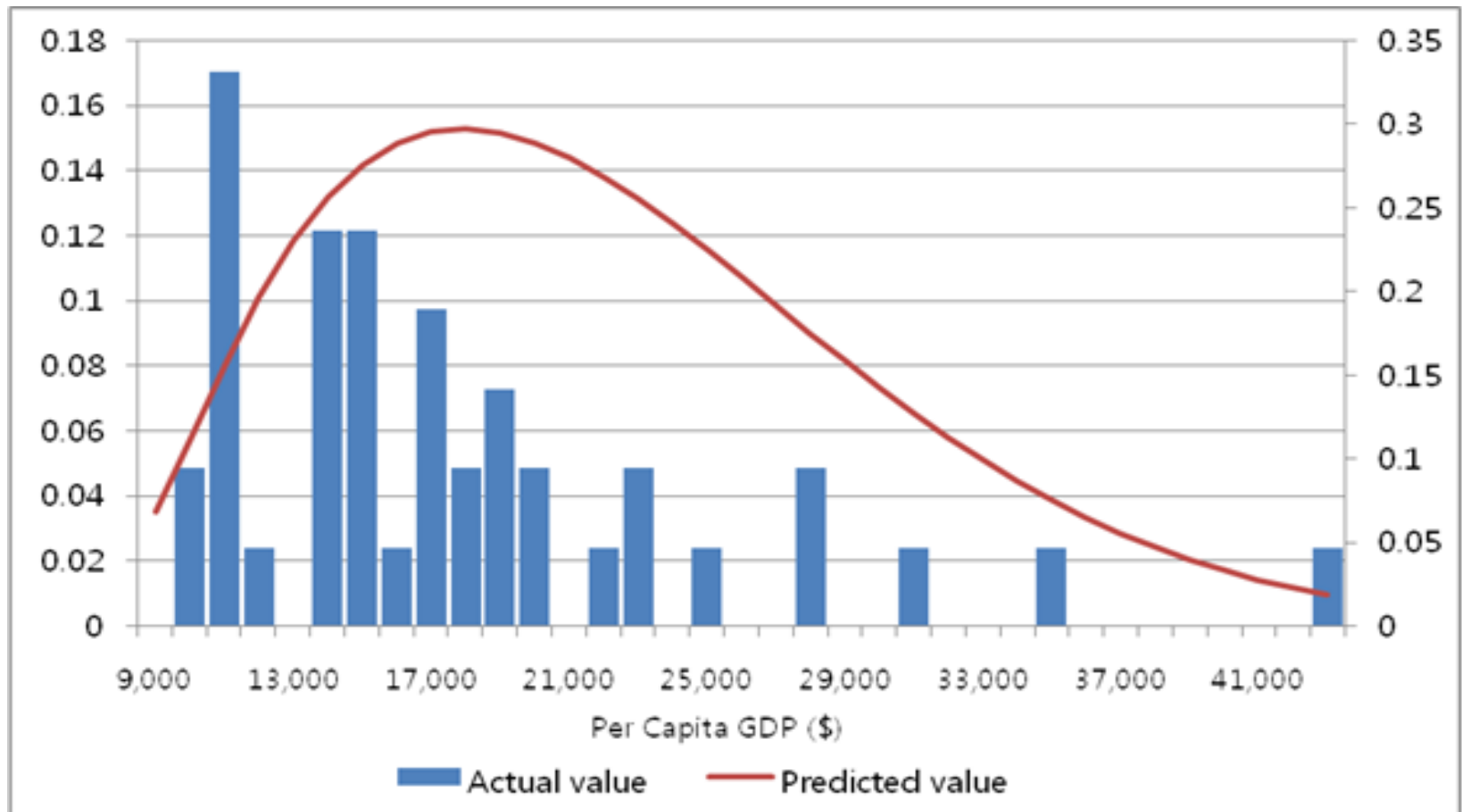
Four Comments

- (1) Growth slowdown is inevitable
- (2) A risk of more abrupt adjustment is not low
- (3) Deposit rate liberalization is not a panacea
- (4) China needs to deal with other imbalances

(1) Growth Slowdowns

- Historical evidence strongly suggests that all fast-growing economies have slowed down at some point.
- Growth theory suggests that growth slows down as a catch-up economy begins to approach the technological frontier.
 - Not many workers available to transfer from agriculture to industry: higher labor costs
 - As capital accumulates, its contribution lowered.
 - Less scope for growing by importing technology

Frequency Distribution of Growth Slowdowns



Source: Eichengreen, Park and Shin (2013)

Factors Associated with Slowdowns

- Eichengreen, Park and Shin (2012, 2013)
- Per capita GDP: \$11,000-\$15,000
- Higher pre-slowdown growth
- A high investment ratio
- Undervalued exchange rates
- A high old-age dependency ratio
- Less open economies
- Less human capital

Factors Associated with Slowdowns (cont.)

- Positive political regime change (movements away from autocracy and toward democracy)
- Less high-tech content of exports
- Financial instability, particularly stock market crises
 - Crises may lead to slowdowns by depressing investment for an extended period

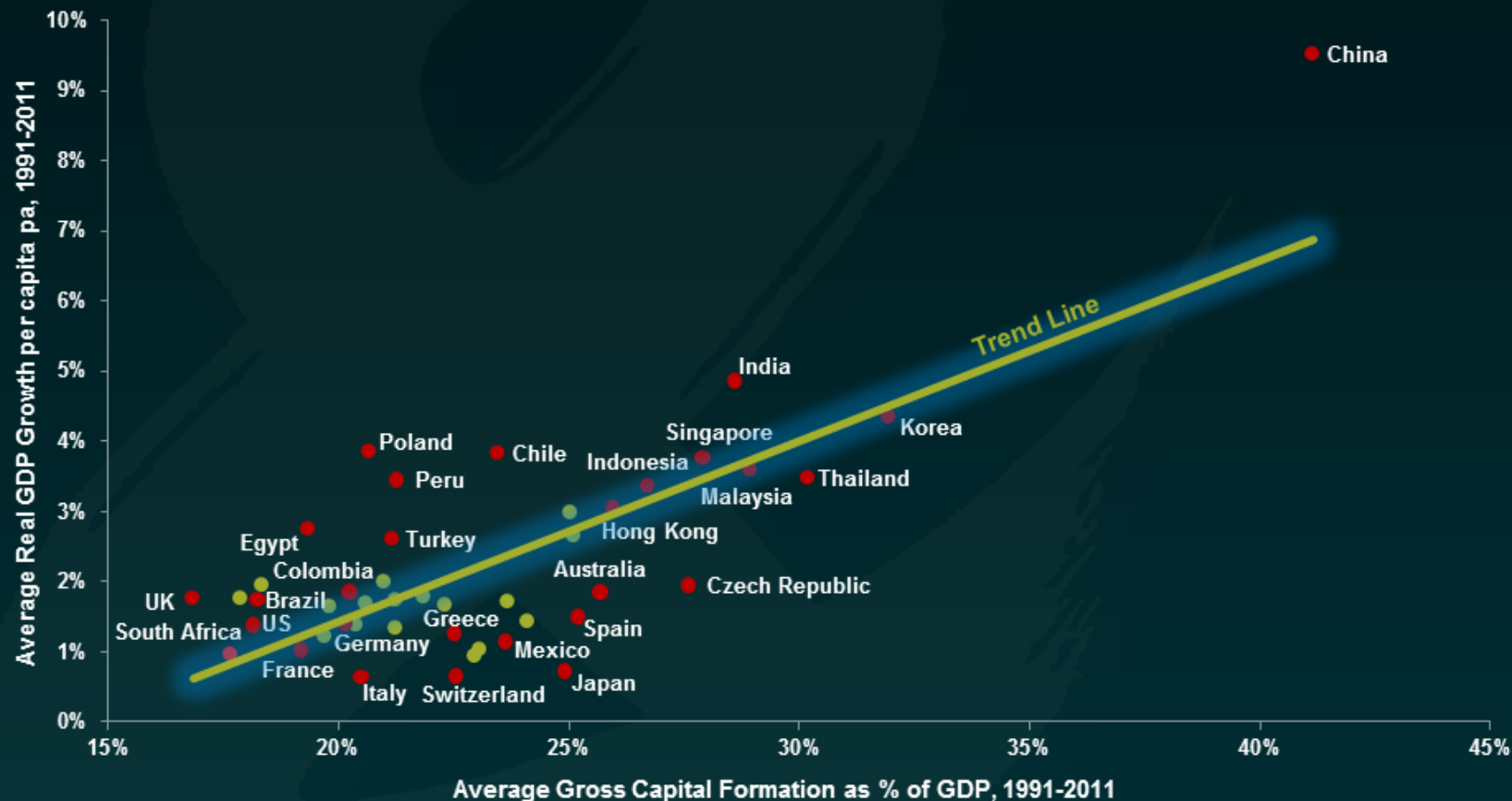
What is the Chance for China's Slowdown?

- China's growth rate has meanwhile decelerated from more than 10 per cent in 2010 to less than 8 per cent (expected) in 2014.
- China's 2010 per capita GDP at 2005 PPP prices is now estimated to be \$7,129.
- China appears to be doing slightly better than average in moving up the technology ladder.
- Other factor such as population aging, high investment, undervalued exchange rates, ...

(2) A Risk of More Abrupt Adjustment is not Low

- NPLs in the banking sector
- Housing bubble
- Shadow banking
- Inefficient investment and overcapacity

Countries that invest heavily usually see strong GDP growth too

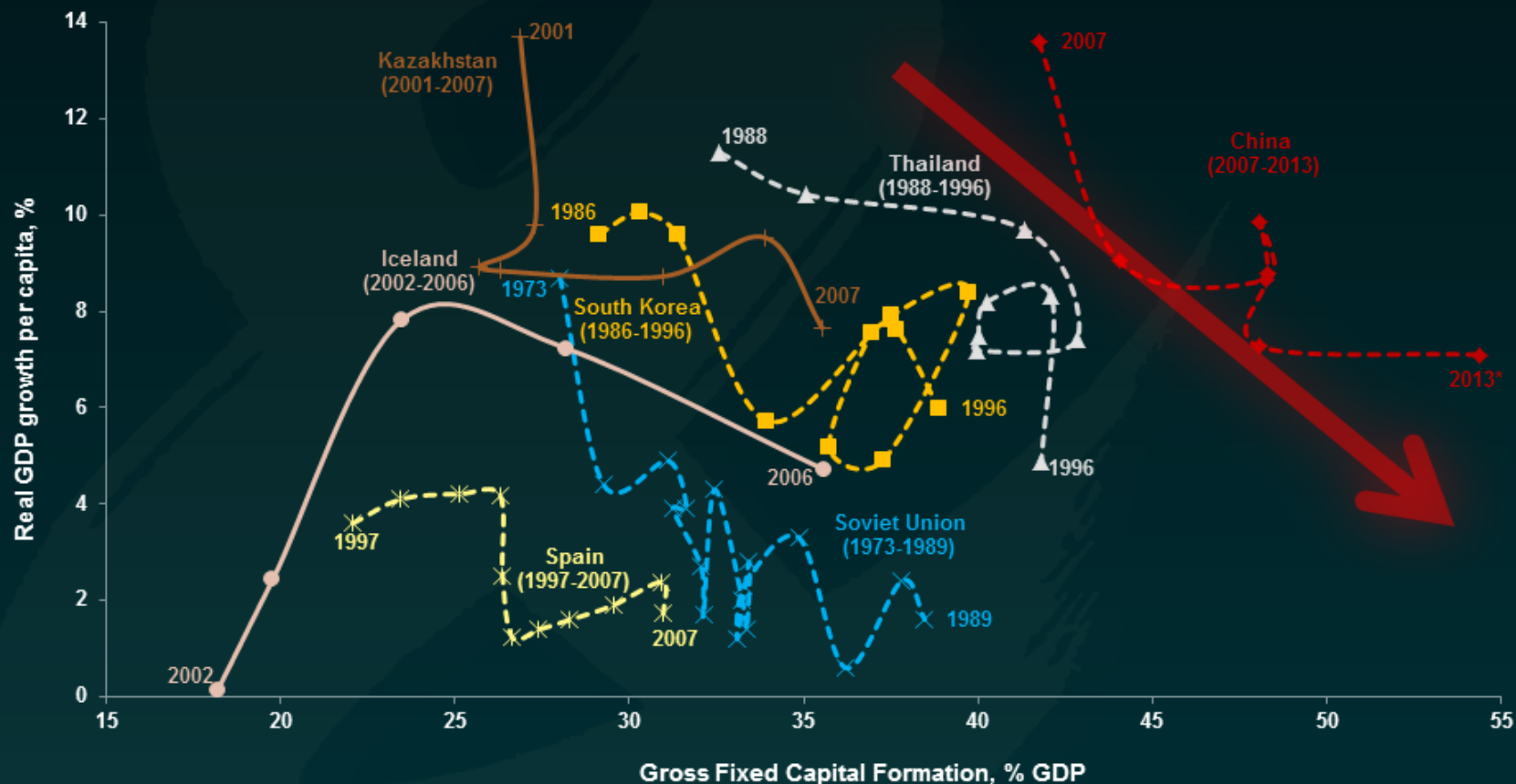


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Source: M&G, World Bank, December 2013. Countries selected are world's 50 biggest economies as at 2011 and where data available since 1991

Be very afraid when soaring investment has lower and lower returns



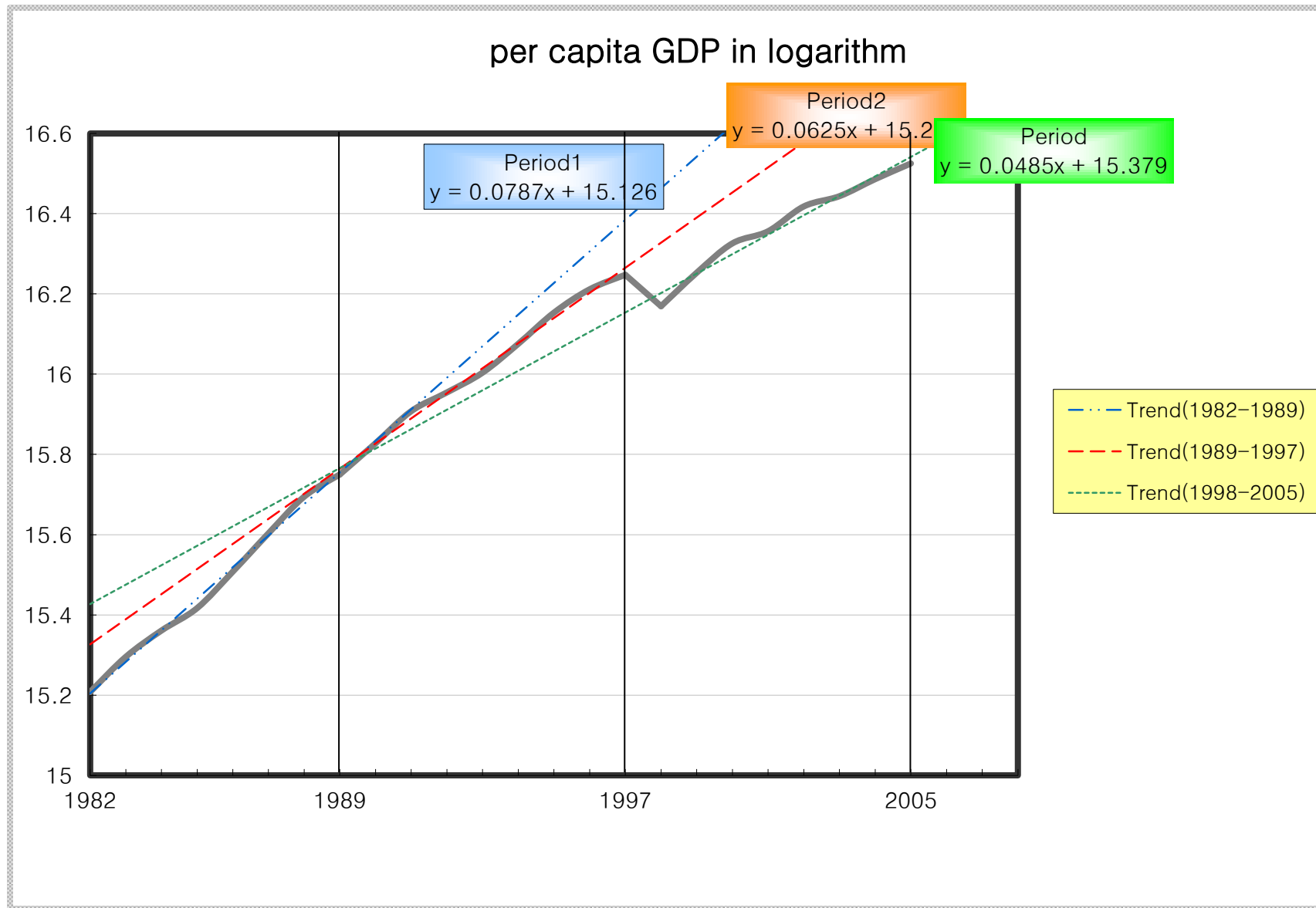
The quality of China's GDP growth has become increasingly poor

Source: M&G, World Bank, January 2014. * China population growth for 2013 estimated at 0.5%

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A Korea's Case



(3) Deposit Rate Liberalization is not a Panacea

- How deposit rate liberalization works?
 - It will increase household income from bank savings
 - Increasing lending rate lowers investment share of GDP => Reduces profit share of GDP and increases wage share of GDP
 - Reducing implicit subsidy to industry increases investment in services and increases employment growth

Any Problems?

- Financial liberalization is likely lead to financial fragility as NPLs increased for the ninth straight quarter to the highest level since 2008
- Investment will surely decrease, but deposit rate liberalization alone is not sufficient for efficient lending
- Given other distortions related to high savings, there is no guarantee that consumption will increase enough.

(4) Other imbalances

- What imbalances?
 - Investment vs. consumption
 - Public vs. private sectors
 - Manufacturing vs. service sectors
 - Financial repression
 - Housing bubble
 - Rise in income inequality

Other Policies to Deal with Imbalances

- Deposit rate liberalization will help reduce investment and increase consumption
- China needs to develop other policies to deal with imbalances

Conclusion

- Rebalancing China is a great challenge not only for China but also for the world economy.
- Deposit rate liberalization and eliminating monopolies are not enough for rebalancing
- Even if China is successful in avoiding a crisis, there are forces leading to inevitable growth slowdowns