Domestic Rebalancing to Reduce Global Imbalances: The Role of Financial Market Measures

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I. "Two Ends Extending Abroad"

"Taking advantage of the opportunity offered by the structural adjustments of the global economy..."[1]

The decisions on the four modernisations taken at the Third Plenum represented a radical change in Chinese domestic development strategy. However, its initial implementation in the strategy of "two ends extending abroad", based on the development of manufacturing exports in the coastal regions, was also premised on an assessment of changing global production, trade and political relations. The success of China's "opening" policy has thus always been conditioned by conditions in the global economy.

This dependence on international conditions refers not only to the deteriorating relations between China and the USSR and improving relations between China and the US and Japan enunciated in Mao's "differentiation of the three worlds". More importantly it refers to changes ushered in by the end of the Bretton Woods System of fixed exchange rates in the early 1970s and the increasing global integration of production, trade and finance in the advanced capitalist economies.

Recounting the decisions taken to initiate modernization of the Chinese economy Zhao Ziyang notes,"Outside of China, adjustments in the international economic structure were already

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[1] Zhao Ziyang Prisoner of the State, p. 150

under way, and … would cause labor-intensive production to gradually move to places where labor costs were lower. In the Asia Pacific Region, it was the United States that first moved some of its labor-intensive production and manufacturing to Japan. Japan took the opportunity to develop itself. Later the United States and Japan moved some of their production and manufacturing to the four Asian Tigers. As the Asian Tigers developed, Japan and the Asian Tigers are moving some of their industries to the countries of ASEAN. Economic structural adjustments, whether from a global or Asian Pacific perspective, will not stop. This revolving process presents an opportunity for developing countries. In the past, because we had closed our doors to the world and implemented a rigid, higher centralized system without the free flow of information, we had missed many opportunities, We could not throw away another chance." (Ibid., p.151)

The success of the policy of opening the economy on the basis of a socialist market economy was thus crucially dependent on propitious international economic conditions. As is now well documented in Zhou's personal account of the period and Ezra Vogel's recent biography[2] of Deng Xiao Ping, there was always tension at the highest levels concerning the role that the market should play in the modernizations with resistance among the supporters of the market as a supplement to the maintenance of economic planning represented by Chen Yun, and the market reformers who were themselves divided between those who sought more rapid displacement of planning by market mechanisms and those who proposed a more gradual path of transformation.

[2] Ezra Vogel, Deng Xiao Ping and the Transformation of China, Belknap Press of Harvard University, 2011

Indeed, the cycles in Chinese economic growth can be read as a roadmap of political dominance of the different approaches as excessive speed in reform led to inflation and production imbalances in the economy which brought the planners back to prominence to slow or reverse change and restore stability. However, there was never contention that the new policy would be built on exports, on “producing what other people need”. Exports were the initial motor force of the policy.

An important characteristic of the cyclical behaviour of the economy was that it was initially independent of the cycles in the global economy and that corrective measures were independent of external economic conditions. This was to change in the 1997-1998 Asian crisis and changed the way the external environment influenced domestic policy decisions. Indeed, after the decisions to join the WTO in 2001 the performance of the domestic economy seems to have shifted from one in which external demand was a modest contributor to growth to one of seemingly ever increasing export surpluses and accumulation of foreign assets.

It is only from this period that China’s consumption, investment and external accounts appear to become increasingly out of balance, and it is also the period in which the international environment shifts from one that is supportive of Chinese policy to one that is openly critical of excessive external surpluses and Chinese management of the exchange rate. Indeed, both the Chairman of the Federal Reserve and multilateral financial institutions went so far as to identify global imbalances (and thus the growing Chinese export surplus) as one of the major causes of the recent financial crisis.[3]

Thus, while it is true that the initial decade relied on increasing introduction of the market, reiterated after its short interruption in 1989, it is also true that in the early period the expansion in exports took place with little emphasis on investment which was provided by external sources or relied on state enterprises formed during the previous planned growth strategy. By the mid-1990s however, investment had become the dominant source of Chinese growth. Thus, internal criticism focussed on overcapacity in manufacturing, rather than excessive reliance on an export surplus as the basic problem facing Chinese growth.

Since traditional macroeconomic financial balances require that the private and government sector balances of saving and investment must match the foreign sector balance of exports and imports, relevant criticism must focus on the components that can be influenced by policy. Given that government balances have been close to equilibrium, this leaves the private balances as the counterpart of the external surplus. And despite the over-investment the problem results as excess household saving or alternative deficient household consumption.

II. Everyone Agrees: Rebalancing is Good for China and the World

Thus, the increasing international criticism of the external surplus from abroad was met with government recognition

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[3] In this view a fundamental cause of the recent financial crisis was excessive Asian savings rates, expressed in the external surpluses that produced a decline in global interest rates and the unsustainable asset bubbles in the advanced economies. Borio and Disyatat argue convincingly that the decline in interest rates was primarily due to innovations in financial systems which created unlimited global liquidity that was the root cause of the crisis. See BIS Working Papers No 346, “Global imbalances and the financial crisis: Link or no link?”, Monetary and Economic Department May 2011

that the problems were to be found in domestic rather than foreign balances. For example, at a Press Conference following the March 2007 annual meeting of the National Peoples Congress (NPC) Wen Jiabao noted that despite recent experience of high, stable growth in conditions of price stability "There are structural problems in China's economy which cause unsteady, unbalanced, uncoordinated and unsustainable development."[4] He returned to the theme in the 2011 Anniversary meeting of the Chinese Communist Party where he reiterated his belief that: "China suffers from a serious lack of balance, coordination, and sustainability in its development; … We must firmly follow the line, principles, and policies adopted since the Third Plenary Session of the Eleventh Party Central Committee, be confident and courageous, … and strive to make greater progress in reform and opening up."[5] And in the work report to the March 2013 NPC he again raised the issue of the imbalances in Chinese growth strategy.

In the 2007 Press Conference Wen indicated the measures that were to be taken" "Can we sustain this momentum? First, the conditions are there. The most important condition is that we have a fairly long peaceful international environment that enables us to focus on economic development. Second, we have a domestic market with huge potential. However, the key to sustaining the momentum of China's economic growth lies in our ability to pursue the right policies. We will continue to expand domestic demand, especially consumption. We will press ahead with reform and opening up to remove institutional and

[4] http://nz.china-embassy.org/eng/xw/t304313.htm

[5] http://news.xinhuanet.com/english2010/china/2011-07/01/c_13960505_11.htm

structural obstacles and enhance knowledge and technology based innovation."(loc cit)

This emphasis reflects the recent 12th five-year plan that calls for a decline in the target growth rate to 7 percent per annum, based on an economic restructuring that will increase domestic consumption and also to increase service sector value added by 4 percentage points of GDP. That is a transformation from an economy driven by investment to one with increasing household consumption and production of services.

The new plan makes clear that the reduction in the share of investment in GDP will lead to a shift in the composition of domestic production from manufactures in favour of services. Here it is important to note that the service sector is still predominantly under state control and ownership so that it should be presumed that the calls from reform are at the very least directed at this sector.[6]

At the same time, since services tend to be primarily domestically consumed, this also implies a decline in the production of manufactures for export. In this sector, ownership is predominantly in the hands of foreign joint venture companies. Most foreign entities originally invested in China to take advantage of the potential for domestic market growth, but have been primarily engaged in the use of China as a lost-cost production platform for export sales into their own domestic markets. Domestic wage policies relative to productivity growth and the possibility of exchange rate appreciation will thus determine whether the rebalancing will indeed lead to a decline in manufactured goods exports by joint venture companies.

[6] While manufacturing that services investment is largely under the control of State-Owned or formerly State-Owned Enterprises.

Despite this recognition of unsustainable growth, the Chinese economy has continued to expand at very higher growth rates, while the share of consumption in national income has continued to fall. That little progress had been made in shifting the source of growth to consumption is evidenced by Wen's admonition in the 2013 work report to the incoming government to "'unswervingly' take expanding domestic demand as the government's long-term strategy for economic development, … 'The difficulty in and key to expanding domestic demand lie in consumption, and that is also where the potential lies,' ...To expand individual consumption … the government should enhance people's ability to consume, keep their consumption expectations stable, boost their desire to consume, improve the consumption environment and make economic growth more consumption-driven. … NDRC's draft plan promised to raise the income of low- and middle-income groups, set up a sound mechanism for regularly increasing workers' wages, raise farmers' income and improve the social security system that covers both urban and rural residents."[7]

This official support for rebalancing thus meets the criticisms that have been made by developed country governments and multilateral institutions of China's external surpluses. Indeed, in the aftermath of the financial crisis virtually all developed countries have proposed or undertaken measures to increase public savings and the private sector is in the process of deleveraging that requires an increase in savings rates. This leaves the only possibility to achieved these goals as an increase in net exports.

[7] http://news.xinhuanet.com/english/china/2013-03/05/c_132209225.htm

In a sense China is being asked to support the recovery of the developed countries from financial crisis by embarking on domestic rebalancing that would reduce the export surplus by increasing demand for imports from developed countries. There thus seems to be broad agreement that rebalancing is necessary from the point of view of both domestic and international growth and stability.

While such adjustments would seem relatively straightforward, they will be very difficult to achieve and are fraught with risk. Most Asian economies have built their rapid growth on repressing consumption and subsiding investment. As in the case of China, their extremely high savings rates were cited as one of the causes of the Asian financial crisis. Indeed, this is a strategy of restricted consumption and forced savings to fund investment that was originally recommended by Ragnar Nurkse,[8] as well as by Nicholas Kaldor in his role as an adviser to CEPAL and Latin American governments. Indeed, the latter criticised Latin American economies' failure to control domestic consumption as a source of low investment and growth. But, in Asia the problem has been to reverse the strategy without losing growth momentum.

Japan was the first post-war Asian economy that was asked to rebalance in order to reduce its export surplus in support of developed countries' interests of international financial stability after the Plaza Accord and it is still paying the price of its failure to rebalance in terms of low growth. For Japan, low population growth has made low growth more bearable, for China the political and economic consequences will be not be. On the other hand, Korea appears to be making the transition

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[8] Ragnar Nurkse, *Problems of Capital Formation in Underdeveloped Countries.*Oxford: Basil Blackwell, 1953

to higher domestic consumption led growth without major difficulties.

III. But no one Agrees on How to Do It: What Market Reforms Support Domestic Rebalancing?

Since management of investment (and more recently infrastructure and residential construction) has been the major counter-cyclical policy used by the government, and since this management is achieved through controls of the banking system erogation of credit it would appear that banking and financial services may be the most important area for further opening and market reform. Indeed, the Chinese banking system has remained under tight government regulatory control that has been crucial in the implementation of government expenditure policies to offset the impact of global financial crises on export demand. If rebalancing is to bring a reduction in reliance on directed investment and foreign demand, the financial services sector might be ripe for further market liberalisation.

Indeed, since the recent financial crisis, there has been substantial financial innovation and deterioration of Central Bank control over domestic liquidity and interest rates through a “shadow” banking system in which borrowing and lending are determined outside formal regulations. The success in shifting to greater reliance on consumption demand may thus depend on the process of reform of the financial system and how the market-led adjustment currently taking place outside the formal banking system is dealt with.

The official, regulated Chinese financial system appears to be currently configured on much the same principles as the US system after the New Deal legislation. The US experience of increased market liberalisation leading to increased financial fragility may provide valuable lessons for the process of market reforms in this area.

Indeed some commentators have already suggested that even without further liberalisation there is potential for a Minsky moment in the Chinese financial system. This would clearly act as an impediment to the desired rebalancing. As is well known, Minsky considered excessive reliance on investment as the driver of growth as a source of financial instability because financing higher investment rates generally requires increasing issuance of financial liabilities, an increase in financial "layering" or in modern terms, increasing leverage. This makes the system more vulnerable to any fall off in the rate of investment as the income generated by the investments falls short of that required to validate the interest commitments on the liabilities issued. Thus, the reliance on bank financing for government anti-cyclical expenditure packages, rather than the use of direct government financing,[9] may be seen as a prima facie example of increased fragility in the system generated by the financing used to preserve the stable, high rate of investment and growth. And if there is substantial excess capacity as well as out of average capital-output ratios this suggests that the banks are primarily engaged in Ponzi financing in which the service on the lending is being created by additional borrowing for additional investment. Were the rate of expansion in investment to decline then borrowers would no longer be able to meet their commitments leading to bank loan losses and potential insolvency that would require another government restructuring.

[9] Only a quarter of the government expenditure implemented in response to the recent global crisis were financed directly by central or local government.

But there are other possible sources of financial instability in the system that suggest similarity with the post-war evolution of the US regulatory system. For example, interest rates on retail deposits have been kept extremely low and since 2004 have been increasingly negative in real terms. In the US New Deal legislation introduced Regulation Q that set nominal rates on retail deposits at zero, and thus negative in real terms. The intention of the regulation was to prevent interest rate competition among banks from driving rates above what could be earned investing them. But, more importantly the intention was to give commercial banks a monopoly on the deposit business and an insured income from the resulting guaranteed positive net interest margins. Controls on bank spreads and the absence of alternative outlets for household savings aside from securities markets has meant that banks in China have had a similar protected source of income which serves as the first line of defense against loan losses. Such policies to fix interest rates have been criticised as an impediment to growth under the guise of financial repression and as creating inefficiency because of the lack of a market mechanism to allocate savings.

Failure to protect the commercial banks' monopoly by allowing non-regulated banks to offer close substitutes to deposits and bank loans at rates that were not controlled led to the elimination of Regulation Q and the 1980s Savings and Loan crisis. It is interesting that the generalised decline in US savings ratios occurred in tandem with the elimination of these regulations.

In the academic literature Ronald McKinnon[10] and Edward Shaw[11] argued that directed, low or negative real borrowing rates allowed governments to displace private investors and misdirect savings to uneconomic uses. This view has come to be interpreted as a causal relation between low real returns to deposits and low domestic saving and thus as an impediment to high rates of investment needed for high growth. The policy conclusion drawn from this approach is that liberalisation of financial markets and higher, market determined real interest rates would generate more savings held as deposits that would finance private investment and increase incomes.

There is however, little evidence of this type of response in countries that have experimented with such policies. Indeed, China appears to be consistent with this evidence against the Shaw-McKinnon thesis as ever since the slow down in interest rate liberalisation in the early 2000s savings rates have increased rather than fallen as interest rates have become negative in real terms. China thus appears to mirror the US experience where high personal savings rates of from 7 to 11 percent under Regulation Q have been replaced by saving rates falling to below 2 percent after the introduction of market determined interest rates in the early 1980s.

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[10] *Money and Capital in Economic Development*, Brookings Institution, 1973. Note that initially financial repression was defined as controlled borrowing rates leading to a reduced deposit base and thus a suboptimal provision of bank financing for development: "The failure of banks to earn high equilibrium rates of return from their privileged [government] borrowers is reflected back in an unduly low return to depositors -- one that may well be negative in real terms… . Scarce capital is underpriced by the banks … It is hardly surprising that savers respond to low real returns by reducing their holdings of money and near-monies far below what might be considered socially optimal; and of course bank credit is reduced commensurately." p. 69. This led to the idea that development could be gauged by the degree of "financial deepening". This view of course relies on the belief that reserve deposits limit bank lending, rather than the view that loans create deposits.

[11] *Financial Deepening in Economic Development*, Oxford University Press, 1973.

Building on this relation Nicholas Lardy[12] and Michael Pettis[13] have argued that the rise in Chinese household saving rates can be dated to the suspension of market reform of interest rate determination and the persistence of managed low, negative interest rates from the early 2000s. Since the majority of household wealth is held in bank deposits low interest rates also contribute to the slow growth of household incomes and thus may be considered as a source of the decline in consumption over the same period despite the official attempts noted above to rebalance. The negative real return to depositors has a counterpart in a real reduction in the costs of finance and thus represents a subsidy leading to over-investment.[14]

Both authors call this managed interest rate policy "financial repression" but is appears to be centered on the impact on the depositor rather than on the borrower. The implication of this approach is that allowing more market determination of interest rates will lead to higher passive interest rates and thus higher household incomes and more consumption, lower savings rates and lower investment, all of which should contribute to rebalancing the Chinese economy. But, this raises the question of how the elimination of financial repression should take place. The answer may be found in another similarity between the US and China.

Since the early 2000s and more importantly in response to the 2007-8 crisis both the US and China have employed extremely low nominal and negative real interest rates, imposed by central

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[12] See *Sustaining China's Economic Growth After the Global Crisis*, Petersen Institute, January 2012.

[13] See "China Financial Markets" various issues.

[14] This suggests that there is a high interest elasticity of investment, a finding that has not had much empirical verification. More common is evidence of a positive relation between investment rates and growth and of liquidity.

bank monetary policy, and both have experienced a search for yield by depositors and rapidly increasing real estate investment and a rapid rise in real estate prices. Indeed, a large proportion of the extremely “high” Chinese rate of investment has been in residential real estate construction. Lardy notes that this increase in investment has not been associated with a rise in the share of owner-occupied homes, but rather has been for the purchase of a second or third property on the expectation of price appreciation. But, in difference from the US, the Chinese housing market provides an alternative investment vehicle for Chinese households “searching for yield” while in the US financial innovation has provided for increased household leverage and a mispricing of lender’s risk. Thus the positive aspect of this “search for yield” is that it has not produced increasing household leverage provided by financial innovation. Rather it is provided by “real” savings, that is, a reduction in household expenditures and a shift from deposits. Since Chinese regulations require relative high down payments and provides subsidies to borrowing rates, this provides a further explanation for the increase in household savings rates matched by a decline in household deposits and a decline in consumption.

But to what extent does the Chinese government utilise financial repression to fund its expenditures? First, the Chinese government has not been a large net borrower, and as already noted, the majority of the anti-cyclical measures employed by the government are financed through the financial system rather than by direct government borrowing. But there is a more important aspect of Chinese financial repression. If repression is the major cause of rising private savings, and government financial balances are not deteriorating, then the improvement in the foreign balance since the beginning of the 2000s is not the result of currency undervaluation but of low interest rates on consumption and investment and the government's low cost of borrowing.

But, control of interest rates as practiced in China requires that financial markets be insulated from international capital flows. One of the ways in which this can be done, besides administrative controls, is by keeping interest rates low. In addition prohibition on speculative investment in real estate ensures that the total returns that can be earned by foreign investors remains below foreign alternatives.

But negative return differentials may not be sufficient, since foreign investors may also have to be convinced that the Chinese currency will not appreciate, creating an additional return to holding RMB. Financial repression in the form of control of domestic deposit interest rates then also requires control of the exchange rate. It is not necessary for the rate to be fixed, it is simply necessary to prevent market expectations of a continuous appreciation of the exchange rate. This means that the Central Bank must be constantly present in the foreign exchange market to sterilise external surpluses, as well as any capital account inflows. And that the management of the exchange rate it integral to the control of domestic interest rates.

But this implies that it is the very existence of financial repression that requires control of the exchange rate because it is the repression that creates the external surplus that would in a free market produce an appreciation. But, there is another side to exchange rate management: effective control of the exchange rate requires financial repression to provide sterlisation as minimal costs to the Central Bank. This is because of the traditional negative carry associated with sterlisation due to the lower interest rate on the investment of foreign currency purchased by the central bank relative to the higher interest on the government or bank liabilities that are sold to domestic residents.

Before the decline in US interest rates there was a positive carry on these operations for dollar sterilisation. But when foreign interest rates fall, low domestic interest rates are a means of controlling or reversing the traditional negative the costs of sterlisation and control of the domestic money supply while avoiding translation losses for the Central Bank.

In addition, the Peoples Bank of China (PBC) has also used higher reserve requirements (or dollar reserve requirements) paying low rates. These measures have a similar impact on domestic banks as low interest rates have on households. And since control of the money supply is also control on bank lending it also has an impact on bank profitability. Low interest rates used in sterilisation and money supply growth are thus equivalent to a tax levied on the banks and a subsidy to the Central Bank in carrying out its monetary management operations in the presence of high external surpluses.

The similarity of the impact on banks with that of households closes the circle of mutually reinforcing interests that support the maintenance of managed low interest rates associated with financial repression. The guaranteed commercial lending margin means banks are able to offset the costs of subsidising sterlisation carried out with the issue of low interest rate bills.

Households have an offset to the low interest rates in rising house prices, the banks have an offset in low funding costs and high net interest margins, the Central bank has an offset in positive carry on sterlisation and control of the money supply, while the government has the ability to finance its countercylical investment in infrastructure and other investments at extremely low interest costs. The system of financial repression is thus self-reinforcing as any attempt to improve the position of one player may be to the detriment of others. It is for this reason that the implementation of a policy to move to market determination of interest rates may be extremely difficult.

In addition, there is a series of risks in reversing this policy of financial repression. The first is the risk of seeking to remedy symptoms rather than causes. For example, as soon as the US dollar started to devalue along with the decline in US interest rates critics of the accumulating dollar claims pointed to the capital losses and called for liberalisation of the foreign exchange market as a remedy. The benefit would have done nothing to protect the value of the dollar credits, but might have reduced the external surplus, on the unlikely possibility that this would have led to an appreciation of the exchange rate sufficient to offset differences in unit labour costs and thus reduced the rate of accumulation of depreciating dollar claims.

But if financial repression is the cause of the external surplus, then it is not the policy of exchange rate management and sterlisation that is the cause of the problem; rather it is in the management of domestic interest rates that has made exchange rate management necessary. While it is not clear what the impact of exchange rate liberalisation would be, there is a distinct possibility, given the experience of liberalisation in Japan in similar conditions, that it would have led to more domestic transfer of assets abroad than vice versa and depreciation of the exchange rate which would offset any impact on the value of the accumulated stock of dollar claims from the increased competitiveness of exports and reduced domestic consumption. It should be clear that management of the money market and management of the exchange rate and restrictions on capital flows are all part of the same policy and must all be moved together.

On the other hand, there may be an even bigger risk in maintaining current policies. Again, reference to the US experience is instructive. Commercial banks constrained to offer zero interest rates on deposits soon found their clients seeking alternatives with higher returns. First, large corporate clients shifted their deposits to higher yielding Treasury bills and then City bank produced an innovation, an ersatz Treasury bill for corporations called a negotiated certificate of deposit that escaped the Regulation Q limitation and induced primary dealers to make secondary markets in the bills which made them as liquid as deposits. Then retail depositors started to seek higher yield and a series of innovations led to the creation by savings and loans banks, who were exempt from interest rate controls, of negotiated orders of withdrawal which made their term savings deposits as liquid as sight deposits. The next step on the erosion of the monopoly of commercial banks to offer liquid deposits and of Regulation Q was the creation of money market mutual funds that offered liquid “shares” that paid commercial interest rates earned by investing in corporate commercial paper but could be redeemed on demand at a stable net asset value of $1 per share.

As a result banks lost both their short-term corporate lending business to commercial paper underwritten by investment banks and their depositors to non-regulated investment bank innovators paying higher rates. Thus, competition based on financial innovation eroded the the commercial banks' guaranteed profit base grounded in the Regulation Q zero deposit rate and a managed lending rate. The response, ironically, was to "save" the commercial banks, by allowing the liberalisation and deregulation of financial markets which eventually led to the instruments that produced a financial system that by the new millennium was funding itself with short-term wholesale money to invest in long-term assets, and used derivatives and other structured vehicles to produce massive leverage. Rather than forbidding the new market innovations, they were encouraged, because, in the words of Chairman Greenspan they were presumed to reduce risks and lead to greater stability and resilience in the financial system.

Currently, China faces a similar choice, as a very similar scenario is playing out in modern Chinese financial markets where non-bank sources of funding are currently estimated to have risen by 15 percentage points of GDP since their appearance in 2008-9 after the financial crisis to reach 65 percent of GDP in 2012.[15] On the deposit side trust companies offer substitutes to deposits and wealth management products (WMP) that give depositors attractive interest rates -- around double the official benchmark rate. Both provide funding to small and medium sized companies, but overwhelmingly they fund property developers, local government financing vehicles, infrastructure projects and outright speculation. As in the US, these structures are able to pay the higher interest rates by investing in higher risk, longer term assets. In this they resemble special investment vehicles (SIVs), the off-balance sheet variable interest entities that were the first innovations

[15] This result is a difference derived from the official lending target of 130% of GDP and the 200% ratio of total social financing to GDP.

to collapse in the 2007 demise of the sub-prime mortgage market. The Trust companies also have a very similar structure to an SIV. Aside from the risks created from the extreme maturity mismatch, -- most WMPs have tenors of three to six months and in no case above one year while investing in fixed assets of three to ten year duration-- and the potential increase in leverage, they offer little transparency as to the composition of their assets. Most do not issue prospectuses and do not make their assets public. Indeed, they are often offered by banks themselves to serve as an off balance source of funding bank investments. Following US practice with CDO's squared, some have been formed in order to repay losses on prior WMP's gone bad in a Chinese version of a Ponzi scheme.[16] The first insolvencies of WMP have already occurred.

Thus, if increased market liberalisation of the financial system takes the path of allowing financial innovation to respond to the existence of financial repression, not only will it not provide a remedy to high domestic saving, it will destroy the guaranteed income base which has covered bank's losses from directed lending and allowed the government to use the banks to finance the countercyclical expenditure policies that have kept China out of the Western cycle of financial crises.

Thus Chinese banks are experiencing disintermediation similar to that in the US during the elimination of Glass-Steagall. The share of bank loans has fallen below 60% of total social financing in 2010 from around 90 percent in the early 2000s while the shadow system accounts for some ten to twenty percent of total bank deposits.

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[16] This characterisation is due to Xiao Gang, Chairman of the Board of Directors of Bank of China, see "Regulating shadow banking," China Daily, 2012-10-12 http://www.cinadaily.com.cn/cndy.2012-10-12_content_15812267.html

The shadow system might solve the problem of over-saving, but at the costs of substantially increasing financial stability, making countercyclical policy more difficult and generating losses in wealth to the general population with the possible result of households increasing savings to restore lost value.

Finally, as Lardy notes, any attempt to eliminate financial repression that produces a shift away from real estate investment could produce a collapse in house prices, produce further losses for the banks, a reduction in household wealth and yield the paradoxical result of a fall in consumption and a rise in savings to counter the losses on speculative property investments. Given the low loan to value ratios there would not be a flood of households underwater or a process of deleveraging, but a simple attempt to restore wealth to income ratios that would reinforce the high existing propensity to save.

There is much to suggest that the appropriate response would be prohibition or more severe regulation of this parallel financial system. There is a very big difference between market determination of interest rates and allowing free market interest rate competition for household deposits through financial innovation. Indeed, there can be no question of the market determination of interest rates, short term interest rates will always be set by the Central Bank, so that liberalisation can come mainly through the regulation of new types of financial institutions and new types of products. Something similar to Elizabeth Warren's Consumer Financial Protection Bureau might be most appropriate if the official authorities are not willing to exercise control in this area. But, at the same time, it will be necessary to avoid the problems created in the US by having different regulations and different regulators dealing with functionally similar activities such as bank deposits and money market mutual funds.

However, the steps taken so seem to indicate that the PBOC will follow the path taken in the US, announcing in June 2012 that bank deposit rate caps would raised the limits on deposit rates to 110% of the PBOC benchmark rates lower the lending rate floor to 80% of benchmark rates and then in July to 70% of corresponding benchmark rates.[17]

According to a Nomura research report the rates on term deposits with maturities of up to 12 months for large state-owned banks have been little changed, while mid-sized banks have raised their rates on term deposits of up to 12 months to the maximum allowable level (110% of benchmark rate). "If banks lower their lending rates to the rate floor of 70% of the benchmark rate, they would not earn much more than they could by lending in the call market. When other costs are factored in, banks look likely to have difficulty lending profitably at these interest rate levels"[18].

In addition, the government has announced a program of Special Financial Zones,similar to the SEZ that launched the new economic policy in the 1970s, in Wenzhou for lending liberalisation and Qianhai (Shenzen) for currency liberalisation.

The State Council approved the establishment of the pilot financial reform zone in Wenzhou in March 2012 to regulate

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[17] Deposit rates at large banks have remained in the range of 3.25 % since these changes and the prime lending rate has been 6 %. Lending rates averaged 7.26 from 1991-2013, with a high high of 12.06% in July of 1995 and a low of 5.31 % in February of 2002. See http://www.tradingeconomics.com/china/bank-lending-rate.

[18] Takeshi Jingu, "China resumes interest rate liberalization," *lakyara* vol.148, Nomura Research Institute, 10 September, 2012, p. 4

private financing activities. The measures have been represented as an attempt to formalise underground banking activities, aiming to put them under prudential regulations. “While interest rate liberalisation is not explicitly mentioned [in the Wenzhou reforms] we believe that more market-based interest rate mechanisms will be implemented when pushing forward the reforms.”[19] The major element has been the creation of a “Private Lending Registration Service Center in Zhejiang Province, an institute founded in April 2012 to regulate the private financing market and promote transparency. Xu Zhiqian, the center's general manager said, ‘The transparency of the interest rates in the center lowered the monthly rates which stood at 3 to 4 percent in the underground market to 1.2 to 1.3 percent.’ The center has eight companies which work as "go-betweens" for those in need of borrowing and lending.”[20] The reforms however have not extended to the licensing of private banks, applications from private individuals to do so have been rejected.

The degree to which such liberalisation on interest rates includes the extension of regulations to these private lending markets is not clear, But it highlights the contradictions faced by those who seek to raise interest rates in order to rebalance the economy and who seek liberalisation to do so and those who believe that lending rates are too high and lower regulation is the answer to providing affordable financing to small and medium sized businesses.

[19] “China’s Shadow Banking Revisited; Size, Implications, Risks and Reforms,” Caijing, 12-05 http://english.caijing.com.cn/ajax/ensprint.html

[20] http://news.xinhuanet.com/english/indepth/2013-01/01/c_124175146.htm

It is to be hoped that Chinese regulators will be better able to control this process than their US counterparts. Otherwise higher interest rates will not contribute to rebalancing, but simply to increasing risk in the financial system and creating greater volatility in growth and employment.