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How Effective Is Monetary Policy in China? A Comment on Woo's "Inflationary Tango"

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The spectacular performance of the Chinese economy over the last two decades or so has been only matched by the spectacular changes in the country's economic policy. From a centrally planned economy, China has turned into an economy in which markets have become a powerful instrument of resource allocation. Even though the "hand" of the bureaucrat continues to be still very "visible" in many spheres of economic policy, the "invisible hand" of markets for labour, capital and foreign exchange has been clearly playing an important role. From a country virtually completely closed to foreigners, China has become by now one of the biggest markets for foreign investment, an attractive destination for foreign tourists and businessmen and a country which has made a powerful mark on the ongoing process of globalisation. As a WTO Member, China is already treated as a "market economy" which was, after all, one of the main strategic objectives of the Chinese government in pursuing its interest in the WTO Membership.

However, the Chinese economy is still by no means a "laissez-faire" market economy. What continues to make the Chinese economy different from a *bona fide* market economy is the presence of state enterprises, which were the backbone of the centrally planned system before the introduction of reforms and which continue to play an important economic role in the economy even today. While the share of state enterprises' output in GDP has declined, it still represents about 30 percent of GDP. But even more significant is the engagement of

state enterprises in the financial sector. The share of loans contracted by state enterprises from local banks is currently about 70 percent of the total! It is evident, therefore, that the performance of state enterprises is still critical in many ways for the Chinese economy.¹

It is this high share of state enterprises in economic activities in China that has motivated Professor Wing Thyee Woo in the previous chapter to look more closely at their role in the macroeconomic performance of the economy. His interest is in assessing the role of state enterprises in the process of building up inflationary pressures. China's inflation rate has been respectable over the years. However, inflationary statistics may be sometimes quite misleading as noted by Professor Woo. He observes cycles in the build-up of inflationary pressures in the form of the size of non-performing loans. The latter always carry the potential of open inflation if they are accompanied by accommodating monetary policy. Moreover, changes in the current account surpluses can also be traced to the cycles in the build-up of non-performing loans. His conclusions are quite stark and surprising – state enterprises have been responsible for the periodic build-up of inflationary pressures and the authorities have been fully aware of the problems and dangers arising from the lack of financial discipline in the public sector. Furthermore, observes Woo, the authorities have not been able to effectively use monetary policy to contain those inflationary pressures, and they have only succeeded in doing so by relying on non-market instruments such as credit rationing.

Professor Woo raises several issues that are interesting as well as unorthodox and controversial. The first important point of his chapter is that the Chinese economic performance has not been as sparkling as one is typically made to believe from figures on growth and international trade. The economy has been subject to dangerous inflationary pressures even though these pressures have not been shown in the movements of either retail price or wholesale price indices. The treatment of China as a market economy in the WTO notwithstanding, the second interesting feature of the chapter is that the Chinese authorities have to rely on non-market instruments to contain inflationary pressures.

¹ A recent McKinsey's report provides figures that are even more dramatic with regard to the share of state-owned enterprises in bank credit – 73 percent. McKinsey estimates the share of public sector companies in GDP at 48 percent. See McKinsey (2006).

There is a third element of Professor Woo's chapter that is particularly intriguing. As economic theory tells us, domestic inflationary pressures cannot be contained to the domestic economy and the pressures will inevitably spill over to the external balance. How the pressures affect the domestic economy and how they affect the external balance will depend on the transmission mechanism of those pressures – from the build-up of non-performing loans to the emergence of internal and external imbalances. That mechanism is not discussed in the chapter at great length and it is, therefore, the issue to which I want to turn in this note.

The purpose of this note is twofold: (1) To shed further light on the model used by Woo; and (2) to explore in some more detail the linkages between the external and internal imbalances of the Chinese economy. I shall address the latter by raising a number of questions that seem to me pertinent to a better understanding of Professor Woo's model and his argument. Given the nature of the Chinese economy, it is quite easy to misunderstand the logic of Professor Woo's argument.

I shall start by outlining again the main general features of Professor Woo's model with a particular attention to the linkage between the external and internal imbalances. Section 2 will address the issue of the transmission mechanism by raising questions about policy responses of agents and by making comments about specific issues raised in Woo's chapter. Policy implications of Professor Woo's chapter are discussed in Section 3.

1 The Model of “Inflationary Tango”

The first important feature of Professor Woo's model is its structure. The model has four sectors of the economy: government, state-owned enterprises (SOEs), private sector and banks. This structure may not appear unusual except that private sector firms operate alongside state-owned enterprises and that many banks are also state-owned with close ties to state enterprises and (provincial) governments and they operate alongside state banks.

The second important feature of the model is that markets do not necessarily clear. This feature comes out from the objective functions of the agents, and those objectives differ a great deal. The behaviour of state-owned enterprises is not driven by the desire to maximise profits since the only shareholder is the state, and the profits are appropriated by

the state through taxation. Their incentives are related to profitability only tangentially at best. What matters more is their “hunger” for new investments that lead to more employment, bonuses and non-pecuniary benefits for enterprise managers. The state may be concerned about profitability of its enterprises but it also has other objectives such as employment, and this often determines its response to failures of state-owned enterprises to be profitable. When state enterprises are not profitable on a prolonged basis they are not closed down for fear of unemployment and they will be urged to continue their operations.

The only way in which the system can be maintained is if somebody is prepared to pay for the losses and that “somebody” is Chinese banks (and ultimately, the taxpayer, of course). It is the banks that lend to state-owned enterprises, and it is also the banks whose balance sheets will be affected by the emergence of non-performing loans. The model is characterised by a “dichotomy” between those who save and those who invest, and between those who manage and those who control. When the size of non-performing loans becomes “excessive”, the government or monetary authorities have to act. They will either have to recapitalise the affected banks or they will have to impose restrictions on new lending.

This unorthodox behaviour of banks has two major effects. First, the accumulation of non-performing loans on banks’ balance sheets leads to a build-up of inflationary pressures. Bank-financed activities of state-owned enterprises increase incomes of households, which are not matched by a corresponding increase of output and availability of consumer goods. Second, the demand for investment by state-owned enterprise and the willingness by banks to lend are the critical forces behind changes in the current account. By definition, and as can be seen from equation (1), any change in investments of state enterprises will affect the size of the current account imbalance, *ceteris paribus*.

$$CA = (T-G) + (S-I) \quad (1)$$

where CA is the current account imbalance, T stands for tax revenues, G for government expenditures, S for savings and I for investment.

The term (S-I) has been persistently highly positive in China, reflecting strong savings habits and high propensity to save by Chinese households. Professor Woo devotes considerable attention to the reasons why China generates large excess savings (over domestic investment) – arguments which I find very credible. The reasons include, *inter alia*, the

one-child policy, the uncertainty created by incomplete reforms of state-owned enterprises, the precautionary motive, and, ingeniously, investment motivated savings.²

Now, consider the case in the model of increased investments by state-owned enterprises. What will be the effect on the current account? Under normal circumstances and *ceteris paribus* conditions, the increased investment would result in a *reduced* current account surplus. Considering the concerns of the outside world about the large trade surpluses of China, this would be a desirable policy alternative since it would reduce the size of the Chinese trade surplus. In contrast, this would be an unattractive option for Chinese policymakers.

However, the model does not describe “normal” circumstances. Increased investments of state enterprises funded by loans that are not repaid will lead to increased spending, but the effect on current account will depend on the response of banks to the emerging difficulties of enterprises in servicing their loans. In competitive markets, increased commercial debt of firms raises the risk of lending. This leads to a higher rate of interest on loans to the indebted firms. In the circumstances of China’s markets, banks do not necessarily reduce lending to SOEs even if the latter accumulate excessive debts. The only solution is a kind of moratorium on bank lending (a “freeze”).

If banks cut access to new loans and refuse to disburse the outstanding loan balances, actual spending will be reduced. The adjustment will take place through a reduction in *desired* spending once the adjustment works itself out through a reduction of incomes and savings. On the other hand, if banks continue to provide funding, actual spending will be equal to desired spending and the adjustment will take place through increased nominal incomes and savings. Moreover, the adjustment may be also in the form of a higher rate of inflation and, hence, in the form of an appreciation of the real exchange rate.

The effect on current account may also depend on what banks do and, in addition, the outcome is ambiguous in the case of a lending freeze. If banks do not stop lending, the current account surplus is reduced as SOEs expand their investments and demand for imports. However, if lending is reduced the surplus will be unchanged or may even increase.

² Investment-motivated savings result from the imperfections of financial markets which discriminate against small and medium-scale enterprises, regulated deposit rates, and, in general, a low level of financial sophistication.

The current account surplus will also be reduced by inflation as the real exchange rate appreciates.³

What will be the actual outcome with regard to the current account surplus will critically depend on what happens to the saving and spending pattern in the private sector, which has played a major role in the improved performance of the Chinese economy. Unfortunately, this issue is not covered by Professor Woo.

2 Questions About the Response Functions of Chinese Economic Agents

The simple macroeconomic model of the Chinese economy outlined above is an interesting way of explaining current account imbalances in China. The model starts from the traditional “open economy” model derived from national income identities, which are then applied to the Chinese economy. In addition, the model follows the tradition of the literature on state enterprises in centrally planned economies, which emphasises elements of objective functions other than profit maximisation. However, what makes the model rather different from the traditional literature is the presence of the private sector, both in the real sector and in the banking sector. These features raise several questions.

1. The first question is perhaps the easiest to answer. If banks do not cut off loans to state enterprises in the face of cumulating non-performing loans, why is that the case? In a normally functioning market economy in which banks have to account for their performance to shareholders, the banks in question would indeed have to take the responsible action of cleaning up their balance sheets. This does not happen in China for reasons mentioned above.
2. This leads to another question. What is the size of non-performing loans and how does it change over time?⁴ Is the size correlated with the performance of the economy?

³ Movements of the exchange rate of renminbi have been seen by many observers as key to changes in the Chinese current account. The point has been made forcefully by John Williamson in our discussions of Professor Woo’s paper. For more recent evidence see, for example, Marquez and Schindler (2006).

⁴ According to a recent Ernst & Young report, the estimated value of China’s non-performing loans was \$911 billion. The report caused a major controversy which the US-based accounting firm had to retract and called “an error”. See *Time Magazine*, May 2006.

3. When the size of non-performing loans is increasing, so is the credit risk of banks' clients. As a result, demand for credit by SOEs should fall as lending rates rise and the willingness of banks to lend falls at the going rate of interest. Profit maximising banks would shift their lending activities to the private sector. This, too, did not happen. Why not? Was it because there was a lack of projects in the private sector or were there other reasons?
4. If the authorities were concerned about inflationary pressures due to the build-up of non-performing loans, what about households and private firms and their concerns? If inflationary pressures rise, should we not expect a fall in savings as real interest rates fall? Or was the government perfectly capable of hiding inflationary pressures from the public?
5. This leads to the fifth question. In order for the model to work it is important to assume that savings be made by households, investments by SOEs and that the level of investment be determined jointly by state banks and the government. In other words, changes in investments of SOEs are unrelated to changes in *aggregate* investments and savings as well as to changes in government revenues from taxation and government expenditures. Even though the SOE sector accounts for 70 percent of bank loans and represents therefore most likely the "critical" mass of bank lending, does this not mean that both the variable "T" and the variables "G" and "S" are completely exogenous? Surely, a part of "T" – tax revenues – comes from incomes and spending in the non-state enterprise sector.
6. Most importantly, why should banks and the Chinese government worry when their non-performing loans are rising? As long as real GDP growth exceeds that of rate of interest, banks' stock of debt will fall. Few individual banks may be hurt but the banking sector as a whole remains solvent. My own impression is that the authorities should be concerned – the "Chinese economic growth has apparently come to depend on a high rate of investment and a rising one. In the first half of the 1990s, China required \$3.30 in investment to generate \$1 of additional income, but since 2001 it has required \$4.90, which is 40 percent more than the amount required by other Asian Tigers in their high-growth period."⁵ In other words, the incremental capital-output ration has been rising since the early 1990s.

⁵ The quote comes from the McKinsey's report cited in Martin Wolf, *Financial Times*, column 7, June 2006. For more details, see McKinsey (2006).

Woo's position is basically the same – he, too, is concerned about the size of debt and the potential dangers arising from it. He reaches the conclusion by carrying simulations using different assumptions about the rate of growth of GDP, interest rate on government debt and the rate of bad loan creation. His simulations lead to the conclusion that the dangers are even more dramatic than those implied in the numbers above.

3 Policy Implications

The discussion in the previous section indicates that it may be somewhat premature to draw strong policy conclusions. Nevertheless, if the model is fine-tuned in a manner that addresses the outstanding issues, the policy implications would be extremely important. Here are a few suggestions.

Perhaps the most important policy implication is that monetary policy continues to be ineffective in China – due to the presence of state-owned enterprises and the way the firms are treated by the economic policy-makers. What lies behind the unorthodox behaviour of those enterprises is their objective function, which is not driven by profit maximisation as is the case of firms with private ownership. Changes in interest rates may be important for the private sector but they are far less important for state-owned enterprises. Moreover, changes in interest rates are unlikely to affect the level of savings and investment as long as the share of state-owned enterprises in GDP and bank lending is large. Here I find myself arguing the same point as Professor Woo.

Another policy lesson that can be learned from the model is that the effects of monetary policy could be perverse. For example, a rise in interest rates will lead to higher savings, a greater liquidity of banks and further expansion of lending to state-owned enterprises, and larger investments.

It is evident that as far as the public sector is concerned, the costs of capital of state-owned enterprises are less than the true opportunity costs of capital. This also implies that, for the SOEs, the costs of loans from China's banks are lower than the true opportunity costs of capital since non-performing loans are financed through various interventions of the government and they represent, therefore, a subsidy. This could potentially raise serious questions in the WTO, which disciplines the use of subsidies since they affect the competitiveness of countries in world markets.

Further reforms of the banking sector are clearly needed, a point fully recognised by Wing Thye Woo. Banks' ties to the government remain too close, which is one of the main origins of their problems. This leads to inefficient use of capital and "excessive" dependence of Chinese growth on investment. The latter is already extremely high and rising.⁶ Thus, it will be necessary to introduce measures to create strong and competitive banks by recapitalising the big four state banks, possibly by breaking two of them into regional banks.⁷ Sale of banks to foreigners should be encouraged. Banks' balance sheets may again have to be cleaned up but only if the banks are fully privatised. These and other measures should be undertaken with a speed not exceeding the regulatory capacity of the monetary authorities.

Some revaluation of renminbi will be necessary. An exchange rate adjustment may be required as much as an instrument of domestic adjustment as well as a part and parcel of an international solution to the current problems of global imbalances. A revaluation would also be desirable to slow down the inflow of speculative capital as well help reduce inflationary pressures. Such an adjustment is likely to be effective because of China's extraordinary exposure to international trade. In 2005, China's ratio of trade to GDP was much the same as that of South Korea, even though the latter has only 4 percent of China's population! China's current account surplus already reached 7.1 percent of GDP and the country's foreign currency reserves are now 40 percent of GDP – the world's largest (Min Zhao, 2006).

Wing Thye Woo is far more sanguine on the question of revaluation. His argument is that revaluation will not help, especially since it will be eroded by capital movement upon the liberalisation of capital account. In this respect, he is probably too conservative given the role of the private sector in the "real" segment of the economy and its role in the process of macroeconomic stabilisation.

⁶ These conclusions are echoed in a recent IMF paper, which argues that the risk that a banking sector underpinned by government guarantees would be motivated to make another round of bad loans rises as liberalisation proceeds. See Prasad and Rajan (2006).

⁷ Wing Thye Woo offers an interesting discussion and a review of the arguments for and against recapitalisation of banks. Some observers argue strongly in favour of recapitalisation (e.g. Lardy), others are against as long as banks are lending to state-owned enterprises (Fan Gang). My position combines both arguments.

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