China Economic Update
by NAB Group Economics

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An open capital account will end financial repression but still a slow path to reform

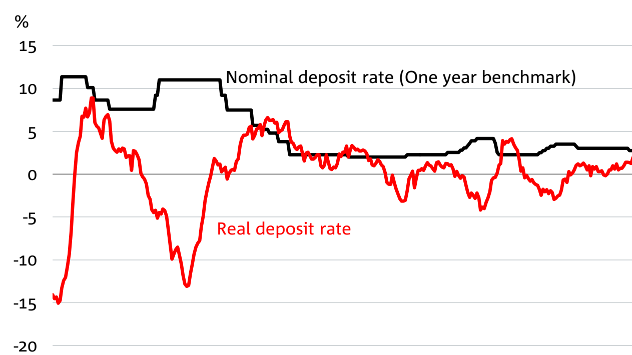
This report is the first of two looking into capital account liberalisation in China. This report looks at the domestic implications of this reform.

Over the history of the People's Republic, China has maintained a closed capital account (albeit to varying degrees) – restricting the flow of investment funds in and out of the country and allowing the government to implement a policy of financial repression. Traditional economic theory argues that financial repression is a constraint on economic growth – however more recent research suggests that this policy was critical to China's model of growth over the past three decades. That said, the benefits of this policy have severely decreased and as China's growth model evolves, the need for both capital account and financial reform is becoming more urgent.

Financial repression – constraint or driver of growth?

Financial repression refers to a range of government measures that result in low-to-negative real interest rates. These policies create a pool of low cost funding, which is often directed by governments into preferred industries. Financial repression is an implicit tax on savers – with the benefits of the policy transferring from lenders to borrowers.

China's financial repression has seen minimal return for savers – but it is gradually easing



Source: CEIC, NAB Economics

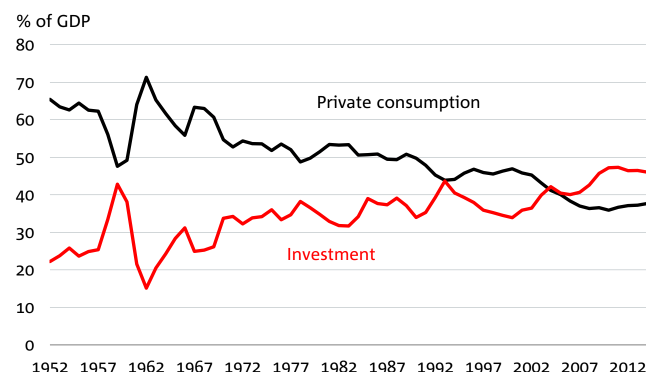
In the case of China, the government has typically regulated interest rates, maintained comparatively high reserve requirements on bank deposits and directed investment from state-owned banks to state-owned enterprises in heavy industrial sectors.

China's financial repression has only been possible because of a closed capital account – an open capital account in a low real interest rate environment would result in capital flight, as savers searched for higher yields in overseas markets. Restrictions on the flows of capital have largely prevented savers from transferring funds out of the country (although there are exceptions), while domestic investment options were limited until relatively recently – the Shanghai Stock Exchange didn't reopen until 1990 while private property ownership wasn't permitted until 1998 – resulting in a strong growth in bank deposits, despite poor rates of return.

Traditional economic theory – formulated between the 1970s and 1990s – has viewed financial repression as a constraint for economic growth. By maintaining artificially low interest rates, financial development is slowed and incentives to improve efficiency are reduced. Similarly, the policies lower the returns on investment and tend to limit innovation, restricting longer term growth.

More recent research has suggested that there is a non-linear relationship between repressive financial policies and economic growth – with specific studies related to China suggesting that these policies may have had a positive effect. Financial repression was arguably critical to China's growth model – limiting consumption and directing the country's high rate of savings into investment in heavy industry.

Financial repression drove the falling share of private consumption and rising investment



Source: CEIC, NAB Economics

As yet unpublished research led by Yiping Huang suggests that financial repression has no significant negative impact on low-income economies, but becomes significantly negative as economies reach middle income levels (China's current position under IMF methodology).

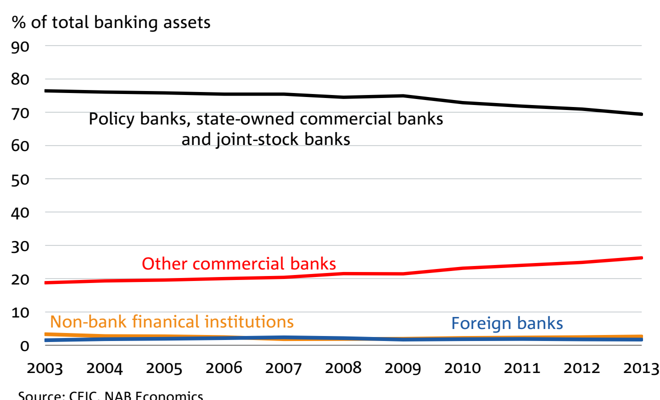
China's financial repression is eroding

Tight control over the banking sector is also a requirement to effective implementation of financial repression. China's government has maintained control in two ways: regulated interest rates (only relatively recently deregulating lending rates and beginning the process for deposits) and dominating market share of the financial sector via state-owned banks. The latter minimises competition that could otherwise drive up deposit rates.

This level of control is gradually eroding – competition in the financial sector is increasing; although it remains

dominated by the larger state-owned banks, their share is in decline. Similarly, the process of deregulating deposit rates has commenced. Recent interest rate cuts have been accompanied by a widening of the permitted ceiling above benchmark deposit rates (now out to 150%) and may soon head towards full liberalisation. A deposit insurance scheme was introduced in May, which was seen as a key hurdle ahead of deposit rate liberalisation, which may occur before the end of the year.

State owned firms still dominates China's banking sector, but competition is rising



Source: CEIC, NAB Economics

Repression and closed capital account doesn't suit the new model

The erosion of financial repression largely reflects the reality that these policies are no longer advantageous to China's evolving growth model. Since the Third Plenum of 2013, a key focus of government reforms has been the transition away from an investment focused model towards domestic consumption – and repression of savers has a negative impact on this goal. Liberalisation of interest rates should free funds from inefficient investment, allowing for further expansion of the services sector and domestic consumption.

Capital account liberalisation could improve this transition. Opening the capital account and allowing the free movement of funds could provide Chinese investors with greater returns in global markets than those available domestically. This increase in wealth could support longer term consumption. Similarly, greater internationalisation of financial markets could improve the allocation of resources within the domestic economy.

That said, capital account liberalisation is not without risk. China's closed account shielded the economy from the Asia wide capital flight during the 1997-98 Asian Financial Crisis – unlike many South East Asian peers. This remains a risk, particularly if reforms around interest and exchange rates do not progress in tandem with capital account liberalisation, while greater prudential regulation of the financial sector is also advisable.

Conclusions

Financial repression, hand in hand with a closed capital account, once suited China's economic growth model, but this is no longer the case. Removing the implicit tax on savings and broadening options available to savers (through greater access to global financial markets) will help support the transition to a more consumption based economy.

That said, like many major reforms in China, the path to progress is likely to be both opaque and slow. In March, PBoC Governor Zhou Xiaochuan publicly stated that China will realise Yuan capital account convertibility this year. Later statements to the IMF noted that it will be a system of managed convertibility – with a goal of limiting the risks from cross-border capital flows and maintaining a stable currency and 'safe' financial environment. This suggests the process of liberalisation will be a continued evolution over the longer term – in line with the slow pace of other major reforms.

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