For China, monetary policy autonomy is vital to further reforms'

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Excerpts from the interview:

China has been recording spectacular growth over the last couple of decades and its share in world trade has increased substantially. But there is this growing consensus that to sustain this level of growth there is urgent need of financial sector reform. So how is the financial and banking sector reform unfolding in China?

I think the Chinese authorities are clear that financial sector reform is going to be important for sustaining and improving the quality of growth over the longer term and the welfare that results from this growth. There was a period when export-led growth was the way the economy was moving forward. But since 2000, the growth has been more investment-led and given that much of this investment is being financed through the banking system, it remains that so much of this growth should come from investment is not the right balance. So they are trying to shift to a more consumption-oriented growth. And the feeling is that boosting consumption will, in fact, be aided by financial sector reforms. People will be able to borrow against their future income stream, with access to opportunities to diversify their investment portfolio. And, all this will require financial sector reforms. There is a presumption that financial sector reforms will not only improve the quality of investment but also tilt growth more towards consumption.

Disinvestment of public sector enterprises is a controversial issue in India. How has China gone about its privatisation programme?

Now, in China, the political structure and constraints are different from that in India. In China, the state enterprises are the social safety nets. They provide health, education, housing services and a lot of people are employed in these enterprises. So, without a proper social safety net in place, it is difficult to reform these enterprises. But the Chinese authorities have taken a measured approach by subjecting the State enterprises to stiff constraints. So rather than going in for privatisation, they have been reducing the subsidies, both implicit and explicit. They have created this new agency, State Administration for State Assets, which is supposed to take care of about 200 of the very large state-owned enterprises. And this agency is to make sure that these enterprises face hard budget constraints and function like commercial enterprises without relying on the public exchequer. The other approach has been to introduce joint-venture arrangements to enable the flow of managerial, technical expertise and capital from abroad At the same time, they have shut down a number of unviable state enterprises. Even in the financial sector, they have attempted to reduce the size and scope of the large banks. So they are trimming but it is not a drastic trimming strategy. But, at the same time, they are setting the ground for the private sector to flourish. So between the two, I think the balance will shift over time.

On financial sector reforms, does China have the adequate regulatory mechanism and institutional framework in place or is it still evolving?

Right now, the China Banking Regulatory Commission is in charge of banking sector reforms. The People's Bank of China is responsible for financial sector reform broadly. There are also such institutions as the China Insurance Regulatory Corporation, which handles insurance reform, and the China Securities Regulatory Commission. These bodies are trying to work together.

Right now in China, the banks are the financial system, though there is a small stock market and a tiny corporate bond market. The Chinese recognise that in addition to the banks they need to have the stock market and the corporate bond market re-energised and they are taking steps on that front. However, legacy issues pose a problem. The state banks lent heavily to the state enterprises. In the stock market, only state enterprises are listed and there is a large block of non-tradable shares, which casts a shadow over the market. So the transition is going to be difficult and challenging too.

The authorities are trying to get the banks to function more like private banks on commercial principles, but the banks do not have all the internal mechanisms for evaluating risk. So, this is where foreign investors come in.

It is a difficult and potentially risky time for China. But whether the regulatory mechanisms in place will be able to cope with these risks during this transition period remains to be seen. Let me make one other important point which touches upon financial sector reforms and the piece-meal reform approach, that is exchange rate flexibility. I think this is a top priority for China for a variety of reasons. It deals with the unfortunate conflation of the exchange rate flexibility issue in China-US trade balance. I think the bigger issue is China needs exchange rate flexibility rather than a revaluation, because they need monetary policy autonomy. An independent monetary policy will be very important for China as it is becoming more integrated with the world economy and they are becoming a more market oriented economy and with these developments you need macro-economic instruments and they don't have that right now.

What of the fisc?

They have very low explicit fiscal deficit, low levels of debts and they're keen to remain very disciplined on fiscal policy. Monetary policy is where you can get a lot in the short run and they don't have that instrument. I think that is a very important priority of them. And again flexibility is a key issue because then you can use interest rates. The reason why I bring that up in the financial sector reforms context is that I think this is why exchange rate flexibility is important. It is not going to essentially be the key factor to financial sector reforms, but unless you have the ability to use the interest rate instrument you cannot get the banks to respond to market signals. The old command and control method of directing the banks on how much to lend is still the way they operate. And that may not serve them well in terms of their broader financial sector reforms.

Another thing that will be important for financial sector reforms is the opening up of the capital account. I think there are big risks in opening up the capital account if you don't go in for exchange rate flexibility first. So I think they are in good shape now, the economy is growing well, they have capital flowing in, they have appreciation pressures on their exchange rate and usually that's a good time to allow for more exchange rate flexibility. That, I think, will be a very important element in the overall reform process.

The concept of special economic zones is something which India has borrowed from China. But in India it has generated a fair amount of controversy, on the fiscal front as well as the land acquisition aspect. What has China's experience been on this front?

China has one very big advantage — the large and flexible pool of labour, which India does not quite have. That is one of the reasons why the SEZ concept worked a lot better in China. They were able to attract foreign investors giving them the right environment and a pool of labour willing to work at competitive wages.

But one has to be very careful about what one can hope to get out of SEZs. Because in the context of India, there is some discussion about how existing companies are moving into the SEZs just to get the tax-breaks. In China, SEZs were largely used to draw FDI. So they allowed that component of capital to come in and that was clearly identified as capital coming from abroad.

So again such concepts as SEZs can serve as a catalyst, but my fear again is that they're seen as the solution and I don't think even in the case of China they have been the primary answer. I think having a large and, more importantly, flexible labour pool is imperative. Labour market flexibility is going to be a very important determinant of India's future success when you think about it in comparison with China.

Regional imbalances are have dogged the Indian reform experience, as with China, where the coastal provinces have grown much faster than the hinterland. How is China addressing this issue?

In China, as in India, regional disparities are a serious concern. There is one big concern that is the urban-rural divide. A lot of prosperity accruing from the reform process has been concentrated in the coastal provinces. The Chinese authorities have attempted to take care of this by having a concerted strategy to develop the inner provinces through large infrastructure investments and so on. They're taking steps but it is a difficult process because many of the inner provinces are still by and large agrarian. The infrastructure has developed a great deal but still if you're far away from a port it is difficult to develop a manufacturing base. Their strategy to deal with disparities is to try and use fiscal mechanism to provide transfers to some of these states — a social safety net type of system or making more investments. They also have something called the `Develop the West' programme where they're trying to actively pour money into the western provinces.

They haven't solved the problem yet but yes this is an issue which exercises the minds of the Chinese authorities a great deal.

I think for economies like India and China this is very difficult issue to deal with and it is important to deal with it urgently because it can stall the reform process.