

General Discussion: Luncheon Address

Mr. Portes: I agree very much with what you said, especially suggesting that it's not likely that China is going to have a crash. It's rather strange to me that the people saying it's going to be a huge crash are the same people who said China should be doing the things you said have been happening. Indeed, for example, reducing the investment ratio, raising consumption ratio. But you didn't say anything about the financial sector and financial sector liberalization; both the domestic and the international side of that. I'd be very interested in your views on those issues.

Mr. Furman: I was surprised that in your acupuncture stimulus, none of it seemed to include the consumer. And if anything, if you did all of it, it's hard to picture how that trend of consumer spending growing as a share of the economy, which you touted, would continue. And related to that, how much of the increase in the current account surplus—a large increase over the last year—do you think is transitory versus permanent? How much do you think it has been caused by policy deliberately? How much do you think policy can, should, or will restrain it? The same question about consumption. Do you see rising consumption in a world where a big part of the rise in consumption the last couple of years was the current account surplus coming down from 10 percent of GDP to 2 percent of GDP

and without moving in the opposite direction, do you see that trend you were talking about continuing?

Mr. Liikanen: There seems to be one major problem during the last weeks, and that's the one of communication—first with citizens and second with the markets. How would you comment about communication of the authorities with the markets and with the citizens; how will this develop from this?

Mr. Li: Very important and interesting questions. First, on the financial sector. Yes, I think the financial sector reform is perhaps the only bright spot of the reform so far. Interest rates are gradually being liberalized. The central bank is careful in its packaging. Financial reform is upcoming, although capital account convertibility, I think, might be more cautiously pushed forward for the fear of capital flowing out. Again, personally I think it's a pity because there are so many ways to do it properly. For example, China can do a hedge fund approach, that is to only allow people with a balance in the bank of say 5 million RMB to be able to convert because these people are small in number, so it's relatively easy to deal with. And the financial sector reform that I think is most important—let me repeat something I already mentioned—is to have a long-term debt market. China does not have a long-term debt market. This is kind of ridiculous, right? High savings, no long-term debt market. Foreign pension funds are waiting to invest in a long-term debt market in China with a government guarantee. This is part of the RMB internationalization process.

OK, on consumption. I did research trying to understand Chinese household consumption. The conclusion is that at end of the day, policies are not that effective. Why? Because unlike the widely claimed point that people don't consume because they don't have confidence in the future, people don't consume in reality because they do not have enough disposable income in their hand. Higher disposable income is the best and only instrument to induce people to consume. Because we're talking about relatively low income people, I do not know. I'm not aware of any effective policy to boost consumption. I may be wrong.

Mr. Furman: There's fiscal policy.

Mr. Li: You mean cutting taxes. Well, again, if you cut taxes, such as the labor tax, it's not clear whether the money would go to corporates, employers or to employees. So, it is possible; you may be right, but it is not obvious to me.

Trade surplus. I think trade surplus mostly goes up due to the domestic economic contraction, as I mentioned. Things are slowing down, especially in the tradable sector, products, physical products. Therefore, less industrial equipment is bought from Germany, from Japan. Fewer Swiss watches have been bought due to the anticorruption campaign. The last thing officials want when they give a talk is to show their watches. People take a picture and say your income is not able to support that watch. Get investigation. So, there's trade surprises coming up, mainly because of the economy's own dynamics, that I believe, if the stimulus package is put in place, if the domestic economy expands a little bit, the trade surplus will come down in the coming years.

Communication. Yes, I think the government in the last round of communication was very indecisive. It was not forthcoming; it did not come out with strong enough messages. So, it was a failure, frankly speaking, of communication, both with the market and with domestic citizens. And in the last run, in late June when the stock market fell, I also thought the government overdid it. They mobilized police to investigate investors who did naked short selling. Naked short selling was not illegal. Why use the police force? Many people, including myself, do not agree with that policy. That's not a wise policy in dealing with the stock market.

Mr. Eichengreen: I have two quick questions. One, we've heard various theories for why China devalued the currency by 2 percent a couple of weeks ago; to boost the tradable sector, to transition to a new exchange rate mechanism, to pave the way toward SDR inclusion. What do you think was important from that list, and please don't say all of them.

And secondly, I didn't get a strong impression of what your view is that GDP growth really is in 2014 as opposed to the published report.

Ms. Reinhart: I have a follow-up on the earlier question on the financial sector, on the policy response. There is a legacy of lending tied to real estate that, it's thought that at least a significant share is already in problems or may be in problems. What are the sort of policy approaches? Is there an approach toward write-offs of some of these loans? Ditto, for provincial debts tied to real estate. Is restructuring of some of these debts part of the policy response?

And the second is related to Barry Eichengreen's question, which is, you started off your presentation mentioning the weakness in exports, so what is your own sense of potential overvaluation, given especially the significant depreciations in a lot of currencies in the recent past?

Mr. Spriggs: I have two questions. Well, a question and an answer for you. So, the question is, when you were evaluating the middle income trap, you were using countries that aren't in China's position. China is quite unique. China now influences the world. So, as opposed to other countries, your slowdown means something to everybody else. What happens in China does impact the world, so it strikes me it's a far more complicated middle income trap. Have you thought it through on that level? And in answer to your consumption puzzle, you didn't mention "clarifying" labor in China. So, while workers have started to get some wage gains, there still needs to be quite a bit of clarification on worker's rights in China and their ability to sustain getting those wage increases is going to be related to clarification of what their rights are. That, I think, would be a big key in getting consumption up because then you could get your labor share up.

Mr. Fischer: Well, thanks for that very interesting presentation. I just want to get a sort of big picture response from you. Until a few months ago, everybody thought China could do everything, was managing everything very well. It didn't seem to have fiscal problems, probably because the economy was growing so rapidly that you could always finance something out of the growth and receipts. Now we're in a situation where people don't know how to think about it. There are some saying, "well, we got it all wrong" and there's a deep crisis, and then there are others saying, "well, this can be fixed without a lot

of effort.” What you proposed was fixing with quite a bit of effort. So, how do you see the overall picture and how do you think that society is placed to deal with the serious problems that could arise if the economy is in worse shape than we think at this moment?

Mr. Li: OK, very, very important questions. First, on Barry Eichen-
green’s question about currency depreciation. The Chinese central
bank’s motivation, as far as I can tell from the outside since I’m no
longer with the monetary policy committee, is to follow the market
force, to take advantage of the market pressure to devalue as an op-
portunity to further free the exchange rate. So the motivation is to do
reform. And, I do not deny that there has been pressure within other
government branches. For example, from the Ministry of Commerce
to push for devaluation to help exporters. My view is that this de-
valuation did not and will not be of tremendous help to the exporters
because the RMB, for good or for bad, is already a headline currency.
When the RMB depreciates, the currencies of many, many countries
would follow suit. Kazakhstan, Vietnam. They all follow. So in the
end, the net gain is not that much for the Chinese exporters. But, at
least in terms of domestic politics, it serves a certain purpose.

GDP figure. Let me put it this way. First, GDP statistics are be-
coming much more difficult to come by than maybe even two years
ago. Why? The structural change. The services are now becoming
so important and Internet business is so important, so it’s a more
complicated issue than before. Second, I would say that in terms of
trend, in terms of the GDP figures indicating that the whole econo-
my is slowing down, that trend is superclear. That is, last year coming
down from a year before, and this year, the first half of the year is also
coming down. The trend is clearly shown, even though in the first
half of this year the official GDP statistic is still the same as the last
year. So, I don’t know how far the real number is from the announced
number. No one knows. This is a very complicated issue.

Property market loan. I would say that the property market is, re-
latively speaking, a much smaller issue in terms of bad loans than the
local governments. Why? Because people have been calling about the
wolf is coming for so many years. In the property market, the devel-
opers have been the bad guys for many, many, many years, so that

commercial banks are supercautious in lending to them. And also, commercial banks, also developers are also extremely smart in doing the following thing. They do not borrow money; they get a piece of land and quickly do some simple construction. Then, they do a pre-sale. In China, you sell an apartment before it's finished. That is you sell the blueprint. You sell the site. The developers say, look, this is the construction site, this is the blueprint—buy it. This way, the developers are not highly leveraged. So overall, I do not think the property market, or developers will create a major threat to the banking sector, or financial sector. Local governments, yes, we've already mentioned them. Many local governments have accumulated huge debts while doing infrastructure on industrial parks and they borrow very high levels of debt. What's the resolution? The resolution put on the table is to swap. That is, the central government would allow local governments to float long-term debt and use long-term debt to replace bank loans. The issue is that the amount of the swap is not big enough. So, in my acupuncture stimulus package, the first thing is much bigger, much stronger, multiple times the strength. Currently, this is too slow.

Overvaluation of RMB. Again, it is hard to come up with the answer because the RMB is such a headline currency. A lot of neighboring countries follow the RMB. So, it's kind of a situation of multiple equilibria, if the RMB wants to devalue against the U.S. dollar, other currencies would devalue. If the RMB doesn't devalue, then other countries wouldn't devalue. So in my view, it's not a key variable to make adjustment now.

China's position in the world as opposed to Japan, Korea and Taiwan in their respective years. I do not have a complete answer, but I did think about this issue. My view is that China—unlike Japan or Korea, Taiwan—now is a large country with a large economy. It's like a small world. Inside China, we have three full provinces with populations similar to or bigger than Germany. And inside China, there are relatively advanced economies in the coastal provinces, almost like parts of Europe, like Greece maybe. And other parts are still poor, like Nigeria. So, internally, provinces can trade. Currently,

they're not trading enough. Currently, there are still domestic barriers to trade. So, again, I guess the answer is that if proper policies and reforms are put in place, the big size of the country can be an advantage. On the other hand, without reforms, then the big size will be a disadvantage. Because as you implied, China simply cannot repeat the success story of Korea and Taiwan. Japan's a bigger economy, a different story.

Consumption, labor standard. I have the following view, that when I travel around China the best weapon for workers to have higher labor standard is labor shortage. Now the labor shortage is emerging so that the treatment workers get is much better. For example, I talked to an exporter in Guangdong Province. The employer, my age, complained to me: "Look, young people are so lazy and are spoiled; they want hot water. Hot shower. When we were young, we took cold water showers." And I told him: No the story is that when you were young, there were many of us. Now the young people are in shortage. You better treat them well. He said, "Indeed. Of course we have to give them the hot water; I'm just complaining." So, to me, that is the best weapon for workers.

China's government power. Let me put it this way. This current government and leadership that came to power almost three years ago are more ambitious than previous governments and previous leadership. They are more proactive, so they have more things on their plate, more than just the economy. They want a cleaner party, cleaner government. They want, again just my view, a more proactive international profile. And they're busy dealing with international affairs. South China Sea, Japan, the U.S., APEC, G-20. By the way, the Chinese government for many years has avoided being the chair country of the G-20, until now. All of these require energy and time. Time is fair—everybody has 24 hours a day. So, common sense tells me that until now, the leadership's energy on economic affairs, relative to previous leadership, has declined. I believe the recent downfall of the stock market and having the international spotlight on China is a stimulus or shock of its own for the leaders because they don't want to travel to Turkey or to the United States—I'm talking about Xi Jinping; he's coming to the United States in September and

going to Turkey in November—and always be asked the questions you are asking. So, I do think that from now on, economic reforms will become a higher priority in their agenda.

Mr. Lockhart: This may be a little bit naïve and simplistic, but I'm going to ask you to be a sociologist. The image of the Chinese people is the love of gambling. Are we going to see recurrent cycles of stock market rising and crashing because of a somewhat immature investment culture?

Mr. Li: Good question, also a very entertaining question. It's fitting to be the last question. Let me tell you something. The Chinese stock market is becoming more efficient. In 2007, when the Chinese economy was not as attention-grabbing as today, the stock market index by October went to a P/E ratio of about 70. And within a few months it dropped to 10—70 to 10, a big drop. Now, before it dropped this time, my calculation of the P/E ratio was 30 and it dropped to 20. And then in late August, it dropped from 20 P/E to about 17. So you see, there is an improvement in having a smaller range of volatility. But this improvement might be too small to celebrate.

Culture certainly is important, but the institution is also very important. Why is there a compression of the range of volatility? Shorting. Shorting, which now is allowed, was not allowed in 2007. Of course, shorting is blamed by the police. Shorting is gambling; it's good gambling. Some people are gambling long, some people are gambling short so that the stock is not going too high or too low as before. So, I do have hope that the stock market will become healthier.

Let me end by saying that fundamentally, for the stock market to be really as efficient as the ones we understand, one thing is missing in China—the rule of law. There are lots of stories people tell of insider trading in China. Still, there are virtually no lawsuits against this—unlike in New York, where you have a federal court and the DA is going after all this very relentlessly. In China, we don't have this because in China the courts are local. If you bring an issue of insider trading to a court, that court mostly like would protect the local guy. You cannot win. Even if you win, you'll win symbolically. So, my proposal is to consolidate all the securities lawsuits and

prosecution in one spot, in Shanghai. And I would elevate that court to the highest possible level, not the Supreme Court of course, one step down. That way, the Chinese securities court and the prosecution will be like the Chinese Maritime Court. The Chinese Maritime Court in Shanghai is very well-respected internationally because they are independent. Many ships go to China for their lawsuits. Fundamentally, I think that is the institution to cure the gambling culture, not only the gambling culture but also the culture of violating rules.

