Comments

Interest Rate Liberalization and Capital Account Opening

Loren Brandt
Department of Economics
University of Toronto
Summary

• Tackles important question – sequencing of reforms
• Related to older literature on complementarities and interactions of reforms
  – Profit incentives in distorted market lead to misallocation
  – Pricing reform under weak incentives may not have much effect
• Parsimonious but elegant GE model
  – Restrictions captured by series of wedges/taxes
  – Directed lending/Dual-track banking system
Summary

• Key findings – Tradeoffs
  – Relaxing constraints on capital inflows raises productivity, but distorts households consumption decisions
  – Easing controls on capital outflows raises returns on household savings, but raises domestic lending rates for firms and lowers TFP
  – Implication: Need to eliminate financial repression before opening up capital account

• Formalizes intuition of earlier literature
  – Lardy and Douglass (2011)
Financial Repression – Historical Context

- **Objective** -- Help state meet multiple objectives
  - Lending to the SOEs
  - Finance government expenditure
  - Rents to build patronage and networks
  - Largely redistributive

- **Measures**
  - Credit plan and quotas on lending to the state sector
    - Largely indicative but at times administrative
  - Restrictions on interest rates (deposits and loans)
  - Limited development of equity and corporate bond markets

- **Consequences**
  - Misallocation of capital
  - Emergence of shadow banking sector – improved efficiency but new risks
  - Boom-bust cycles
  - Insolvent banking system

- **Late 1990s, early 2000s – major banking reform**
  - Setting up of AMCs
  - Recapitalization of banks, followed by IPOs
  - Establishment of policy banks
  - Interest rate liberalization
  - Opening up capital markets
  - Objective: Bank lending on more commercial basis
Financial Repression – Where are we today?

New Net Corporate Lending to State Controlled Companies

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>30</td>
</tr>
<tr>
<td>2011</td>
<td>25</td>
</tr>
<tr>
<td>2012</td>
<td>30</td>
</tr>
<tr>
<td>2013</td>
<td>35</td>
</tr>
<tr>
<td>2014</td>
<td>50</td>
</tr>
<tr>
<td>2015</td>
<td>60</td>
</tr>
<tr>
<td>2016</td>
<td>70</td>
</tr>
</tbody>
</table>

Legend: State controlled companies
Requirements and Pre-conditions

• Removal of directed lending to SOEs
• But other things important as well
  – Strong domestic banking system
    • Reduces likelihood of capital outflows with opening of capital account
  – Reasonably developed domestic capital markets
    • Competition for banks – accelerates commercialization
    • Easier to absorb capital inflows (and avoid bubbles)
    • Currency and maturity mismatches less likely
  – Flexible exchange rate near equilibrium level
    • Reduces likelihood of destabilizing capital flows tied to under (over) valuation of currency
Things to consider?

• Households as borrowers?
• Effect of liberalization on productivity and growth?
• Implications of financial repression and capital controls for China’s imbalances?
• Data
  – How big is the state-nonstate TFP gap?
  – What is the size of the state sector?
  – How well do our measures of capital frictions capture constraints of private sector firms?
  – What percentage of lending is directed?
TFP Differences

TFP - Non-state vs State, 1980-2011

TFP: Non-state vs State
Rates of Return to Capital

$MP_K$, Non-state vs State, 1980-2011