How Can Developing Countries Maintain Macroeconomic Stability?

Lessons from China's Reform and Opening Up 1978-2018

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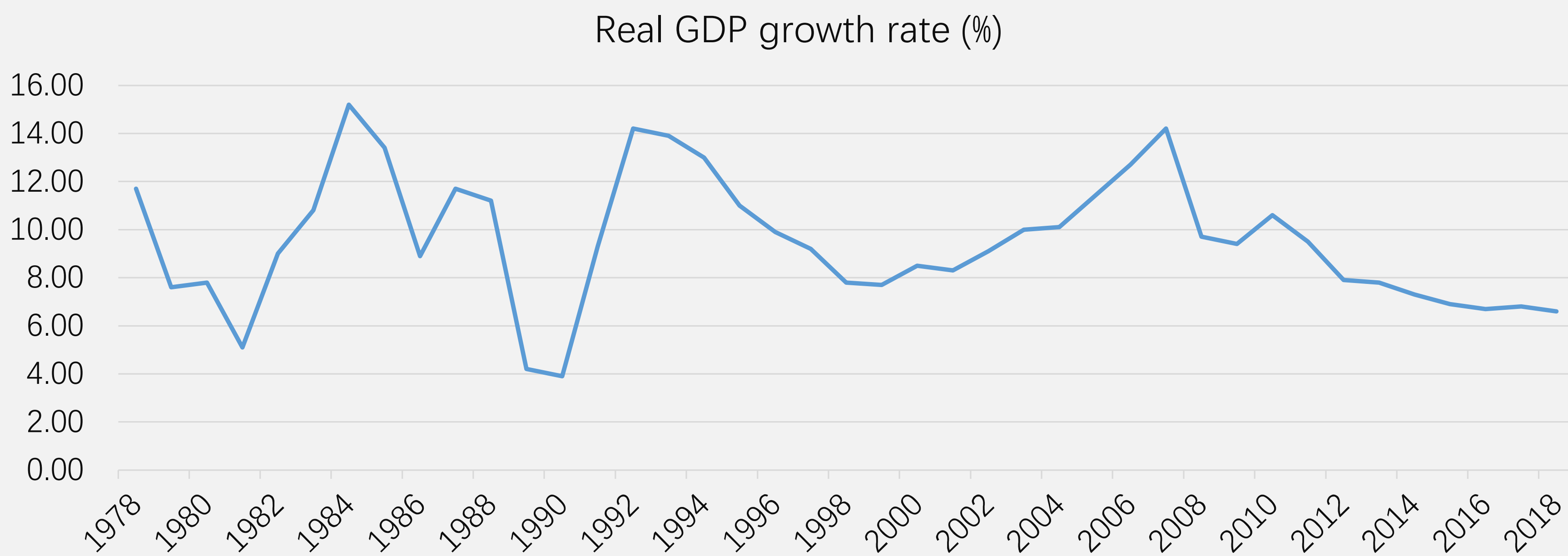
China's real GDP growth



Data Source: NBS of China.

CPI inflation: Cross-country comparison

Annual average CPI inflation across countries

	Simple average	Algebraic average
The US（1986-2016）	2.60%	2.70%
China（1978-2017）	4.90%	4.90%
Japan（1960-1980）	7.30%	7.20%
India（1986-2016）	7.50%	7.70%
Korea（1967-1990）	11.40%	11.60%
Russia（1986-2016）	38.00%	73.00%
Poland（1988-2000）	58.50%	87.90%
Brazil（1986-2016）	99.40%	361.20%

Note: The source of data for China is the National Bureau of Statistics, and other countries' data are from the World Bank WDI database.

Lessons could be learnt from China's successful experiences

- The direction of Chinese reforms follow the textbook prescriptions
  - Market liberalization: market determined prices in the financial market (interest rate, FX rate)
  - Open to the world: trade and free capita flows
  - Changing role of the government: deregulation, fiscal discipline

- China's reforms take into account the imperfections of the emerging markets
  - The frictions of the market impede the market clearance.
  - The financial markets are immature.
  - The information asymmetry between domestic and foreign investors

Policy Mix I: Proactive Macroeconomic Management

Market failure: The frictions of the market impede the market clearance

Why should the government conduct proactive macroeconomic management during structural transformation?

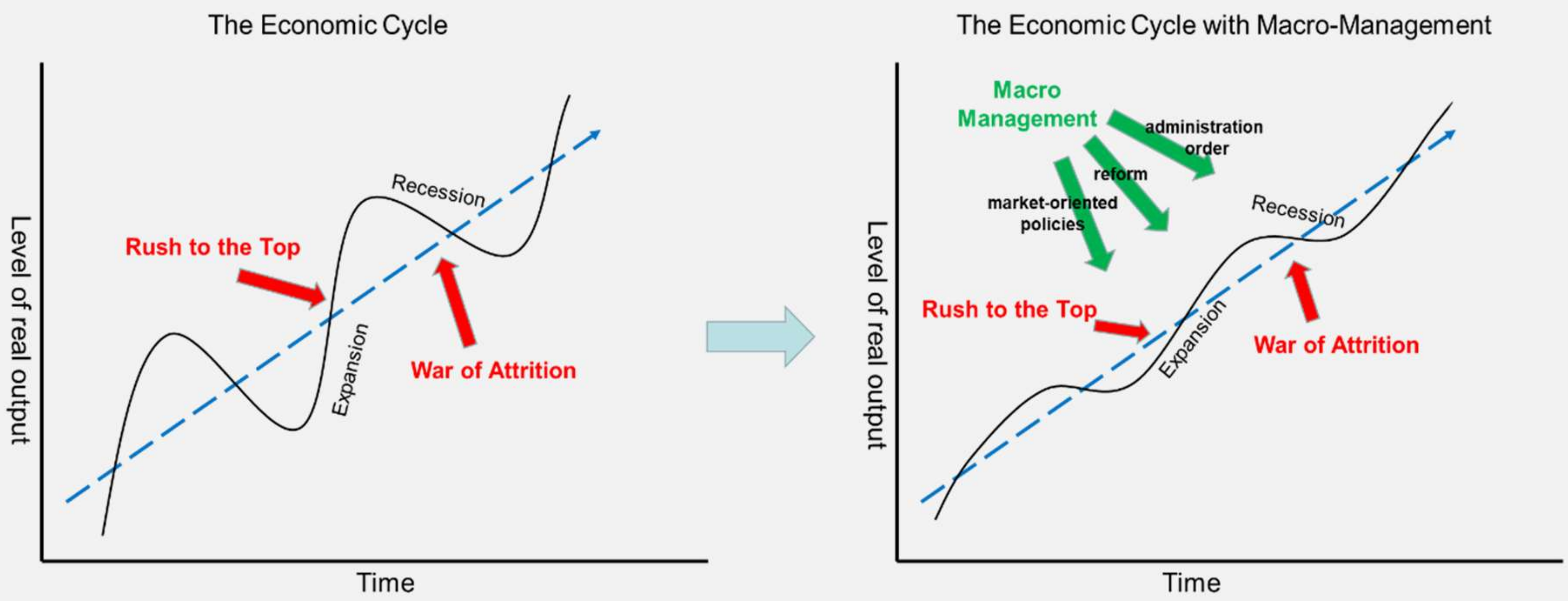


Figure: Schematic diagram of economic cycle and macro regulation

China's Macroeconomic Management framework: the "three pillars"

The "three pillars" help stabilize China's macroeconomy:

1. Market means

Monetary and fiscal policy tools

(i) adjustment of deposit and lending benchmark rates as well as the RRR;
(ii) adjusting the enterprise income tax rate, export rebate rate, and VAT rate;
(iii) providing fiscal subsidies to stimulate consumption;
(iv) subsidizing enterprises to incentivize equipment upgrading.

2. Countercyclical reforms

Example: Enrollment expansion of colleges and universities

3. Administrative means

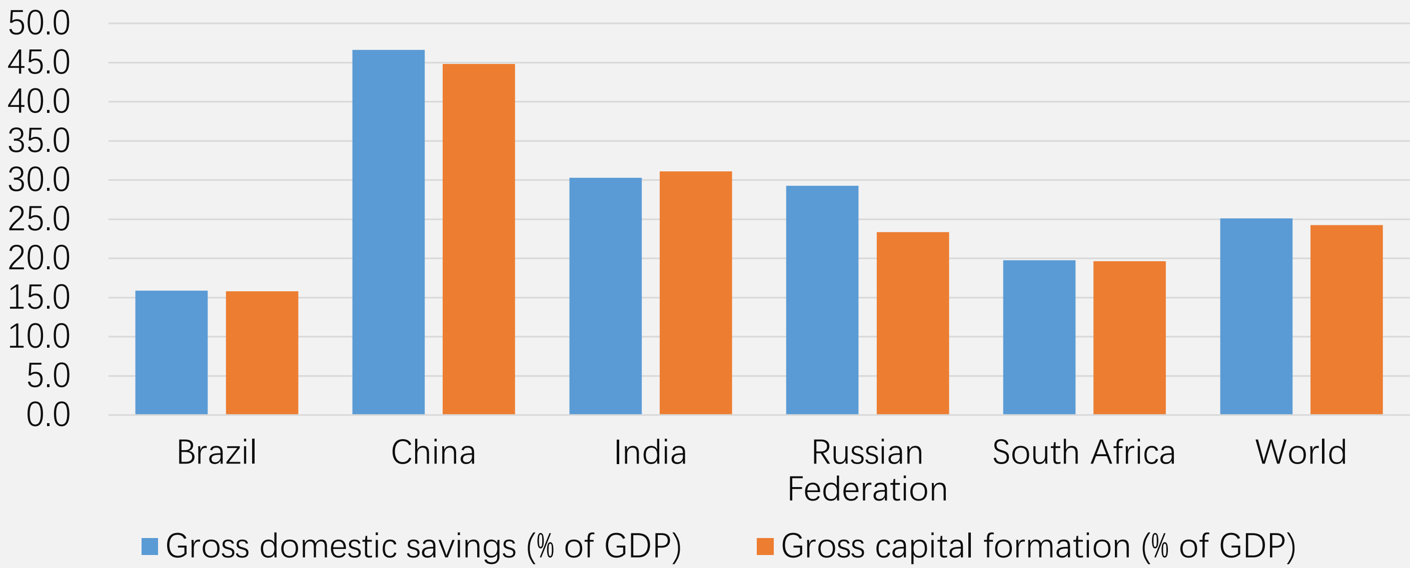
Stop new investment projects

Force non-profitable firm to exit.

Policy Mix II. Financial Reform and Financial Market Cultivation

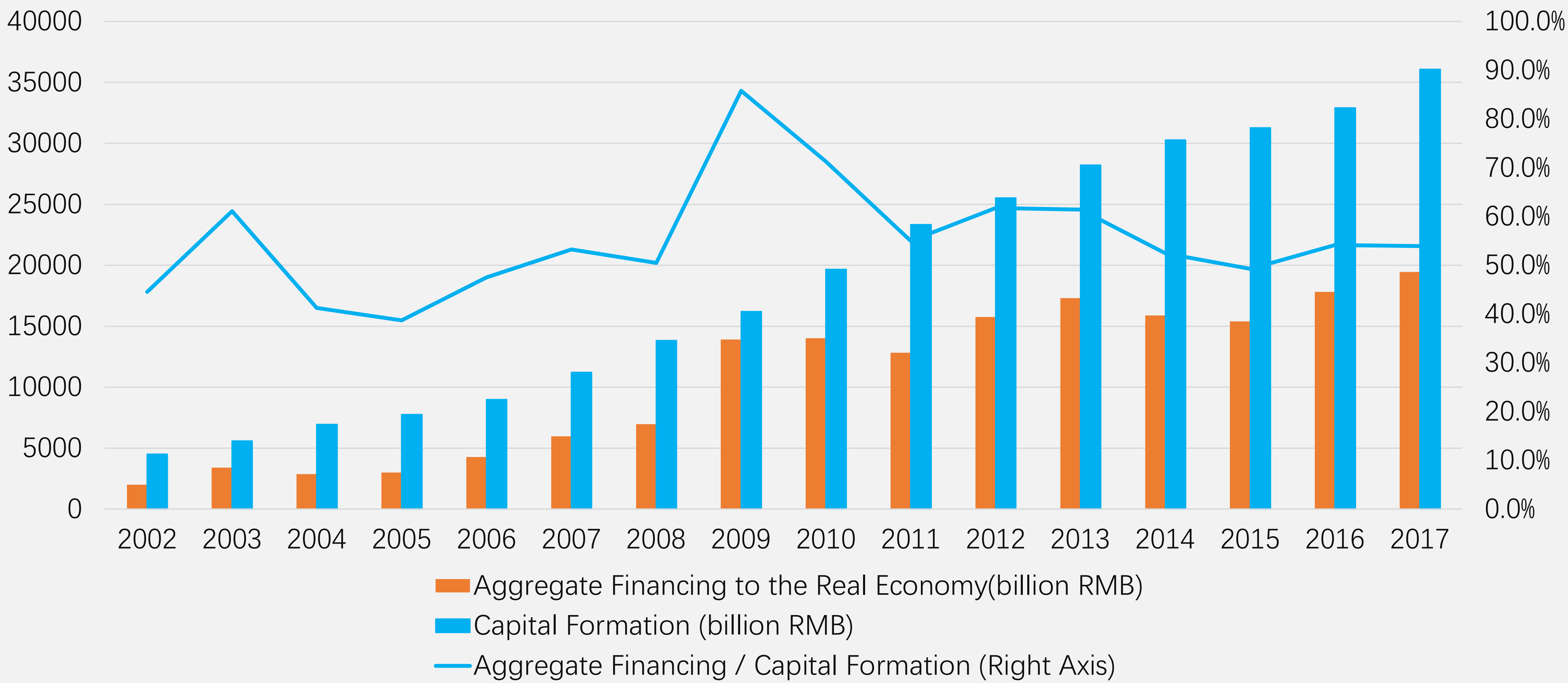
Market Failure: The financial markets are immature

- Due to the underdevelopment of the financial market,
  - It is difficult for savings to be effectively converted into productive investment in developing countries, with misallocation of capital being a common phenomenon;
  - Financial risks are easily amplified, which makes the macro economy prone to drastic fluctuations.



Data Source: WDI databases

Financial system: Channeling savings to investments



Data Source: NBS of China.

Two principles followed by China's financial reforms

1. At the early stage of economic development, the single most important goal of financial reform was to cultivate financial markets.
   - Banks should be given priority in the early stage of economic development.
   - Infrastructure investment requires special financial arrangements

2. Maintaining financial stability is a life-or-death issue.
   - Low CPI inflation and stable exchange rate
   - Financial assets denominated in local currency

Policy Mix III. Carefully Managed Capital Account Liberalization

Market failure: the information asymmetry between domestic and foreign investors

- Emerging markets are more vulnerable to external shocks compared to the advanced countries
  - A certain level of capital controls is perceived to be an essential measure to maintain the stability of the financial market.
  - Capital accounts should be liberalized in a gradual pace, and the sequencing of the reforms is important to maintain the financial stability of the emerging markets.
  - Foreign exchange reserves are important buffer to stabilize the financial market

China carefully manages the timing and sequencing of capital account liberalization

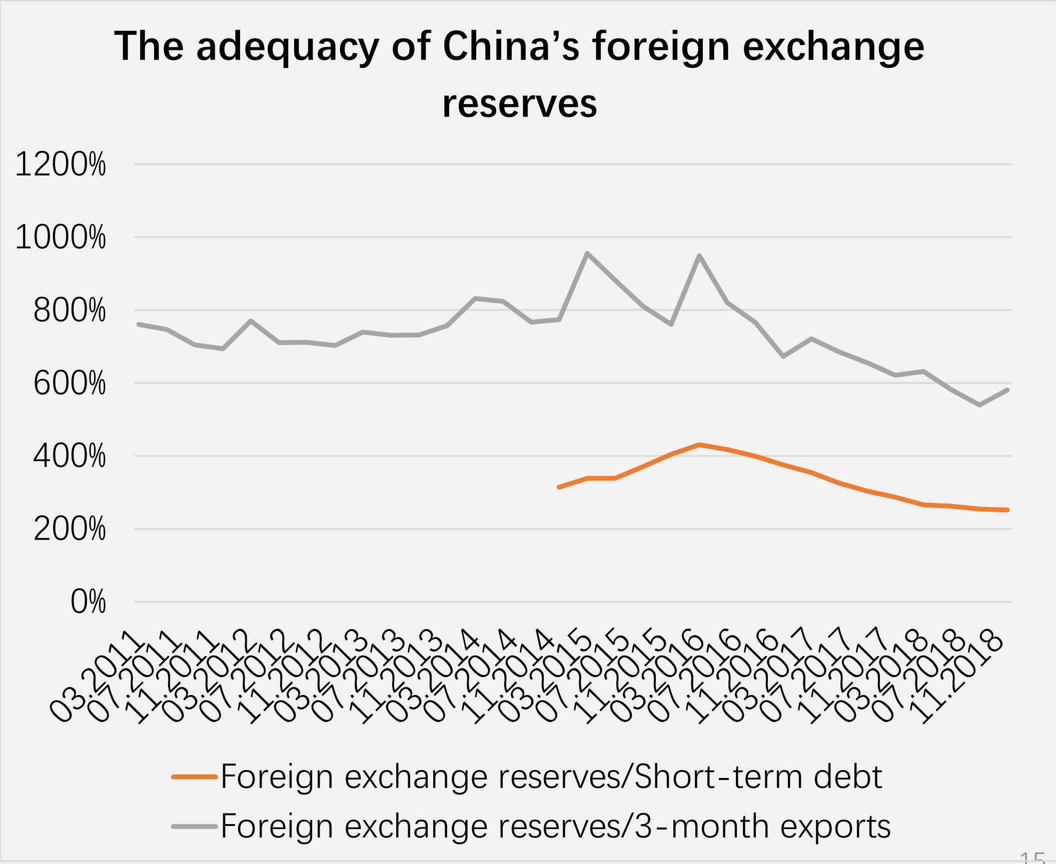
- Proactive in relaxing the controls on cross-border direct investment
  - In the 1990s, relax the limits on foreign direct investment to introduce foreign technologies and equipment
  - In the 2000s after joining the WTO, promote the overseas direct investment to get integrated to the global value chain
  - Restrictions in strategically important sectors (financial sector, energy sector, etc.)

- Prudent in liberalizing portfolio investment
  - Qualified Foreign Institutional Investors (QFII) mechanism (2002)
  - Qualified Domestic Institutional Investors (QDII) mechanism (2006)
  - RQFII (2011) and RQDII (2014)

- The timing of China's capital account liberalization were carefully managed to avoid shocks to the financial markets.
  - China relaxed the controls on overseas portfolio investment by introducing the program of QDII in the late 2000s when there was an appreciation pressure of renminbi.

The changing roles of foreign exchange reserve

- Promote economic transition in the early stages of economic development
  - A centralized licensing system to utilize the limited FX reserves to the best use with the aim of building up productive equipment that is urgently demanded in the industrial sector.
- Maintain financial stability in the post-industrial stage
  - Financial stability is foremost important: China has accumulated far more foreign exchange reserves than the “adequacy ” red line.



Summary

Three key lessons for other developing countries:

Market Characteristics	**Policy Mixes**	**Policy Goal**
Market frictions	Proactive macroeconomic management	Continuous high growth; Low volatility; Low inflation
Inefficient financial market	Financial reforms and financial market cultivation	Financial deepening; Channel savings into investment; Financial stability
Information asymmetry	Carefully managed capital account liberalization	Industrial upgrading; Financial stability