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PATH TO FUTURE

EXPERTS PREDICT ROBUST OUTLOOK FOR SINO-EUROPE TIES, AS NEW LEADERSHIP TAKES OVER IN CHINA

Interest rate reform would be good step

CHINA MUST REDUCE INCOME INEQUALITY, BOOST SOCIAL WELFARE TO SUSTAIN LONG-TERM GROWTH

By OLIVER BARRON

Chinese leader Hu Jintao opened the 18th National Congress of the CPC by highlighting the need to build a "beautiful China". The man who replaced him as the general secretary, Xi Jinping, closed the session by talking about the "great renewal of the Chinese nation". Together, they conjure up an image of a sublime butterfly emerging from its cocoon, preparing to spread its wings and embrace a new and brighter future.

While the future may be full of promises, China today remains in its cocoon, both in its relationships with the international community and in its own domestic development.

On the international front, China remains secluded from the global economy due to the closed capital account and currency controls. Domestically, China is in dire need of both social and economic reform.

For sure, the achievements of the last three decades cannot be understated — China has grown to become the second-largest economy in the world and, in the process, pulled some 600 million people out of poverty, equivalent to almost twice the population of the United States. A successful past, however, can only do so much to guarantee a prosperous future.

The list of necessary reforms is seemingly endless. In addition to those highlighted above, other economic reforms include interest rate liberalization, changes to resource and utility pricing and an extensive overhaul of the tax system, including revised revenue sharing between central and local governments, adjustments to resource taxes, property taxes and land fees. On a higher level, China's growth must become more sustainable by reducing reliance on investment and exports and boosting the role of domestic consumption.

Probably most importantly, the system needs to be adjusted to reduce income inequality and boost social welfare. Significant efforts are needed to reform and improve the education system, improve medical and healthcare provisions, expand social security and pensions and clean up the environment.

None of this will come easy, however. With countless barriers to reform constructed by special interest groups seeking to maintain the status quo, although nearly all analysts and commentators share the view that China needs reform, few can agree on the pace or actual direction of that reform.

One of the most fundamental questions is whether China should have state-led or market-led reform. The benefits of market-led reform are highly touted, but such a path also has the potential to step on too many toes. As a result, state-led reform may be a more fruitful path.

Of the many potential reforms, interest rate reform may have the greatest chance of appeasing both camps. Sure, interest rate reform is usually associated with the reform camp, but perhaps China can achieve "interest rate liberalization with Chinese characteristics". Even with freer interest rates, savers are likely to keep money in larger banks due to their stability, reputation and the convenience of their branch networks.

As the central government appoints the chairman of each of the major banks and remains their majority shareholder, it would still be able to dictate the flow of capital, if needed. It could become similar to China's edible oil market, which despite being fully liberalized years ago, can still fall under administrative control of the government from time to time.

Not only would liberalizing interest rates support economic restructuring through the proper pricing of risk, but it can do a lot more to reduce income inequality and improve social welfare than any amount of government spending. For too long have Chinese individuals seen their wealth eroded in savings accounts earning negative real returns. If rates were liberalized, banks would be forced to offer better returns on deposits in order to prevent capital flight.

Furthermore, interest rate liberalization would also foster financial innovation, leading to the creation of more new savings vehicles. The greater options for savings, beyond simply bank accounts, would significantly boost the return on savings.

Broader product offering and more stable investments would also support the growth of the underdeveloped insurance sector. A more robust insurance sector then could increase provision of health and life insurance, as well as share the burden of pension provision with the government system that has been overburdened with unfunded liabilities since state-owned enterprises' reform in the 1990s.

More importantly, better healthcare and pensions, when combined with the greater returns on savings, would reduce the need for incremental savings, therefore freeing up money for consumption.

Despite its abounding benefits, practical interest rate liberalization will need to go hand in hand with other reforms, such as deepening the domestic bond market, to allow the government to run greater deficits to fund state initiatives and allay fears that control will be lost.

If we can learn anything from recent history, however, those hoping for rapid reform in the short term are likely to be sorely disappointed. Let's just hope that meaningful progress isn't too late.

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