

# Comments

## Interest Rate Liberalization and Capital Account Opening

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# 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

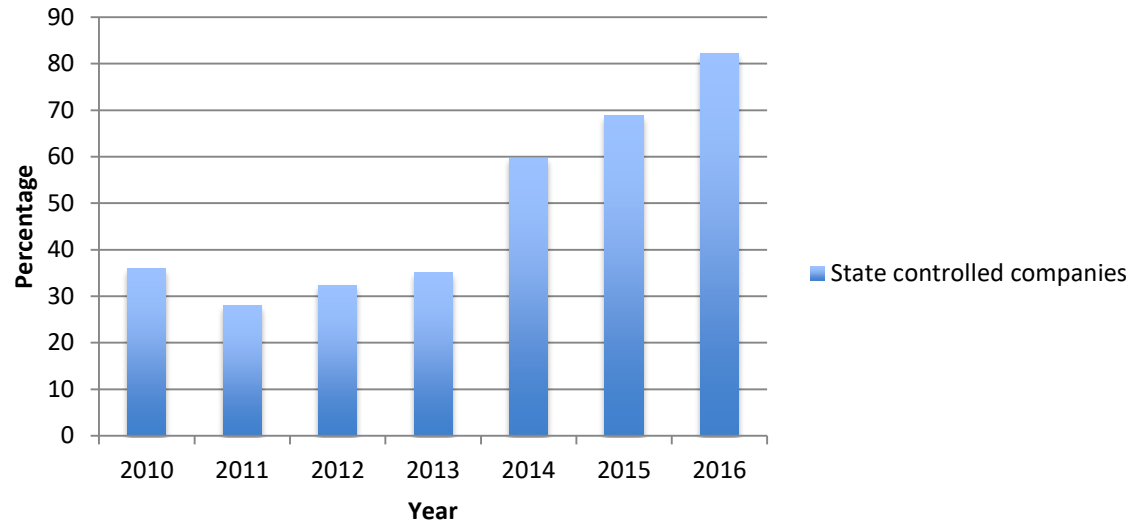
- Key findings – Tradeoffs
  - Relaxing constraints on capital inflows raises productivity, but distorts households consumption decisions
  - Easing controls on capital outflows raises returns on household savings, but raises domestic lending rates for firms and lowers TFP
  - Implication: Need to eliminate financial repression before opening up capital account
- Formalizes intuition of earlier literature
  - Eichengreen (2004)
  - Prasad, Rumbaugh and Wang (2005)
  - 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



# Requirements and Pre-conditions

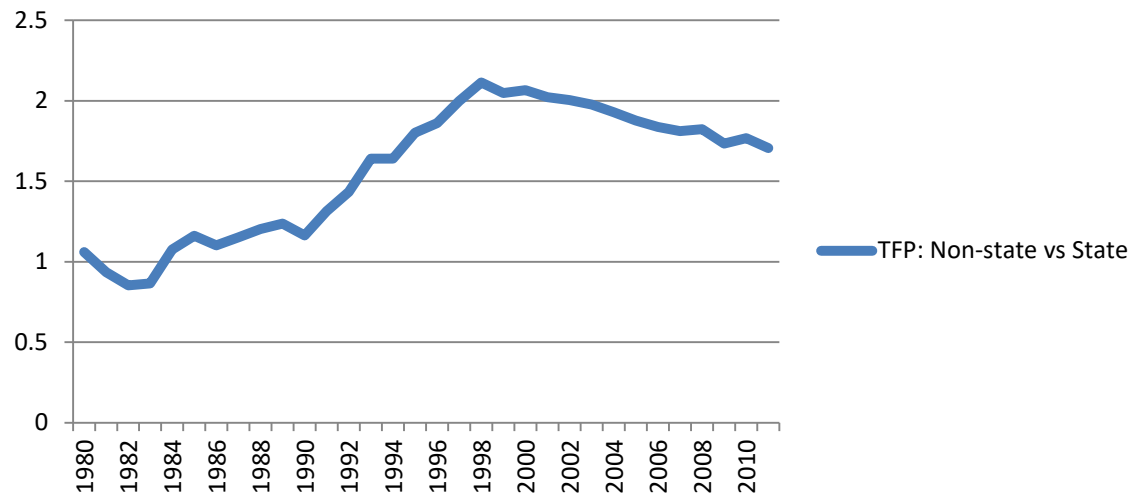
- Removal of directed lending to SOEs
- But other things important as well
  - Strong domestic banking system
    - Reduces likelihood of capital outflows with opening of capital account
  - Reasonably developed domestic capital markets
    - Competition for banks – accelerates commercialization
    - 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**





# Rates of Return to Capital

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

