

Supply Side Structural Reform: Seeking Progress while Maintaining Stability

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This meeting marks a milestone

- 20 years of CDF
- 20 years of open discussions of China's development strategy and reform
- Discussions of 10th, 11th, 12th, 13th Five Year Plans
- Now setting the stage for the 14th Five Year Plan
- 20 years of enormous success for China
 - Largest economy in world in PPP
 - Huge increase in income per capita
 - Almost 800 million moved out of poverty
 - China has become a middle-income country
 - In some areas, China is a world leader

Much work ahead

- China's is still a developing country, though a large one, with one fifth per capita income of most advanced country
 - Needs to close gaps in technology, knowledge, human capital
- Large inequalities—rivaling US, the worst in advanced world
- Long way to go to ensure equal opportunity for all
- Large environmental problems
- Institutional problems
 - Excessive dependence on short-term debt-driven growth
 - Challenges in creating stable equity markets
 - Equity provides better risk distribution
 - Challenges in creating long bond market
 - Many key investments are long-term
 - More stable than short-term finance
 - Insufficient tax base for government, especially local
 - Greater economic diversification

Key message from previous years

- **What matters is *quality growth*, not just GDP**
 - Which means environmentally, economically, and socially sustainable
 - Inclusive growth
 - Stability
- **Has to be approached from both demand and supply side—keeping two in balance**
 - “Wrong” supply side measures can weaken demand and impede sustainable reform
 - “Right” supply side measures can strengthen demand, increase output today and in the future, and help achieve other goals

Important lesson from US

- Supply side measures taken in the US (tax reductions at the top, deregulation) led to *lower* growth over long run, more inequality, greater instability, less opportunity (share of new firms in decline), more concentration of market power
- Studies elsewhere confirm results are more general
- Other countries have undertaken different policies
 - With same global environment (same globalization, same technological change) have achieved better outcomes
 - Shows that policies matter

First question: What is real source of the wealth of a nation?

- In the capacities of its people
- In their knowledge (both knowledge about the world, and their human capital)
 - Importance of universities, knowledge institutions
 - Dangers of disinformation and attacks against and restrictions on “truth-discovering, assessing, and dissemination” institutions
- In their ability to work together, cooperatively and with stability
 - Importance of “social organization”—including rule of law
 - But not *any* rule of law—feudalism is a rule of law that didn’t work
- Key insight: distinction between wealth creation and rent-seeking
 - Many people become rich through exploitation of others and rent-seeking
 - But this cannot be the basis of the creation of the wealth of a nation

Helps explain natural resource curse

- Why countries with large amounts of natural resources often don't do well and are marked by high levels of inequality: these societies developed into rent-seeking societies
- China has been remarkably successful, in spite of lack of natural resource
- But land is China's really scarce resource
- And there has been excessive focus on real estate
 - Giving rise to potential bubbles and instability
 - Source of much of corruption
 - Giving rise to inequality

A supply side agenda for China

- **Continue and expand investment in research, education**
 - Including pre-school and in rural areas
 - High return, essential for equality of opportunity
- **Continue and expand opportunities for women and aged to actively participate in labor force**
 - Especially important with demographic changes
 - Greater flexibility in hours, family leave policies, child care, etc.
- **Redirect investment away from real estate**
 - Property tax
 - High capital gains tax on real estate gains

Supply side measures ensuring *quality growth*

- **Environment**

- Carbon tax, together with strong regulations, and measures to ensure against any adverse incidence
- Including good public transportation systems
- Carbon tax will have positive demand and supply side effects
 - Retrofitting the economy to create a green economy
- Key message of the “Green New Deal” is that the societal transformation to a carbonless economy can be transformative
- Cost of not undertaking transformation greater than the cost of doing so
- China has shown the way in developing low-cost solar panels, of enormous benefit to entire world

Supply side measures ensuring *quality growth*

- **Creating livable cities**
 - Which is where most people will live
 - With good health care, education, green spaces, public transportation
 - Happier and healthier people are more productive—supply side measure
 - But investments to create these livable cities are also a demand side measure
 - Livable cities have to be well-planned: zoning is crucial
 - But 21st century zoning is different from 20th century
 - Reflecting changes in demography, economic structures

Removing impediments to growth

- **Importance of finance**
- Overall, as financial markets in West grew (e.g. in US from 2½% of GDP to 8%) did not serve society well
 - In spite of “innovativeness” —some of innovativeness was in rent-seeking
 - Failing to perform key role in intermediation
- China depends excessively on debt finance and too much of finance based on large banks and shadow banking system
 - Excessive leverage source of instability
 - Key information is local, especially as China transforms itself into an innovative, service sector economy

Broad reforms in financial sector

- Richer ecology of well-regulated financial institutions
- More local and regional banks
- Closer regulation of equity markets, with greater emphasis on long-term investments and growth
 - Financial transactions tax to discourage short-term speculation
- Encouragement of venture capital funds
- Deleveraging over-leveraged parts of economy can be consistent with increasing leverage elsewhere
 - Some parts of Chinese economy have not been able to obtain sufficient funds

Removing impediments to growth

- In all economies, there are barriers to entry
 - Some natural
 - Some created by incumbent firms with market power
- **Competition is essential for a dynamic economy**
 - Part of basis for China's success—competition among TVE's and others
- Increasingly, many economies are being characterized by an increased concentration of market power
- It is essential for China to guard against this—this is a key **supply-side** measure

Government will have to play an important role in supply side measures

- Promoting innovation—basic research, education
- Promoting restructuring of economy
 - Industrial policies to promote new sectors of the economy
 - Active labor market policies to help people move into sectors of the future
 - Social protection to make sure that no one is left behind
 - Regulations to protect the environment
 - Taxes to encourage productive economic activities, to discourage rent-seeking activities
 - To promote other supply-side measures
- Promoting the private sector
 - Through encouraging a financial sector that serves society
 - And providing assistance (e.g. transmission of knowledge) where appropriate
 - Ensuring that there is competition

What I have not emphasized— overcapacity reduction

- Overcapacity reduction has largely achieved its original goals
- Always strange to call “overcapacity reduction” a supply side measure
 - Actually reduced potential supply
 - Key aspect: rationalizing supply, focusing on most productive enterprises
- As growth slows, China may have to pay more attention to problems of excess capacity
 - When a country grows at 10%, excess capacity in a given area quickly disappears, social cost relatively low
 - Takes much longer to deal with when growth is 6%.

A balanced agenda

- This is a demand *and* supply driven growth agenda
 - But not just a consumption-driven growth—China still needs investment
- This is a public- *and* private-sector-driven growth agenda
 - Many domains in which private sector will be driving force
 - But government has to set the rules of the game, address limitations of markets (under-regulated markets have created or contributed to problems of inequality, environmental degradation, unlivable cities)
 - Government will have to play important role in key services citizens want—health, education, security in retirement

A pro-active rather than reactive agenda

- Driven by China's own evolving needs and capacities
- But adapting to changing global situation
 - America's walking away from a rules-based multilateral trade system creates new uncertainties
 - Uncertainties unlikely to be removed even after Trump—new global perspective
- **China has to keep focused on its goal of increasing living standards of its own people in a sustainable way**
 - Using its own model—social market economy with Chinese characteristics
 - Adapting it to changing circumstances not only globally but also with China, including changing aspirations of China's citizens
 - Continuing the strategy that has worked so well for four decades—crossing the river by feeling the stones
 - Pragmatism is key to success
 - Important to learn from successes and failures both in China and elsewhere
 - Many of the challenges confronting China have never been faced before
 - Policy design will be increasingly critical