

## Zhou Xiaochuan: Issues related to the global financial crisis

Address by Mr Zhou Xiaochuan, Governor of the People's Bank of China, at the Global Think-tank Summit, Beijing, 3 July 2009.

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Ladies and Gentlemen,

It is a great pleasure to attend the Global Think-tank Summit organized by the China Center for International Economic Exchanges (CCIEE). I would like to take this opportunity to discuss issues related to the global financial crisis, possible post-crisis scenarios for international economic adjustments and policy responses by national governments.

### **1. Pay adequate attention to the micro causes of the current crisis and strengthen regulation.**

The causes for the outbreak of this crisis were very complex. Factors both at the macro and micro levels had played some roles. We have heard about a lot of discussions, or even over-emphasis, from some parts of the world, on the impact of macro factors. However, the crisis originated from Wall Street and many indisputable facts have established that micro factors had played an overwhelmingly important role in causing this crisis, including pro-cyclical factors at the micro level, problems with credit rating agencies, mark to market and fair value accounting rules, problems with financial institutions including lax lending standards, excessive leverage and deficient corporate governance, frivolous development of derivative products, chaos in the originate-to-distribute models of asset securitization, and etc. These glaring problems have exposed the great havoc caused by inadequate regulation and should deserve adequate attentions and dramatic remedial measures.

### **2. Distribution of global imbalances**

There are macro factors among the causes of current crisis. To what extent these factors contributed to the crisis has always been subject to dispute, including the role of global imbalances. In the view of traditional Chinese philosophy, imbalance is a state of normalcy and balance is only a relative concept. The current global imbalances have a counter-intuitive feature. That is, in relative terms, low-income countries have high savings rates whereas rich people in the high-income countries have consumed beyond their means.

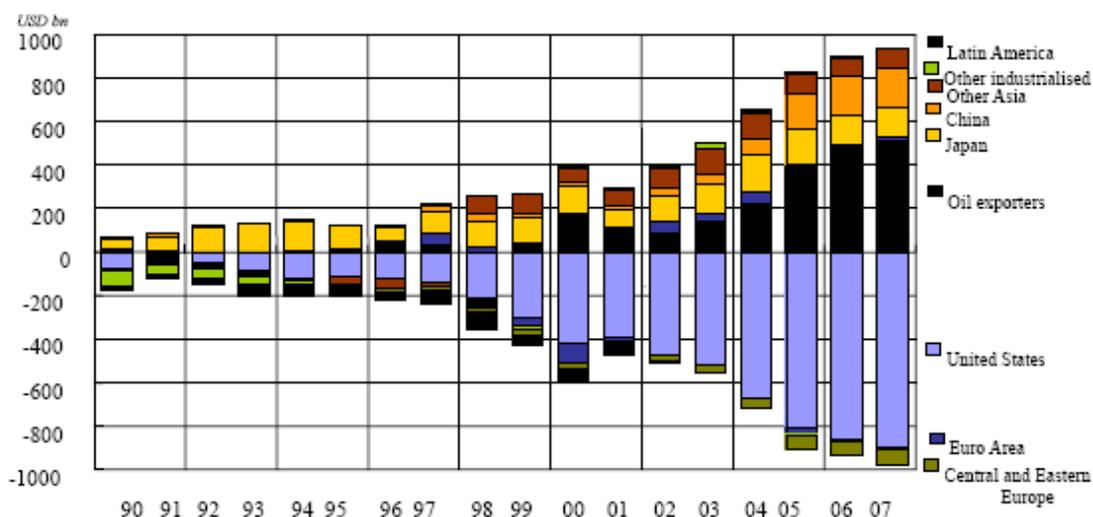
Some advocate that both China with too much savings and the U.S. with too little of it should make adjustments. We want to make efforts towards this end, but it is not plausible to over-estimate the impact of the two countries. There is no available data on the flow of global savings. We have found the following graph of current account positions of the major economic blocks. I have used it earlier this year when speaking at an event hosted by Bank Negara Malaysia.

On this graph, China's current account surplus, though large, is just a part of the global total. Oil exporters, Japan and other Asian economies all have a significant share in the global surplus. Among the deficit or low saving countries, the share of U.S. deficit is very large. The East and Central European countries account for a very small share of the total deficit. Other economies do not have a prominent share in global imbalances.

In recent years, this matter has received a lot of attentions. The IMF (International Monetary Fund) has organized a series of discussions, and the focus has shifted from balance of payments surplus to savings gluts. It is comforting to see that the household savings rate has gone up to almost 7 percent in the U.S. as recently as this last May. Whether this is a sustainable long-term trend remains a question for prudent judgment. Generally speaking,

structural adjustment is never easy. In addition, the U.S. has a problem of public deficit. How the US healthcare reform will unfold, a matter that the international community follows with great interest may shape the future trend of U.S. savings rates.

**Graph 1: Current account positions (yearly data) (1990-2007, annual data, in USD billion)**



Source: IMF (World Economic Outlook and Direction of Trade Statistics) and ECB staff calculations.

### 3. The distribution of savings in China

People outside China need a better insight into the high savings rate in China. The general view is that China consumes too little and has to consume more. The following chart shows that the income distribution during China's economic transition has contributed to the savings pattern.

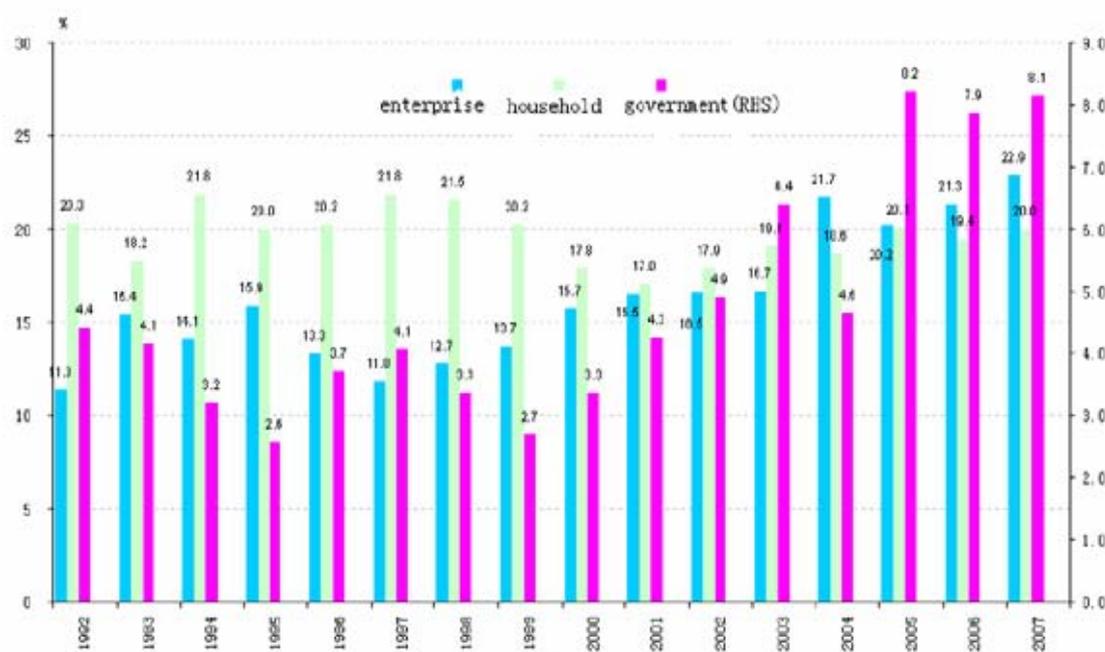
The share of China's household savings in GDP has been quite stable. It was 20.3 percent in 1992 and 20 percent in 2007. Though once hitting a low of 17 percent, it basically remains around 20 percent. The share of corporate savings in GDP was 11.3 percent in 1992, and doubled to 22.9 percent by 2007. Meanwhile, the share of government savings, namely public sector savings in GDP was 4.4 percent in 1992, and nearly doubled to 8.1 percent by 2007. Given the comparatively small size of the government savings, surging corporate savings played a more important role.

High corporate savings in China are closely related to the large rural labor surplus. Seeking opportunities to better realize their productivity, surplus rural labor has gradually found jobs in coastal and urban areas, in industrial and the service sectors. This, as matter of fact, is part of the urbanization process. Labor cost has remained and will remain comparatively low before the process is completed. During this process, the choice of staying on farms or going to cities depends mainly on the comparative advantages and benefits of farming and working in cities. Other policy related factors, however, are relatively insignificant.

Due to the equity ownership structure, employees only receive a small proportion of corporate profits, which have maintained at high levels. To solve this problem, the 17th Party Congress stated in its report that conditions would be created to enable more people to receive incomes from properties and investments. For the same reason, part of the state-owned common equity is transferred to the national social security fund when a company goes public. Greater efforts are needed to enable the public to share the corporate profits.

In China's structural adjustments, the optimal choice is to expand household consumption, which will directly enhance the domestic demand and lower the savings rate. This is, however, easier said than done. While the current income distribution structure cannot be dramatically changed in the short term, the second-best choice is to maintain and expand investments, and channel investments to sectors and areas to achieve efficient but not wasteful allocations. This way, the residual savings, namely, total savings net of total investments (savings surplus), will not be so large, and will not have a major impact internationally. Apparently, over-investment in industries leads to overcapacity. However, with urbanization still a long way to go, there is enormous investment potentials in the process. Urbanization will prepare China for its demographic migration, consumption expansion and the development of the service sectors. After all, China's urbanization will go on for many years to come.

**Graph 2 Changing structure of China's savings rate (savings as a percentage of national disposable income)**



#### 4. Analysis of several scenarios of rebalancing the global economy

There can be a number of scenarios for rebalancing the global economy through adjustments, and the analyses and policy implications for different scenarios are different.

A lot of discussions focus on the first and also the most desirable scenario. Both the household savings rate and overall savings rate in the U.S. keeps going up, and Chinese household consumption keeps rising, leading to a correction of the global imbalances. Indeed, this is the most ideal scenario, but not easily realizable, because structural adjustments involve quite a lot difficult issues. Furthermore, we cannot, based on the latest short-term data, jump to the conclusion that this problem can be easily solved.

In the second scenario, U.S. household savings rate goes up, and thus the U.S. consumes fewer Chinese products. Subsequently, China will see greater excess capacity, lower equipment utilization, job losses, and a path for slower GDP growth. We need to avoid this situation with our best efforts. A variation of this scenario may be that, inflation in China

causes effective RMB exchange rate movements in real terms and thus resulting in the completion of the adjustment process.

A third scenario sees higher household savings rate in the U.S. and moderately stronger consumption in China. Also in this scenario, China's investment in urbanization increases. Together these will reduce the savings glut and its outflow. We can assume that this leads to rapid developments in urban infrastructure, housing and the service sectors, supporting future consumption and employment. This is another acceptable outcome. But this requires appropriate reform for the modus operandi of investment and for financing instruments to support urbanization. For example, we have been discussing for years whether local governments should be allowed to issue municipal bonds to finance infrastructure projects.

In the fourth scenario, though higher U.S. savings rate reduces demand for Chinese products, China successfully moves part of its excess capacity, including its manufacturing capacity, to other developing countries through its Going Global investment strategy. In terms of South-North relations, this will help facilitate industrialization and raise future consumptions in developing countries. This scenario is also a step in the right direction. By then, China's trade surplus will no longer be a major problem. A major test will be whether the U.S. will still run large deficits against other developing countries.

In the fifth scenario, the U.S. fails to shore up its aggregate savings rate, its healthcare reform falters, and its public consumption remains high. In contrast, the adjustment efforts in China are successful. Part of its excess capacity is relocated to other developing countries, its foreign trade reaches relative equilibrium, or its savings surplus, if any, is diverted to other countries instead of flowing to the U.S. At that time, the U.S. may still run trade deficits and have savings flow problems with Vietnam and other developing countries, and oil-producing countries.

A sixth scenario is the last thing we want to see. Here, all adjustment efforts are made in vain, the economic imbalances persist, and trade protectionism escalates.

There may be other scenarios. This list is by no means exhaustive. We may end up seeing some combination of several scenarios listed above. I personally think we need to be aware of the difficulties and should not be over-idealistic. A practical way forward, which is a combination of several scenarios above, may be that continued reform leads to stronger consumption and significant progress of urbanization in China. In this case, given the high savings rate in China, we may still maintain residual savings. If any, I wish this to flow to other developing countries. This will need the support of the international financial system including the international monetary system, to help improve the global productivity and income distribution, and drive broader global growth. We also want to emphasize that this growth should be green in nature. Furthermore, from a demographic point of view, developing countries will generate tremendous demand for the world.

## 5. Personal views

**First**, global imbalances are an important and difficult subject matter; however, in addressing the financial crisis, we cannot afford to ignore the flawed micro-level mechanisms and the importance of regulatory overhaul. We should prevent this micro focus from getting off-track.

**Second**, it is necessary to look into the causes and features of the global imbalances, its interaction with the global development patterns, varying development stages of different countries and their income distributions. One cannot expect a simple and straightforward instrument to work the miracle of structural adjustment.

**Third**, based on the above scenario analysis, we should strive to achieve Scenario 1, avoid Scenarios 2 and 6, and do more research on Scenarios 3, 4 and 5. To this end, institutional reform needs to be designed and pursued along the direction of desirable outcomes to bring about the desirable changes.

The scientific view on development conceived and established by the Party and the Chinese government covers many aspects of the needed reforms and restructuring, including putting the people first, expanding consumption and domestic demand, environmental-friendly growth, promoting urbanization, developing the service sectors, trade and investment facilitation and etc. Since the outbreak of the crisis, China has sped up economic structural adjustment, expanded domestic demand, and made a lot of efforts to mitigate the impacts of the crisis and to sustain development. Though the quest for specific rules and routes toward sustainability involves trial and error, experimentation and knowledge renewal, I'm confident that, as long as all countries work together, we will pull out of the crisis and find a path to sustainable and scientific development.