Zhou Xiaochuan: Prospects of the Chinese economy – broad-based growth

Speech and Q&A by Mr Zhou Xiaochuan, Governor of the People's Bank of China, at the 32rd G30 Annual International Banking Seminar, Washington DC, 15 October 2017.

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On October 15, 2017, Governor Zhou Xiaochuan spoke on China’s economic prospects in the Group of 30’s International Banking Seminar in Washington D.C. He attended this event on the margin of IMF/World Bank annual meetings. The following is the major content of his speech:

China’s annual GDP growth rate has been declining for years, from double digit growth in the past to around 8 percent in 2012, then down further to 6.7 percent in 2016. The momentum of GDP growth has picked up this year. The GDP growth was 6.9 percent in the first half and is expected to reach 7 percent in the second half of this year. The driving force is mainly the fast growing household consumption. The gross retail sales volume grew at 10.4 percent in the first eight months year on year. Furthermore, household consumption is shifting from traditional product consumption to service consumption. Therefore, development of service industry has accelerated. The added value of the tertiary industry as a share of GDP grew substantially from only around 40 percent 15 years ago to 55 percent currently. Economic growth has supported stable employment situation. In the first eight months, about 10 million new jobs have already been created in urban China. Given the size of Chinese population, we need to have such a solid employment growth. The CPI and PPI grew at 1.8 percent and 6.3 percent respectively year on year, and nominal GDP growth is around 9.5 percent.

In terms of money supply and credit expansion, China has entered into a stage of deleveraging since early 2017. The growth of M2 has declined continuously to below 9 percent currently. The overall leverage ratio has started to decline. Though the decline is still very moderate, the downward trend has been there. In the global financial crisis period, China adopted proactive fiscal and monetary policies in response. The total debt to GDP ratio went up substantially in the two years after 2009. But it is worth doing because the Chinese economy recovered from the crisis quite quickly. Now we need to find ways to bring the leverage ratio down. Thanks to the positive international trade conditions, China’s performance in external trade has been good this year. So far, the trade in goods posted a surplus of USD 400 billion, 20 percent lower than last year. However, due to rapid import growth, especially that of service import, the current account surplus to GDP ratio is estimated to shrink to 1.2 percent this year. In comparison with the global numbers, this is a very moderate imbalance.

On deleveraging. The leverage ratio of the economy as a whole is relatively high. If we decompose the debt to GDP ratio, government debt ratio is not high; the household debt to GDP ratio is still low, but grows up quickly. The major problem is the fairly high corporate debt to GDP ratio. Thanks to the low interest rate condition, the current debt service ratio is still reasonable. People may ask why the corporate sector had such a high leverage ratio and why the financial institutions, especially the commercial banks, were willing to lend so much to them. One of the reasons, as indicated by many economists, is that in China the local governments borrowed heavily through various financing platforms. Such borrowing was included in the statistics of corporate debt. Thus the debt of corporate sector has been overestimated. If these borrowings are included in government debt statistics, corporate debt would shrink by a large margin and government debt would go up. This will be a more balanced debt structure. Therefore, to study China’s leverage ratio, it is necessary to look not only at the corporate sector, the state-owned sector, and bank credit. It is also important to look at the borrowing of local governments, which is related to promoting urbanization. The IMF’s Article IV consultation team has given us suggestions on the need to carefully study inter-governmental fiscal relationship, and to reform the division of responsibility in terms of fiscal revenue and expenditure among the central and local governments.

On excess capacity and urbanization. In China, we have implemented a program to cut excess capacity in steel and cement industries. One of the reasons behind the excess capacities is that we have had a large infrastructure expansion program. Another reason is rapid urbanization. Large quantity of steel and cement are needed in both programs. Infrastructure has already improved substantially, but urbanization is still going on. Based on household registrations, the urbanization rate is only 40 percent. But by the official population census, it is about 50 percent. If we use the outcome in the sample survey conducted to find out how many people have lived in urban areas for six months, it is 57 percent. That means a lot of farmers are still in the process of moving into cities. Some of them may have already found a job, but they have not moved their family or found a residence or apartment in the cities. Thus, urbanization is still going on rapidly and continues to generate strong demand for steel and cement. The Chinese Government intends to promote structural reform and optimization, and attaches great importance to environmental protection. Therefore, the Government has voluntarily undertaken to cut steel and cement capacity by ten percent. Up till now, progress has been made in removing excess capacity. We expect the goal can be achieved.

On the shift of comparative advantage. The Chinese manufacturing sector has shifted a lot of labor-intensive capacity into ASEAN countries. More and more Chinese investors are investing in Africa and moving some capacity there. Therefore, service industry is accounting for an increasingly larger share in the Chinese economy, which is a very good phenomenon. But the service industry is not competitive. We have some strong sectors but still need to strengthen the relatively weak sectors, such as education and medical services.

On financial stability. This July, a decision was made in the National Financial Work Conference to set up a Financial Stability and Development Committee. In the future, the focus will be on four areas. One is the shadow banking issue. We started to deal with it two years ago and have made positive progress. Many shadow banking activities have returned to the banking sector and are included in the balance sheet of commercial banks. The second is asset management sector. This is relatively complicated. The CBRC, CSRC and CIRC may have different rules regarding the same asset management activity. We agree with FSB's guidance for streamlining regulation of the asset management sector. The third is internet finance. A lot of IT companies are providing financial services. Some have been granted licenses. But some do not have any license, yet provide lending and payment services, and sell insurance products. This may cause competition and financial stability problems. The fourth is financial holding companies. We have observed that some large private-owned companies have got various financial service licenses through M&A. But in the real sense, they are not financial holding companies. They may have engaged in illegal activities, including connected transactions. Yet, we do not have the necessary regulatory policies to deal with such cross-sector transactions. Going forward, we will further deepen reform, gradually push forward the deleveraging process, and strengthen regulatory coordination to promote healthy development of the financial markets and maintain financial stability.

Q&A session:

David Marsh(Managing Director, OMFIF):

It is sometimes said that there is a vacuum in leadership in the world. Do you think it is about time for China to take a greater leadership role in the international monetary reforms? You mentioned a number of very positive developments in your speech regarding the Chinese economy. It seems to provide a good platform for China to push forward some ideas about the reform of reserve currencies, the role of the SDR, institutionalizing the swap, and so on.

Zhou Xiaochuan:

In recent years, along with rapid economic development, China has started to play a role in the international economic governance, including participating in the reform of reserve currency system and policy making in trade and financial stability. But China is still focusing very much on the domestic agenda, including further promoting economic development and regulatory reforms so as to keep pace with global development.

We are pleased to see that IMF has included the RMB into the currency basket of SDR. It's encouraging and it will prompt China to adopt more reform and opening up policies, and support RMB to serve better as a freely usable currency. Although China has strengthened cooperation with the international organizations, such as IMF, BIS and FSB, and participated in standard setting and rule making, we still have a long way to go in order to play a more significant role.

As for the currency swap, it is an unexpected outcome of the global financial crisis. After the outbreak of the global financial crisis in 2008, due to the shortage of hard currencies and the difficulties in developing correspondent banking relationship on the part of commercial banks, some neighboring countries requested to enter into local currency swap agreements with China, in order to support and facilitate regional trade. We first signed an agreement with South Korea, then with some ASEAN countries and central Asian countries. Later on, the swap arrangements gradually expanded into other parts of the world, such as Argentina, Ukraine and Egypt. Therefore, currency swap arrangement is an unexpected outcome of the global financial crisis. China supports the further development of global safety net. In our view, the global safety net may be more efficient than bilateral arrangements.

William R. Rhodes (William R. Rhodes Global Advisors, Inc.):

Last year, you expressed concern about the growing debt to GDP ratio. But you sound fairly optimistic about the issue this year. It seems that the government is actively taking the necessary steps to resolve it. Let me know if I'm right.

Zhou Xiaochuan:

As for the debt issue, it is fair to say that in the stage of urbanization, the fiscal policy transparency is not good enough, the inter-governmental fiscal relationship has yet to be improved, and there is no clear fiscal discipline to constrain the local governments. So in the financial market, there is distortion in the pricing of the local government bonds and the lending to the financing platforms of the local governments. Due to this distortion, the commercial banks and financial sector have underestimated the risks in the fiscal standing of local governments. I believe those issues will be gradually resolved, and the financial market will be more transparent and healthy. This July, the National Financial Work Conference emphasized the need to attach importance to local government debt risks. At the same time, we should note that compared with the private sector debt and external debt, the risks in the government debt are relatively low. We will promote fiscal reform to actively address the matter.