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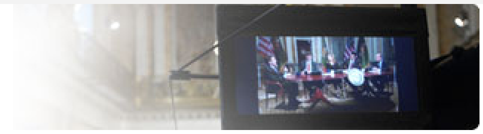

Remarks by Under Secretary Nathan Sheets on China’s Rebalancing and Financial Reform at Columbia University

11/5/2015

1. Introduction

Good afternoon. It is a pleasure to be here at Columbia today. The topic we will be discussing could not be more important. Thinking about China’s economic rebalancing and reform agenda is central to the Chinese economic outlook, has a major impact on the global economy and financial system, and is one of the toughest but most significant parts of my job.

The market volatility this summer reminded the world about the importance of China’s growth and commitment to reforms. And Chinese economic policy decisions continue to make headlines. The country’s thirteenth Five-Year Plan, which was discussed at last week’s Fifth Plenum, will be released in the spring. This Five-Year Plan covers critical years in China’s necessary rebalancing from investment to consumption-led growth. As I’ll discuss today, there has been progress on economic rebalancing and reforms, particularly financial sector reforms, but deeper progress is needed to achieve healthy and sustainable economic growth.

2. Economic Rebalancing and the Outlook

It’s not news that the Chinese economy is decelerating. Based on China’s official statistics, GDP growth slowed in the first half of 2015 to 7 percent, in line with the official target, from an average of nearly 9 percent from 2009 to 2014. Third-quarter GDP data released last month indicate that the economy grew at 6.9 percent year-on-year, slightly below the government’s target and at its slowest pace since 2009. Just the other day, President Xi signaled that China will accept somewhat slower growth of around 6.5 percent over the next five years.

How concerned should we be about the observed slowdown? Weakening industrial production, corporate profits, and purchasing managers’ indexes all indicate that the deceleration in manufacturing has been considerable. At the same time, growth is holding up much better in more service-oriented areas; and services continue to make the largest contribution to GDP growth, a trend that began in 2011 and was evident once again in the third-quarter data. So far, consumption has remained resilient in the face of the growth slowdown, as household income has outpaced GDP growth over the past 18 months.

A reasonable interpretation of these data is that they point to the ongoing and necessary maturation and rebalancing of the Chinese economy, but also that this process will not necessarily be smooth or without risk. This interpretation was echoed by many participants during the Annual Meetings of the IMF and World Bank that I attended last month in Lima.

Chinese officials themselves have noted that the slowing of growth has been due, in part, to the necessary “restructuring” of their economy, a reference to China’s transition away from dependence on exports and investment and toward household consumption to drive growth.

And China has, in fact, made progress toward rebalancing its economy. In 2014, household consumption accounted for about 45 percent of the growth in total GDP, exceeding investment’s contribution. With investment growth weakening and consumption staying resilient so far this year, consumption’s contribution will likely exceed investment’s once again.

Still, there is a long way to go. China’s investment-to-GDP ratio remains the highest among major economies, at 46 percent in 2014. Meanwhile, household consumption was only 38 percent of GDP last year, hardly changed from its 2012 level. A key challenge for Chinese policymakers is to ensure that growth is supported as the economy continues to transition.

3. Supporting Growth through the Transition

Given its need to lower the high rate of investment, China must see a significant and sustained increase in household consumption in order to support domestic demand and avoid too rapid a slowdown in the economy. China has the policy tools to support growth, especially through fiscal policies aimed at promoting consumption. Such measures include strengthening the social safety net with increased dividends from state-owned enterprises (SOEs); lowering consumption and payroll taxes; and cutting the value-added tax.

Some analysts have suggested that an additional or alternative response to the slowdown could be to once again look to export markets to fuel growth, including by boosting competitiveness through a weaker exchange rate. Such an approach, however, would conflict with statements by Chinese leaders, who have sought to reassure markets that the underlying fundamentals of their economy do not warrant continued RMB depreciation.

Indeed, currency appreciation, alongside other measures, is essential to supporting a meaningful shift in China’s economy away from investment and exports toward greater reliance on household consumption.

Similarly, relying – as in the past – on large-scale public investment projects fueled by bank credit to support growth could threaten to postpone or even derail rebalancing efforts. There is certainly scope for targeted investments, but these investments should be disciplined and limited to areas where there is a compelling investment need.

Two reforms central to China’s successful transition and economic performance are financial sector reform and SOE reform. China has been making good progress to broaden financing channels to the real economy, and, just last month, announced significant progress on interest rate liberalization by lifting the cap on deposit rates. This was the last remaining official obstacle to liberalizing interest rates in the banking sector.

The deposit rate cap constrained rebalancing by subsidizing low lending rates to unproductive and capital-intensive sectors of the economy. It also effectively taxed households, which are large net savers. By liberalizing deposit rates, the Chinese financial sector is more likely to allocate credit to productive uses.

On SOE reform, the failure to restructure or, if necessary, to shutter unprofitable and overleveraged SOEs, could potentially deprive productive and growing sectors of the economy of the resources necessary to support their expansion. Inability or lack of willingness to address the related issues of industrial overcapacity and debt overhang could also drag down growth in the medium-term, and have further spillover effects on the global economy.

Other reforms to be implemented over the medium-term – such as universal social security coverage and coordination of rural and urban protection programs – also have the potential to support private consumption and foster a more balanced and sustainable pattern of growth.

As I mentioned earlier, the next five years will be key for China's transition. Chinese authorities released some detail after their Fifth Plenum meeting last week, which included encouraging signs for medium-term reforms, such as providing catastrophic health insurance. However, we'll only know how ambitious the reform agenda will be once we see the full Five Year Plan, which won't be announced until next spring, and then the pace and manner in which the reforms are implemented.

4. Communication and Transparency

China's economic outlook is importantly linked to its communication of policies and outcomes. Despite China's position as the second largest economy in the world, it still suffers from significant data gaps that challenge our ability – and the ability of financial market participants – to analyze what is happening in the Chinese economy, and a lack of transparency limits our understanding of how policy responses are calibrated.

Recently, China acknowledged the benefits of adopting the transparency standards for major reserve currencies. In October, China subscribed to the IMF's Special Data Dissemination Standard (SDDS), a much-needed step toward increasing the transparency of China's foreign exchange reserves and exchange rate policy.

In another welcome step toward greater transparency, the end-September release of the IMF's Currency Composition of Official Foreign Exchange Reserves (COFER) database included for the first time data on Chinese reserves.

To further increase transparency, China should disclose foreign exchange market intervention regularly and participate in the Bank for International Settlements' cross-border banking and securities data-reporting framework.

5. U.S.-China Economic Engagement

I won't spend much time today on the important bilateral relationship between the United States and China. Suffice it to say, the relationships between American and Chinese officials at all levels – forged through hard work and cooperation – have helped us to better understand each other's viewpoints, challenges, and priorities. But I do want to highlight a few of the key objectives and main accomplishments of this engagement.

As many of you know, Treasury leads the economic side of the U.S.-China relationship in the Strategic and Economic Dialogue (S&ED). The S&ED serves as an open channel through which we engage with the Chinese on a near-constant basis. It's here that we discuss our long-term priorities, our short-term concerns, and everything in between, with the discussion of economic issues proving particularly productive.

This year, we have been able to make progress on several priority areas, including many that should have a positive impact on China and the global economy. For instance as I have noted, China recognizes that to achieve successful RMB internationalization it must meet the transparency standards of other major reserve currencies. On the exchange rate, China pledged for the first time to intervene in foreign exchange markets only when justified by disorderly market conditions. Chinese officials need to demonstrate their intent to allow the RMB to respond to upward pressures that would strengthen the currency, not just to downward pressures.

And on capital market liberalization, China committed to expand and streamline existing vehicles for foreign investment in its securities markets. In addition, China announced plans to expand foreign investor access to its bond market.

Among the high-level deliverables negotiated during President Xi's recent State Visit to Washington, China agreed to increase its role in the international financial architecture – such as through greater contributions to the existing multilateral development institutions such as the World Bank. There were also deliverables aimed at China providing greater market access and investment liberalization and an improved business climate to level the playing field for U.S. firms and workers, as well as continued economic and financial reforms to support its rebalancing process.

Further, in our jointly negotiated economic fact sheet released during President Xi's visit, our two countries committed to "continue to discuss mechanisms to facilitate renminbi trading and clearing in the United States." We also reiterated the United States' "support for the inclusion of the RMB in the [Special Drawing Rights] basket provided the currency meets the IMF's existing criteria in its SDR review."

All of these commitments lay a strong foundation for reforms which ultimately can lead to a greater role for the RMB in the international financial system.

The central objective in our ongoing discussions with the Chinese has been to expand China's role as a responsible actor in the global economic system. This has sometimes entailed tough conversations. China must strengthen its sense of ownership in upholding and strengthening the rules-based international system, shouldering greater responsibility as it assumes a greater role.

6. Conclusion

I believe Chinese policymakers have the scope to manage the transition ahead. They have committed to a strong set of policies to reform their economy. But the potential challenges and downside risks are significant; as growth slows, it arguably becomes even more difficult to implement the very reforms that are essential to setting growth on a more stable footing. My hope and advice for my Chinese counterparts is to continue and accelerate the reform agenda in order to get the kind of sustainable economic growth that they aspire to, and that the world needs. Our candor on these issues is a reflection of our investment in China's success. We want to see China emerge as a peaceful, stable, and prosperous country that is a responsible player in global affairs.

With the resolute implementation of further reform, there is no reason China's economy cannot continue to grow at a healthy pace, generating jobs and improving the living standards of Chinese citizens. Decisive progress on economic reform would result in a stronger, more stable, and more balanced Chinese and global economy, which is good for China, good for the United States, and good for the world.

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