

## GLOBAL IMBALANCES AND FINANCIAL REFORM WITH EXAMPLES FROM CHINA

*Raghuram G. Rajan*

I will focus on a familiar issue, the problem of global current account imbalances, and will describe how financial sector reform can help narrow them, using examples from China.

The United States is running a current account deficit approaching 6.25 percent of its GDP and over 1.5 percent of world GDP. To help finance it, the United States pulls in 70 percent of all global capital flows. Clearly, such a large deficit is unsustainable in the long run.

The current situation has its roots in a series of crises over the last decade that were caused by excessive investment, such as the Japanese asset bubble, the crises in emerging markets in Asia and Latin America, and most recently, the IT bubble. Investment has fallen off sharply since, with only very cautious recovery. This is particularly true of emerging Asia and Japan. The policy response to the slowdown in investment has differed across countries. In the industrial countries, accommodative policies such as expansionary budgets and low interest rates have led to consumption- or credit-fueled growth, particularly in Anglo-Saxon countries. Government savings have fallen, especially in the United States and Japan, and household savings have virtually disappeared in some countries with housing booms.

By contrast, the crises were a wake-up call in a number of emerging market countries. Historically lax policies have been tightened, with some countries running primary fiscal surpluses for the first time, and most bringing down inflation through tight monetary policy. With

---

*Cato Journal*, Vol. 26, No. 2 (Spring/Summer 2006). Copyright © Cato Institute. All rights reserved.

Raghuram G. Rajan is Economic Counselor and Director of Research at the International Monetary Fund. The views expressed in this article, which is based on remarks delivered at the Cato Institute's 23rd Annual Monetary Conference on November 3, 2005, are his own and do not necessarily reflect those of the IMF, its management, or its staff. This article also draws on the author's remarks before the Chinese National Development and Research Council Conference on Reforms in July 2005.

corporations cautious, and governments abandoning the grandiose projects of the past, investment has fallen off. Instead, exports have led growth. Many emerging markets have run current account surpluses for the first time. In emerging Asia, a corollary has been a buildup of international reserves.

## Two Kinds of Transition

The world now needs two kinds of transitions. First, consumption has to give way smoothly to investment, as past excess capacity is worked off and as expansionary policies in industrial countries return to normal. Second, to reduce the current account imbalances that have built up, demand has to shift from countries running deficits to countries running surpluses.

There are reasons to worry whether the needed transitions will take place smoothly. Perhaps the central concern has to be about consumption growth in the United States, which has been holding up the world economy. I will not dwell on the obvious risks to it, which include energy prices, stretched housing prices, and inflation. My greatest worry is not that U.S. consumption growth will slow—it has to because it is being fueled by unsustainable forces. My worry is that it will slow abruptly, taking away a major support from world growth before other supports are in place.

One of those other supports is more investment, especially in low-income countries, emerging markets, and oil producers. Parenthetically, China is an exception in needing less, not more, investment. The easy way to get more investment is a low-quality investment binge led by the government or fueled by easy credit—emerging market countries are only too aware of the pitfall of that approach. The harder, and correct, way is through structural reforms that would improve the business environment, increase labor market flexibility, raise expected rates of return, and improve the allocation and utilization of capital by the financial and corporate sectors, all of which would promote more high-quality investment. Somewhat paradoxically, though, the favorable global economic environment and the resulting ability of many countries to rely on exports for growth have allowed their governments to neglect the structural reforms that would have strengthened investment and helped sustain domestic demand. As a result, these countries are overly dependent on demand from other countries.

In sum, then, one reason global imbalances have emerged is that emerging markets have recognized the risks posed by volatile cross-border flows, especially given the fragility of their own financial and

corporate systems. They have learned to fit their investment coat within the domestic savings cloth they have available, even leaving a bit over to finance rich countries.

While, as I have just argued, reforms are needed in emerging markets to reverse this paradox of the poor financing the rich, we must not neglect the need for reforms in developed countries. There is a tendency to attribute the volatility of cross-border capital solely to the inadequacies of policies and governance in emerging markets. Developed countries, however, are not without blame. The tendency of asset managers in these countries to bid up emerging market asset prices overly and discount risk when industrial country interest rates are low, only to withdraw en masse when industrial country rates rise, poses immense problems to emerging markets. Surely, past experience with this volatility accounts for some of the caution, and some of the reserve buildup in emerging markets. There is a need to shine a spotlight on the incentives of these asset managers and ask whether in fact they are appropriate. If regulators in developed countries are reluctant to shine this spotlight, it is in the interest of authorities in emerging markets to press them: responsibility for international financial stability is not one way.

## The Case of China

Let me now turn to China. One quickly runs out of superlatives to describe China's growth. Yet the macroeconomic picture looks increasingly distorted. With investment at around 45 percent of GDP, China is investing more than Japan or Korea relative to their GDPs even in their boom years. The return on capital invested has been falling steadily, so China has to invest yet more to keep up its growth. Nevertheless, this investment has been more than financed by domestic savings so that China runs a growing current account surplus.

One might think that behind these huge volumes of savings and investment lies a strong financial sector. Yet I will argue that the weakness of the financial sector might be a more appropriate explanation. That progress in the Chinese financial sector has not matched the rest of the economy is well known. While the ratio of credit to GDP is one of the highest in the world, the state-dominated Chinese banking system is weighed down by nonperforming loans. It lends primarily to state-owned enterprises (SOEs). Corporate governance has been weak, and because of constraints on listing, the stock market has not been an effective source of capital for the private sector. Households have few safe avenues for financial investment, which is

why the state-guaranteed banks still look attractive despite their poor investment record.

China has grown rapidly nevertheless. In part, this is because the role of the financial system in allocating capital to its highest-return use has been relatively unimportant thus far. China has been catching up. It does not require genius to understand that at its stage of development, roads, bridges, ports, airports, and power plants have high returns, and the banking system has focused on these, often urged on by local authorities who are rewarded for generating growth. But as infrastructure has been built up, further financing has to become more capable of discrimination; do we build a chip plant here or a toothpaste factory there? Also, further consumption growth will need steady support from retail financing. And it is in these areas that the inadequacies of the Chinese financial system are becoming more apparent.

In fact, China's macroeconomic imbalances are not unrelated to problems with its financial system. Start first with the extraordinarily high savings rate. Many see high savings as the natural reaction of households emerging from communism with few assets to their name. Those households face an uncertain safety net as state-owned companies shed employees and are absolved of their duty to provide cradle-to-grave support. In addition, they have only limited ability to rely on emerging Asia's traditional source of social security, children, because of the one-child policy. Yet the low return on savings deposited in the banking system, and the high risk associated with anything invested outside the banks must also play a part—increasing the amount households have to save to attain retirement goals. With financial investment options limited, it is little wonder there is a frenzy to invest in real estate, one of the few seemingly “safe” assets households can access.

Also, a substantial part of the savings, as well as recent savings growth, is accounted for by corporations. Instead of paying out dividends, corporations are reinvesting their cash flows. While some of this investment may be warranted, some of it is indeed excessive. It is unlikely the chairman of a state-owned corporation will prefer to return cash to the state via dividends rather than retaining it in the firm, particularly when banks are under orders to restrain credit growth. And with financial investments returning so little, far better to reinvest cash flows in real assets. Indeed, liquidity plays a greater role than profits in determining real investments.

Similarly, the chairman of a private firm knows that financing from either the stock market or the state-owned banks is very uncertain. So he too will be unlikely to pay dividends, preferring instead to retain

the capital for investment. Again, instead of storing this as financial assets and awaiting the right real investment opportunity, given the poor returns on financial assets, he has an incentive to invest right away.

These tendencies imply a lot of reinvestment in existing industries especially if cash flow in the industry is high, which inexorably drives down their profitability. And they imply relatively little investment in new industries. The inadequacies of the financial system would thus explain both the high correlation between savings and investment and the oft-heard claim that over 75 percent of China's industries are plagued by overcapacity. They also suggest why uniquely among fast-growing Asian economies, China has not raised its share of value-added coming from high-skilled industries, even as its per capita GDP has grown. Of course, if unprofitable investments are being financed and output prices are being driven down to unremunerative levels, some sectors like the extremely efficient Chinese export sector benefit. But the burden will eventually be borne by Chinese households, either in taxes to finance financial sector bailouts, or in miserable returns on savings. Anticipation of these costs will further increase household incentives to save.

### *Reforming China's Banking System*

The Chinese authorities clearly understand that financial sector reform is critical to future growth. The financial system has to be able to recover capital from mature industries and redeploy it in sunrise ones. While it will be important to revive the stock market by overcoming the vested interests who oppose improved governance and fresh listings, and while it will be important to improve governance so that SOEs pay more dividends, the banking system is key to any reform. There are, however, no easy options. Opening up the financial sector to foreign bank entry according to the terms of China's WTO agreement could be seen as a way to pressure the domestic banking sector to reform. But it is extremely unlikely that foreign competition will work miracles by itself.

There is really no escaping the need for rapid root and branch reform of incentives in the banking system. The organizational restructuring and the depoliticization being undertaken by banks, as well as the infusion of foreign management expertise, will help. But market forces also have to be made to play a greater role. And here the need to make Chinese corporations and banks face a realistic cost of capital is essential so that they use capital more carefully. The recent liberalization of lending rates should eventually help banks make more commercially oriented lending decisions. The flexibility to

charge an appropriate interest rate has, unfortunately, not been used, in part because deposit rates are fixed at low levels by the government. Banks continue to pass through those low rates to the firms lucky enough to be able to borrow from them. A bank that attempts to charge a state-owned firm a more appropriate rate typically sees that firm migrate to a cheaper competitor. The effective cost of capital is too low, and it will stay low until firms are forced to pay dividends and until deposit interest rates rise.

Here is where other policy choices such as the exchange rate regime enter into the picture. In order to maintain a fixed exchange rate in the face of capital inflows and pressures for appreciation, the government has had to keep interest rates low. This implies cheap capital for banks and firms. And it also means that to control growth in credit and investment the authorities have little choice but to use administrative measures (including moral suasion) rather than market-oriented measures. This is clearly not consistent with training the banking system or state enterprises to be able to respond to market incentives.

With investment growth at unsustainably high levels, an increase in the cost of capital would serve a useful purpose. An increase in deposit rates, for instance, would raise the cost of funds for banks and eventually enable them to impose a higher cost of capital on firms, thus reducing the profits of state enterprises and making it harder to justify lending to the ones that are only marginally viable. Better loan recovery processes would also help. Lending might then be reoriented toward relatively more efficient private-sector enterprises, and allow China to march faster up the quality ladder of growth. Better governance of enterprises by banks could also facilitate the development of deeper arm's-length financial markets, and afford households a wider investment choice. Higher and safer returns could well reduce their incentives to save, and spur greater consumption.

Of course, as with all reforms, changes have to be measured. For example, too rapid an increase in deposit interest rates, without a commensurate improvement in bank management and lending controls, could decapitalize the banks and increase risk-taking. The point, however, is that changes in the cost of capital should be seen as part of a menu of changes, all of which need to be implemented at a concerted pace.

### *The Exchange Rate Controversy*

Let me turn finally to an issue of some controversy. Some have argued the International Monetary Fund has been remiss in not

pushing China to appreciate its exchange rate more, with some economists asking for a large step appreciation of the order of about 25 percent. First, I reject the premise of the accusation. The Fund has been discussing the need for greater exchange rate flexibility with China for some time—starting as early as 2000—long before others woke up to the growing global imbalances. Nevertheless, more action is needed. With the imbalances increasing, China's reserve buildup reaching enormous proportions, and China's current account surplus starting to grow significantly, it is in both the world's and China's interest to allow the renminbi to appreciate more.

However—and this is my second point—a huge step appreciation will probably do much more harm than good. For one, a number of the most efficient Chinese enterprises will be driven out of business and others forced into distress. In a developed economy, the necessary restructuring could be speedily effected. In an economy like China's, with an underdeveloped financial system, the restructuring would be long drawn-out, painful, and could even damage the banking system significantly. If there is one lesson we have learned in recent years, it is that emerging markets do not handle large, rapid exchange rate movements well. Moreover, it is far from clear that such a large step appreciation would have much of an effect on the U.S. current account deficit—quite possibly other countries in emerging Asia would simply take up China's export share. Simply put, a measure that could do serious damage to a country that accounts for 28 percent of world growth, without much impact on imbalances, is not in anyone's interest.

Instead, the Fund has been advocating a less interventionist approach in which the authorities let the exchange rate react more flexibly to market forces—the authorities already have a framework for this, and they should use it. A more flexible exchange rate, especially if accompanied by more flexibility elsewhere in emerging Asia, will allow the underlying forces adjusting international demand more room to play.

## Conclusion

Financial sector reform is critical to continued growth in many emerging markets. It will also help reduce global imbalances. In particular, in China's case, greater exchange rate flexibility might also help financial sector reform by making possible more market-driven interest rates. More generally, China is not an exception to the general proposition that financial development aids economic development—it may indeed prove the rule.