

Community Leaders Luncheon Speech

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Rebalancing the Economy: A Tale of Two Countries

Thank you so much, Dominic, both for your kind introduction and years of dedicated service to the Federal Reserve. It's a privilege to speak to such a distinguished group of business and civic leaders.

It is often said that when America sneezes, the world catches cold. This adage is a modern adaptation of the 19th century saying—attributed to Prince Klemens von Metternich—that, “When Paris sneezes, Europe catches cold.” Today, economic developments in China have obvious repercussions across borders as well, affecting everyone from small emerging economies to Europe and the United States. We live in a world where our economic fates are increasingly intertwined. Indeed, Metternich's saying is now often heard with China as the proverbial sneezer.

Of course, this audience already knows of the growing influence of China and Asia more broadly. California is at the forefront in terms of business and cultural connections with Asia. Indeed, I often hear from people here that the outlook across the Pacific is more relevant to their businesses and organizations than events in Europe or elsewhere.

With that in mind, I'd like to talk to you today about how two countries—alike in some ways, very different in others—need to rebalance their economies over the next decade. Those shifts will be similar in some aspects, divergent in others; but both face the challenge of how to best manage the transition to longer-run rebalancing. Before I go any further, I should say here

that the views expressed today are wholly my own and do not necessarily reflect those of others in the Federal Reserve System.

It is not surprising that understanding economic and financial issues in Asia more broadly, and China specifically, is fundamental to any discussion of global economics. This is particularly acute at the San Francisco Fed, where fostering expertise on Asian markets is a long-standing focus. Deep knowledge of Asia is essential to formulating monetary policy; to promoting the stability of global financial markets; and to carrying out our responsibilities in banking supervision. Continuing a tradition started many years ago by San Francisco Fed President Bob Parry and carried on by his successor, Janet Yellen, I try to make a fact-finding trip to Asia at least once a year. I've now had the pleasure of visiting China and other Asian countries on several occasions.

The state of two economies

We all know China has been a modern miracle of growth since Deng Xiaoping's reforms were introduced in 1978. For over 30 years, China's real GDP growth has averaged about 10 percent annually—a sustained pace of growth that is unrivaled in economic history.¹ To put that in perspective, over the same time period, the rest of the world's economies experienced an average annual growth rate of real GDP of about 3 percent.² China's growth has been driven by an almost unbelievable pace of urbanization, both natural and managed. The share of China's population living in cities more than doubled between 1980 and 2005, to 44 percent.³ At its

¹ See Aizenman and Spiegel (2010).

² See International Monetary Fund (2013).

³ See Woetzel et al. (2009).

current pace, we can expect to see one billion people living in cities by 2030. That's more than the current populations of the United States, Russia, and the entire European Union combined. This accomplishment is breathtaking.

However, that exceptional pace cannot be maintained forever, and we've seen China's rate of growth slow in recent years. What China faces now is the same core issue confronting the United States: coming to terms with a new normal for the future. Both countries are looking to create more long-term stability by rebalancing the role that domestic consumption plays in their economies. They are simply coming at it from opposite directions. The United States would like to decrease its reliance on consumption as the engine of growth, relying more on domestic investment and exports. China would like to see more consumer spending at home, and less reliance on domestic investment and exports. The contrast is striking: Chinese household consumption accounted for around 36 percent of GDP in 2011; the comparable figure for the United States is 69 percent. For comparison, in the euro zone, private consumption spending averages around 58 percent of GDP.

China's remarkable growth over the past 30 years has been fostered by an emphasis on investment and exports. As the returns to investment have declined over time, and slower global growth provides diminishing opportunities for exports, this model has become less sustainable. The focus must instead shift—as China's leaders have indicated they would like—to domestic household consumption.

The United States, by contrast, has for decades consumed and invested more than it produced, relying on imports to fill the gap. The question for America is: How long can it sustain this imbalance? With every passing year that we don't live reasonably within our means,

and do not produce the goods to pay for our consumption, our debt to creditors outside the country grows. This reduces our net wealth and makes us more dependent on foreign lenders.

Responses to the financial crisis

Every country's economic path is informed by its history. As William Faulkner once wrote, "The past is never dead. It's not even past." Likewise, both China's and America's present conditions—and their outlooks for the future—are greatly influenced by one of the most significant events of the recent past: the global financial crisis.

China responded to the crisis with a large-scale stimulus program, increasing lending by banks to large, state-owned enterprises that totaled 4.4 percent of GDP over three years.⁴ These loans were used largely to finance infrastructure and housing projects. China's growth had fallen from a recent high of 14 percent, in 2007, to 9 percent in 2009. With the boost from the government stimulus, growth rebounded to 10 percent in 2010. That is, in the face of the worst global financial crisis in many decades, China's economic growth actually increased.

This was widely viewed as a success, and an indication that China could persevere despite continuing problems abroad. However, the slow recovery in the United States and the sustained downturn in Europe dampened demand for Chinese exports. This has been a powerful reminder—unpleasant though it was for China—that our fortunes are often enmeshed. These external burdens contributed to slowed growth, and the World Bank now expects the Chinese economy to grow just 7.5 percent this year. I say "just"... obviously, most countries would be thrilled with 7.5 percent.

⁴ See Horton and Ivanova (2009).

While China's growth has been greatly affected by forces outside its borders, the U.S. economy has been influenced by many internal conditions. In the United States, the response to the crisis was threefold: federal government fiscal stimulus in the form of tax cuts and increased spending; programs aimed at restoring confidence and strength to the financial system; and, last but not least, a large dose of monetary stimulus.

This threefold response helped avoid a complete meltdown of the financial system and cushioned the blow to our economy. Nonetheless, it was not enough to stave off a severe recession or the myriad factors hindering the recovery. The financial crisis dealt a devastating blow to household wealth—a full \$6.5 trillion of housing wealth was lost. Combined with a deeply depressed stock market, this sent spending off a cliff. That went for all aspects of spending, including—or, I should say, especially—home construction and household goods. This was a particular problem, because those areas of spending have typically spurred recoveries in the past. The situation was exacerbated by especially tight credit, bringing lending to a virtual standstill.

I don't need to remind anyone here how bad it was. California's economy was especially hard hit. We experienced one of the biggest housing booms and therefore one of the most severe housing collapses. California was also much more affected by the sharp slowdown in international trade. This was felt particularly here in Southern California, where Los Angeles and Long Beach are two of the nation's primary global ports. And even the tech industry was dealt a severe blow. While employment overall fell by 3.8 percent nationally in 2009, Southern California saw a 5.6 percent drop.

The reversal of federal fiscal policy from stimulus to austerity in the intervening years has added to the factors holding back the economic recovery. On one side, we had income tax increases on upper-income Americans and the expiration of the Social Security payroll tax cut. These took a bite out of disposable income that could otherwise have been directed toward spending. On the other, budget austerity and sequestration have resulted in a drag on spending by the public sector. Overall, it is estimated that federal fiscal policy is subtracting 1½ percentage points from economic growth this year.⁵ On top of this, the gridlock and brinkmanship in Washington, D.C., adds to uncertainty and saps confidence. This makes households and businesses reluctant to undertake big investments, further slowing the recovery.

Again, California stands to feel this pain more severely. The effects of sequestration have been neither fully felt nor fully implemented. Next year, a further \$20 billion of federal defense cuts will take effect, which will impact a state with both a large defense contracting sector and numerous military bases. Anecdotally, the uncertainty of further government cuts and the threat of continued gridlock in Washington has put the aerospace and defense industries in something of a holding pattern. The effects on these industries will be felt from contractors to construction workers.

Challenges

Each country has challenges to overcome. China's tightly-controlled financial sector creates systemic barriers to rebalancing the economy. There are limits on investment abroad, and a repressed financial system at home keeps interest rates low and constrains the kinds of

⁵ See Lucking and Wilson (2013) and Congressional Budget Office (2013).

investments people can make. The system also favors state-owned enterprises, hindering small businesses and discouraging entrepreneurship.

It has also contributed to the rise in shadow banking. China's fiscal stimulus program encouraged the state-owned banks to lend even further to large, state-owned enterprises. The government was rightly worried about investment expanding too quickly—after all, over-investment and the resulting bubble in the U.S. housing sector offered a cautionary tale. So China sought to restrict wider borrowing. Local governments and smaller enterprises, however, were eager for capital to invest in their own areas, and financial institutions, unsurprisingly, found ways around government constraints. This created a surge in China's shadow banking sector, which increased its informal and private lending to small businesses and wealthy customers, much of it off-balance-sheet.

There is inherent risk to any loan. Whether sanctioned by the government or made in the shadow banking sector, there is always a possibility it will turn bad. Considering that the heavy borrowing by local governments was directed towards infrastructure projects that often yielded little, if any, return in the short term, timely repayment is a very real risk.

Therefore, many observers fear that excessive lending and borrowing may be creating a bubble, similar to the one that burst in the United States just seven years ago. China's corporate and household debt as a share of GDP rose 45 percent in the four years from 2008 to 2012. This is more than twice the increase in US debt during its credit boom between 2002 and 2008, when the debt-to-GDP ratio rose by about 20 percent. Such rapid increases in borrowing have historically raised the risk of crises in other countries.

Real estate is another area of concern. On one of my recent visits, a Chinese professor told me that everyone in China has two homes or more, because houses are cheap, interest on savings accounts is low, and there are no property or capital gains taxes. Though he was obviously exaggerating, it does highlight the attractiveness of property, in light of the high household saving rate and limits on alternative investment opportunities. In response to bubble concerns, China's government has been working since 2010 to bring down real estate prices by setting limits on bank lending and raising down-payment requirements for mortgages. Despite these efforts, recent data show China's property prices continuing to rise. The resilience of housing prices in the face of concerted policy efforts adds to the worry that a bubble may be forming.

This is a fine line to walk: Though a real-estate bubble is a risk, there is also concern that economic growth could weaken too much and too quickly. With the rest of the global economy lacking the steam to pull China's economy along, it must find some domestic engine for growth.

In the United States, the challenges we face are also about striking balance. One of the sharpest lessons of the past five years is the need to keep financial institutions from taking big risks. However, risk-aversion can mean tight credit, and limited access to capital for small businesses and entrepreneurs may be the price of caution. In addition, while we need to rebalance our economy away from consumption over the longer term, in the short run, consumer spending is critical to getting the economy moving again.

Addressing the challenges

So these are the states of both nations as we move towards change. China faces a balancing act in the near term: Needed economic reforms come at the price of slower growth; but a growth-boosting injection of credit comes at the cost of greater risk to the banking system and the economy down the road.

China's policymakers have ruled out a stimulus package of the size implemented during the crisis. They have also acknowledged that reforms cannot be implemented without a slowdown.

In various speeches, China's leadership has said that it will tolerate some deceleration of growth—though not breaching a floor of 7 percent—in order to shift focus from exports to domestic consumption.

As many of you know, we expect to hear the new government's economic plans at the Third Plenary Session of the 18th Central Committee, which starts tomorrow.

As always, China's policy making will be consensus-driven and won't happen overnight. China's leadership has reason to be guarded in approaching far-reaching reforms. It is perhaps the safer option to loan money to a state-owned enterprise than to risk it on a consumer who may not pay back a home mortgage—the memories of America's recent past are all too fresh. As Cicero counseled, "Advice is judged by results, not intentions." And to encourage more consumer spending is to encourage a certain amount of debt. That debt is, however, manageable, and ultimately necessary if China wants to hasten an economic rebalancing.

On our side of the Pacific, the issues and discussion are much messier. In the near term, we are still facing a slow recovery and high unemployment. However, the cure for what ails us here and now is in some respects at odds with the longer-term rebalancing we need to achieve.

Which leads me to the rebalancing of economies. Unsurprisingly, economists can't agree about the primary reason China's domestic consumption is so low and what should be done about it. One possibility is the population's focus on saving—in large part to cover the cost of health care, education, and preparation for old age. This is exacerbated by China's massive and rapid urbanization; as it currently stands, most social services, such as education and health care, are administered in one's home city. This means that much of the migrant workforce can't access these services in their new cities, and is forced to save to cover those expenses. While local authorities may balk at paying more for social services, there is a trade-off: addressing such structural barriers would free up workers' income that could be spent locally, stimulating host cities' economies.

Another issue is increasing income inequality—something we in the United States can relate to. What money is flowing to households is concentrated largely in the expanding class of wealthy citizens, rather than in rural and middle-class families.

The final and perhaps most important factor is that, while corporate profits have risen, a comparable rise in individual income has not followed. Again, something that has happened in the United States as well.

Low borrowing costs for state-supported firms, combined with low wages for many workers, have helped business profits at the expense of households.

If China is to rebalance the economy away from exports and towards domestic consumption, there must be an increase in household incomes. That means higher wages and dividend payments from firms. Further liberalization of the financial system will also help, as higher deposit rates and more investment options would boost spending power. Furthermore, China's citizens must feel a sense of stability and certainty regarding their future. When we're worried about the future, the natural response is to want to save more. So, even if these steps were to be taken, the question remains whether China's middle- and rural-class citizens are willing to become bigger spenders anytime soon.

Turning to the United States, over the longer run we need to increase investment in education, physical capital, technology, and infrastructure. We will also need to put federal fiscal policy on a sustainable path, which involves making some tough decisions about taxes and spending. Importantly, spending less on current consumption will free up resources for investment areas that foster greater production and will increase the size of the economy over the long term.

However, to succeed at these longer-run goals, we first need to get our economy working at its full potential. That's where the Federal Reserve and monetary policy come in. Since the early days of the crisis and recession, the Federal Reserve's monetary policy body, the Federal Open Market Committee (FOMC), has been taking strong actions to foster economic recovery and get people back to work. We lowered short-term interest rates to near zero almost five years ago. The goal was simple: With very low interest rates, households and businesses are more willing to spend. This increase in demand for goods and services leads businesses to hire more workers.

It is a testament to the stubborn weakness of the recovery that even with short-term interest rates near zero, it wasn't enough to get the economy back on track. We turned to unconventional monetary policies to get longer-term interest rates and mortgage rates down. These included large-scale asset purchases—referred to as “quantitative easing” or QE by people outside the Fed and LSAPs by people inside the Fed—and forward guidance—which is economist-ese for communicating more clearly what we think will happen with interest rates over the longer term. By combining these tools with our conventional policy—the short-term interest rate—we are looking to get more money flowing into the economy to increase demand for goods and services and spur hiring.

Although the pace of the recovery in the United States has been frustratingly slow, we have made a lot of progress, and I expect that to continue for the foreseeable future. We've added nearly 6.4 million jobs over the past three years, with 2.2 million of those in the past year alone. Although the unemployment rate is still high at 7.2 percent, it has been steadily falling. A lot of the growth has been in interest-sensitive sectors such as autos, durable goods, and housing. This is evidence that our monetary policy medicine is working.

Looking ahead, with continued support from accommodative monetary policy, I expect the economy to continue to expand and add a significant number of jobs, resulting in declining unemployment next year and in 2015. I also expect inflation, which has been quite low over the past year, to gradually move back to the Fed's preferred rate of 2 percent.

Conclusion

China and the United States are both facing challenges in rebalancing their economies for the future. There are parallels and contrasts, but both face the difficult challenge of maintaining growth today while moving toward a new normal of longer-run economic health for tomorrow.

Thank you very much.

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