Li Ruogu: Deepening reform and opening wider to ensure sustainable economic growth

Speech by Mr Li Ruogu, Deputy Governor of the People's Bank of China, at the 42nd Annual Meeting of Business Executives, Trujillo, Peru, 23 October 2004.

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Mr. Chairman, ladies and gentlemen,

Good Morning! It is a great pleasure to participate in this meeting. My remarks will focus on four aspects. First, the Chinese economic development against the backdrop of globalization; second, challenges associated with WTO accession facing the Chinese industries; third, our strategies to cope with these challenges; and lastly, prospects of Sino-Latin economic and trade relations. I will also be very pleased to answer any questions you might have during the discussion session if time permits.

I. The Chinese economy has entered an important stage of active interactions with the rest of the world

The economic reform, which started in 1978, has brought about remarkable changes in China. This high growth episode has largely coincided with the deepening of the economic globalization. And the Chinese growth story has proved that developing countries should and indeed can seize the opportunity in the course of economic globalization to promote development.

Between 1978 and 2003, China's real GDP growth averaged at 9.4 percent, and now China is the 7th largest economy in the world. At the same time, China's economic development has created a huge market for the world economy. During the period, China's total trade volume has grown at an annual rate of 16 percent from US$ 20.6 billion to US$ 851.2 billion. China has become the 4th largest trading nation and the 3rd largest importer after the United States and Germany. China's total trade volume is expected to exceed US$ 1 trillion in 2004.

China's economic development has also generated good opportunity for foreign investment. As of the end of July 2004, actual disbursement of foreign direct investment totaled US$ 540.2 billion. And more than 400 of the world top 500 multinational companies have direct investment in China.

II. Stern challenges facing the Chinese industries in the post-WTO environment

As a developing country, China has preliminarily established its socialist market economic system. After 15 years of hard negotiations, China eventually joined the WTO in December 2001 in order to integrate into the development process of the world economy. In the course of WTO negotiations, China made maximum concessions and thus endured grave pressures for economic restructuring.

Since entry into the WTO, China has fulfilled its commitments in real earnest. Tariff rates have been massively slashed and are close to the ultimate target; non-tariff protection barriers have been nearly completely dismantled; and the service industry has opened further to foreign competition. The WTO membership has bought tremendous challenges to Chinese enterprises, particularly as the Chinese economy is still in the process of restructuring. Some state-owned enterprises remain inefficient, the agricultural industry underdeveloped, the financial system un-resilient to risks, regional disparity widening and unemployment pressures still high.

First, pressures of agricultural import have heightened as the market has become more open to foreign competition. (1) China is a country with small per capita arable land. About 70 percent of its 1.3 billion people live in the countryside. In 2003, China's grain output only totaled 420 million tons. In contrast, only 7 percent of the US population live in the rural areas and the US grain production was 350-380 million tons, not much lower than that produced in China. This fact reflects low productivity of China's agricultural sector. (2) With massive subsidies provided by the developed countries to their agricultural industry, China is facing increasing competition from the imports of low-priced agricultural products from the developed countries.

Second, some manufacturing industries also face great challenges. Though I do not like labeling China the "world factory", it should be recognized that the manufacturing industry accounts for a significant part of both the GDP and the export sector in China. Currently, the manufacturing industry contributes 37 percent to the GDP growth. The Chinese manufacturing industry remains uncompetitive as evidenced by the following: (1) Weak capacity for technology innovation. According to some survey, China owned only 60 percent of the 104 key technologies used in the production of color TV sets, only 50 percent of the 65 key technologies needed for mobile phone production, and 15.8 percent of the 57 key technologies required for DVD production. (2) Lack of self-developed brand names. China processes products for many famous foreign brands. 53 percent of the exporters are foreign-invested enterprises, which account for 60 percent of China's total export value. (3) Huge discrepancies exist in terms of management, marketing strategy and the building of modern corporate system compared with the foreign multinational companies.

Furthermore, trade protectionism and unfair trade practices pursued by certain countries also affect its industrial competitiveness. In 1990s, one of every 6 to 7 anti-dumping cases were filed against Chinese companies. By the end of 2003, a total of 540 anti-dumping cases had been filed against China's products.

Third, competition in the service industry has intensified. One weakness of the Chinese economy lies in the underdeveloped service industry. Growth of China's service industry failed to match that of the manufacturing sector. The service industry accounts for 65 percent of the world GDP. It averages 70 percent for developed countries and 50 percent for developing nations, but lingering around 30 percent for China.

China's major telecommunications companies have long been constrained narrow business scope, resulting in persistently weak competitiveness. In the retail market, foreign companies like Wal-Mart and Carrefour, have obvious advantages in terms of capital, management, procurement and distribution.

The gap is even larger with the developed countries with regard to financial services. The Chinese financial institutions are plagued by poor asset quality, capital inadequacy and less diversified products. There exists a big gap between the Chinese and foreign financial institutions in terms of business operation, management skills and staff quality. In the 2nd quarter of 2004, non-performing loans recorded by the State-owned commercial banks reached RMB1.8898 trillion yuan, accounting for 19.2 percent of their credit assets. For the time being, the fiercest competition between the domestic and foreign institutions is over the so-called "high-end" clients as 80 percent of the profits of the financial industry is generated from business with these high-end customers. Meanwhile, competition over quality staff is also becoming ever intense.

In a broader perspective, the Chinese economy has been growing at a fast speed since the beginning of reform and opening up, but its competitiveness has unfortunately not recorded the same impressive improvement. The *Global Competitiveness Report* published by the World Economic Forum in November 2003 ranks China's growth competitiveness the 44th among 102 economies in the survey while its commercial competitiveness the 46th among 95 economies. And of the "Fortune 500", only 14 companies are from China (if those from Hong Kong, Taiwan and Macao are not included).

III. Deepening reform and opening wider to improve China's corporate competitiveness

In face of all these challenges, we did not blame other countries, but have resorted to more aggressive reform to improve our competitiveness. The 3rd Plenary Session of the 16th National Congress of the Communist Party emphasized the strategic objective of improving socialist market economic system and establishing a more vigorous and open economy. Efforts have been mainly focused on the following areas to enhance corporate competitiveness:

1. The reform of SOE has accelerated as reflected in the establishment of state-owned asset management and supervision system and improved corporate governance. (1) The State Assets Administration and Supervision Commission has been established. (2) Rights and accountability of the board of directors, board of supervisors and shareholders have been defined in line with the requirements of modern corporate governance. (3) On that basis, we have taken active measures to develop large enterprise groups which are competitive and further revitalize the small and medium-sized SOEs. Some SOEs have already established reputation in the world. Such well performing enterprises as China Mobile, SINOPEC, PICC Property & Casualty Co. Ltd and CASIC have successfully launched their IPOs overseas. By the end of 2003, the net assets of the top 10 overseas listed companies have exceeded RMB 1 trillion yuan and their net profits reached RMB 146 billion yuan last year.

2. Agricultural restructuring has speeded up and government support strengthened. (1) Land system has been reformed in the rural areas to protect the interests of the farmers. (2) Reform of taxes and fees in the countryside has been deepened. At the beginning of 2004, the State Council decided to eliminate agricultural tax within 5 years. By now, agricultural tax has been removed in 8 provinces, lowered by 3 percentage points in 11 major grain-producing provinces and by 1 percentage point in the rest of the country. This practice has reduced the tax burden on the farmers by 30 percent. (3) Employment environment has been improved to accommodate increasing labor migration from the countryside. (4) Financial support has been granted to pilot reform of the rural credit cooperatives aimed at improving rural financial service.

3. Development of the non-public sector has been boosted. The Chinese government encourages competitive enterprises to grow larger and stronger, and allows greater participation of foreign investment in order to improve efficiency through competition. (1) On January 1, 2003, the *Small and Medium-sized Enterprises Promotion Act* was promulgated to provide legal protection for the development of the SMEs. (2) The *Constitution* has recognized the non-public sector as an important part of the socialist market economy and calls for facilitation, support and guidance for its development. The constitution also explicitly provides for protection of private property. Since the beginning of reform and opening up, the private sector has been growing at an annual rate of 20 percent. As of end of 2003, fixed assets of the non-state sector accounted for 61.1 percent of the nation's total. (3) Now there are more than 400,000 foreign-invested enterprises in China.

4. Efforts are being made to enhance innovation capacity. (1) To seize the great opportunity brought about by domestic industrial restructuring, the Chinese government has speeded up the introduction of advanced technology, management expertise and high quality professionals from abroad. (2) Enterprises are encouraged to enhance their capacity for market development, technological innovation and brand establishment. (3) The government has also redoubled efforts to facilitate study and research in basic science. (4) "Soft environment" has been improved to encourage multinational companies to build R&D centers in China.

5. The opening process has been accelerated. (1) The Chinese government has opened certain sectors in an orderly and sequenced manner according to the requirements of the market economy and the WTO rules. Some sectors, such as insurance and tourism as well as the local currency business for foreign banks have been opened even ahead of the WTO schedule. (2) The "go-abroad" strategy has been firmly implemented, allowing enterprises to grow stronger through international competition.

6. Financial reform has been deepened to speed up the development of the financial markets and improve competitiveness of the financial institutions. The following measures have been taken in recent years to strengthen financial stability, promote the reform of financial industry and improve the quality of financial service.

(1) Accelerating joint-stock reform of the commercial banks, taking advantage of the strong economic growth momentum. Commercial bank reform has undergone several important stages. First, the Chinese government issued special treasury bonds amounting to RMB 270 billion yuan in 1998. The fund raised was subsequently used to recapitalize the state-owned commercial banks. In 1999-2000, four asset management companies (AMCs) were established to take over part of the non-performing loans from the commercial banks. Second, commercial banks used their own resources including reserves, profit and capital, to write off non-performing loans. Third, US$ 45 billion foreign exchange reserves were used to recapitalize two state-owned commercial banks - the Bank of China and China Construction Bank. Meanwhile, efforts have been made to clean up their non-performing assets and improve their internal risk control and corporate governance. Supervision on their capital adequacy has also been intensified. Both banks have finished financial restructuring and transformed into joint-stock companies. The banking system as a whole has improved asset quality, capital adequacy and capacity to withstand risks.

(2) Further promoting market-based interest rate reform. The basic objective and principle of China's interest rate reform are as follows: putting in place a market-based interest rate mechanism in which the central bank could use monetary policy instruments to adjust and guide the movement of the market interest rate so that the market forces can play a dominant role in the allocation of financial resources. Interest rate reform should go hand in hand with the economic and financial developments and be consistent with the improvement of corporate governance and internal control in the commercial banks.

In recent years, the market-based interest rate reform has advanced steadily. Money market interest rate is now determined by the market. Administration of both deposit and loan interest rates was streamlined and autonomy of the commercial banks in the management of interest rates improved. Floating band of the lending rates has been widened to expand access of the SMEs to bank credit. The floating band of the lending rates was further widened on January 1, 2004, bringing the upper limit of the lending rate up to 170 percent of the benchmark rate.

(3) Improving exchange rate regime. It was made clear at the 3rd Plenary Session of the 16th National Congress of the Chinese Communist Party in October 2003 that efforts should be made to "improve the RMB exchange rate regime and keep the RMB exchange rate basically sable at an adaptive and equilibrium level. Provided effective risk control mechanism is in place, restrictions on cross-boarder capital transactions will be relaxed in a selective and sequenced manner so as to gradually move toward capital account convertibility".

Over the recent years, we have made great efforts in improving the RMB exchange rate regime and such efforts have resulted in the acceleration of the State-owned commercial banks reform, current account convertibility, reduced control over capital account transactions, increased openness of the capital market for foreign institutions and foreign-invested enterprises, and greater access to an increasingly diversified financial market.

We will further advance the reform and move toward an exchange rate regime with greater flexibility. The reform in this area is a complex task and should taken into account numerous factors, including macroeconomic performance, social development, balance of payments, the progress of reform in the banking sector, and the regional and global economic and financial situation. We will adopt a mix of measures to advance the reform of the exchange rate regime in a gradual and steady manner.

Reform and opening up has facilitated China's integration into the world economy. At the same time, China's contribution to the world economic development has been growing steadily. The Chinese people are well known for being hard working and frugal. Our strategy is to increase the size of the cake so that all countries have a bigger cake to share rather than fighting for a larger slice of a small cake.

Ladies and Gentlemen,

The first 20 years of the 21st century will mark an important period for China's development. We will stick to the scientific approach to development and continue to deepen financial reform through advancing the restructuring of the financial institutions, strengthening economic management and improving the financial supervisory system. Persistent efforts will be made to support the Chinese enterprises to enhance their capability in technology innovation and international competitiveness so as to enable them to make greater contribution to the sustained and balanced growth.

Sustained growth and opening of the Chinese economy have also created favorable conditions for the development of the Sino-Latin American trade and economic relations. In the past ten years, our trade with the region has been expanding at an annual average rate of 20.5 percent. Brazil, Argentina, Chile and Peru have become China's suppliers of soybean, steel and mineral products.

Great potentials remain to be tapped in the course of Sino-Latin American economic cooperation. In 2003, trade between China and the Latin America reached US$ 26.8 billion, accounting for 3.1 percent of China's total trade volume. China's imports from Latin America totaled US$ 14.9 billion, increasing by 80 percent over the previous year while its export to this region amounted to US$ 11.9 billion, a surge of 25 percent. However, the current trade flows between China and the Latin America is still too small either measured by its share in the aggregate trade volume, or compared with the economic size of China and the Latin America. In this regard, we are willing to take concrete measures to expand our bilateral trade so as to promote economic development in both China and Latin America.

Finally, I would like to wish the annual meeting a great success and the Sino-Latin American economic and trade cooperation more fruitful.

Thank you. I am ready to take a few questions.