

Hu Xiaolian: Recent economic and financial developments in China

Remarks by Ms Hu Xiaolian, Deputy Governor of the People's Bank of China, at the Central Bank of Argentina 2008 Money and Banking Conference "Financial turbulence – impact on developed and emerging economies", Buenos Aires, 1 September 2008.

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Respected Governor Martín Redrado,
Ladies and gentlemen,

I feel deeply honored to be invited to come to this beautiful city of Buenos Aires for the seminar. As you know, recent developments in the global economy has been characterized by a broad-based slowdown, heightened financial market turbulences and rising inflation pressure. I'm very pleased to be able to have frank and in-depth exchange of views with all of you about the challenges China has been facing and measures that have been taken in this context.

I. Recent economic and financial developments in China

Since the beginning of 2008, the Chinese economy has maintained a stable and rapid growth momentum in the process of combating against the challenges resulting from historically rare and severe natural disasters and turmoil both in the international and domestic economic and financial conditions. Investment, consumption and export grew in a balanced manner; domestic demand especially consumer demand became a stronger driving force for economic growth; investment grew steadily and investment structure improved; the national economy developed in the desired direction.

Urban and rural household income continued to rise, and domestic consumer demand remained strong. In the first half of the year, the per capita disposable income of urban residents registered 8065 yuan, a year-on-year growth of 14.4 percent or 6.3 percent in real terms; the per capita cash income of farmers was 2528 yuan, a year-on-year growth of 19.8 percent or 10.3 percent in real terms. The steady income increase in both urban and rural areas supported the continued growth of consumption. In the first half of 2008, the gross volume of retail sales reached 5.1 trillion yuan, representing nominal growth of 21.4 percent or real growth of 12.9 percent, 0.2 percentage points higher than that in the same period of the last year. Among the total, retail sales in urban China grew 22.1 percent to 3.5 trillion yuan, and retail sales in counties, townships, and villages grew 20.0 percent to 1.6 trillion yuan. The growth gap between the urban and rural areas was 2.1 percentage points, 0.4 percentage points wider than the same period of last year.

Fixed-asset investment grew steadily with an improved investment structure. In the first half of the year, fixed-asset investment totaled 6.8 trillion yuan, representing a year-on-year growth of 26.3 percent and an acceleration of 0.4 percentage points. Urban fixed-asset investment reached 5.8 trillion yuan, up 26.8 percent year on year, while rural fixed-asset investment posted 996.6 billion yuan, up 23.2 percent, an acceleration of 0.1 and 1.7 percentage points respectively from the same period of the last year. In terms of geographical distribution, fixed-asset investment in eastern, central and western China grew 22.4 percent, 35.3 percent and 28.6 percent respectively, with central and western China growing much faster than eastern China. In terms of the sectoral distribution, fixed-asset investment growth in the three industries registered 69.5 percent, 26.6 percent, and 26.2 percent respectively, with the primary industry representing an acceleration of 32.0 percentage points, much higher than that of the second and the tertiary industries, whose growth was relatively stable.

In the first half of the year, GDP grew 10.4 percent year on year to 13.1 trillion yuan, a deceleration of 1.8 percentage points from the previous year; the consumer price index was up 7.9 percent, an acceleration of 4.7 percentage points; the trade surplus posted US\$99 billion, a decline of 13.2 billion from that in the same period of the last year; the actual utilization of foreign direct investment totaled US\$52.4 billion, an acceleration of 33.4 percentage points from the previous year.

II. Issues and challenges facing China's economy

1. *Inflation has become the primary concern in China's economy.*

China is currently facing excessively increasing pressures on prices. Since Q4 2006, driven by large increases in food prices, the CPI has grown at a relatively rapid pace. In the first half of 2008, the year-on-year CPI grew at a historically high rate of 7.9 percent. The formation of China's current inflation is complicated, and is a result of various factors. First, external factors have impact on domestic prices, such as large widespread rise in prices of global commodities, foods and assets, and inflation imported from developed and other emerging market economies. Even though the appreciation of the RMB has somewhat offset the impact, the driving force of the imported inflation remains strong. Second, due to the limited supply, prices of important commodities such as pork have risen rather quickly. Third, the rising cost of labor and price adjustment of resources exerted upward pressures on prices. The cost of labor and the imported inflation are reinforcing with each other resulting in spiraling prices.

2. *The impact of sub-prime mortgage crisis on China's economy cannot be ignored.*

Although the sub-prime mortgage crisis has a limited direct impact on China's economy, it can never be ignored. First, the U.S. economic growth and the growth of China's export are strongly and positively related, and the lower growth of the U.S. economy will most likely affect China's export and its economic growth. Second, uncertainties in capital flows have risen and a large amount of international capital flew into China, as a result of successive cuts in policy rates by the Federal Reserve, the continuing depreciation of the U.S. dollar and the turmoil in the international financial markets. Third, the continuing depreciation of the U.S. dollar increased the prices of global commodities denominated in the U.S. dollar, putting comparatively huge imported inflationary pressures on China. Fourth, China's foreign exchange reserve management faces big challenges after the sub-prime crisis. Changes in major international reserve currencies, such as the Euro and the U.S. dollar are becoming more and more unpredictable, thus complicating the management of China's foreign exchange reserves. Fifth, the inflationary pressure and the sub-prime crisis has heightened the moderation risk of China's economic growth. External shocks constitute the greatest risk this year for China's economy, which has become a major part of the global economy. Although the inflationary pressure and the sub-prime crisis have negative impact, they will not change the fundamentals of China's economy, which will maintain a rather rapid growth rate.

III. China's recent monetary policy

The Chinese government has placed anti-inflation as its top priority for a long time. In light of the apparent movements in the price level, at end-2007 China made it a top priority to "prevent rapid growth from turning into overheating and to prevent structural price rises from becoming generalized inflation" in macro adjustment policies. Recently, China stressed once again to put maintaining stable and rapid economic growth and curbing excessive price hikes

as the top priority of macroeconomic management, and put reining in inflation high on its agenda.

In the first half of 2008, the PBC took the following measures to implement monetary policy: **The first was to raise reserve requirement ratio to absorb excess liquidity.** The PBC raised the reserve requirement ratio on many occasions. After the reserve requirement ratio was raised by one percentage point on June 7, except for certain financial institutions and quake-hit areas, the reserve requirement ratio of most financial institutions was 17.5 percent. The rise of reserve requirement ratio absorbed a lot of liquidity, eased the inflationary pressure, avoided the rapid increase of interest rate, and contained hot-money inflows. **The second was to flexibly conduct the open market operations.** In light of short-term liquidity demand of the banking system and changes of fund demands of financial institutions in the first half of 2008, the PBC flexibly used a mix of instruments, rationalized their maturity structures, kept interest rate stable in the course of open market operations, guided market expectation, and conducted cash management of the state treasury when appropriate. **The third was to strengthen “window guidance” and credit guidance.** Efforts were made to guide financial institutions to strengthen credit regulation and extend loans in a sound and balanced manner during the year, so as to prevent volatile movements of lending activities. Measures were taken to encourage growth in some sectors while discouraging it in others and rationalize the credit structure. Efforts were made to restrict loans extended to highly energy-consuming and highly polluting industries and industries with overcapacity. Credit support was increased to some key areas, such as agriculture, rural areas and farmers, post-disaster reconstruction, small enterprises, the services industry and independent innovation, energy-conservation and environment protection projects, and credit line to small- and medium-sized enterprises was raised. **The fourth was to improve the RMB exchange rate formation mechanism reform, and speed up the reform of foreign exchange system.** Efforts were made to deepen the reform of the foreign exchange system, appropriately guide the market expectation of RMB exchange rate, strengthen the monitoring over, analysis of and management of cross-border capital flows, and strengthen monitoring over abnormal cross-border capital flows in the trade sector and other areas; to reform the foreign exchange system in trade in service on a pilot basis in some regions; to allow more market participants on the foreign exchange market, and to promote the equilibrium of the balance of payments. **The fifth was to steadily promote the reform of financial institutions.** For the time being, the stock-holding reform of state-owned banks is further deepened. The corporate governance, business transformation and operation performance of the Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank and the Bank of Communications has been upgraded on a continuous basis. The fundamental work for the reform of the Agricultural Bank of China has made significant progress. The commercialization of the China Development Bank was steadily pushed ahead, and the reform of rural credit cooperatives has made big progress and achieved phased results.

The aforesaid measures have achieved remarkable results. As the food price decelerates with increased supply and the prices of oil and other commodities on the international market slid recently, China's CPI declined from 8.7 percent in February to 6.3 percent in July, and future inflationary pressure is expected to further moderate. In the meantime, the monetary and financial situation remained stable. At end-June, broad money M2 stood at RMB 44.3 trillion yuan, representing an increase of 17.4 percent year-on-year, lower than that at end-2007. Deposits and loans of financial institutions increased in a stable manner. In the first half of 2008, outstanding deposits of financial institutions stood at RMB 45.0 trillion yuan, an increase of 17.8 percent year-on-year; outstanding loans of financial institutions registered RMB 30.5 trillion yuan, an increase of 15.2 percent year-on-year. The exchange rate of RMB displayed an overall appreciating trend. The flexibility of the RMB exchange rate was improved, and the connection between RMB and other major currencies became more apparent. As of end-June, the exchange rate of the RMB versus the U.S. Dollar rose by 6.50 percent from the end of last year, and the RMB depreciated by 1.51 percent and 0.63 percent against the Japanese Yen and the Euro respectively from the end of last year. From

the foreign exchange rate system reform to the end of June 2008, the RMB appreciated by 20.66 percent accumulatively against the U.S. Dollar, depreciated by 7.54 percent against the Euro, and appreciated by 13.33 percent against the Japanese Yen. In the first half of 2008, the daily fluctuation of the RMB central parity averaged 79 basis points, larger than the 62 basis points of that in 2007. The growth of foreign reserves began to decelerate, and is expected to decelerate further.

IV. China's policy stance to be adopted in the next stage

An old Chinese saying goes "ruling a country is like cooking seafood delicacy", which follows that ruling a country requires the same meticulous efforts as cooking palatable seafood. At present, there are more destabilizing factors in the international economic environment, and problems in China's economy are becoming more apparent; therefore, we need more patience and wisdom in order to maintain stable and rapid economic development.

In the next stage, China will **put maintaining stable and rapid economic growth and curbing excessive price hikes as the top priority of macroeconomic management, and put reining in inflation high on its agenda.** Efforts will be made to maintain the continuity and stability of monetary policy, increase the foresightedness, pertinence and flexibility of the adjustment policy, adopt fine-tuning measures when appropriate according to changing situation both at home and abroad, manage the priorities, pace and intensity of macroeconomic adjustment, encourage growth of some sectors while discouraging it of others, strengthen financial support to key areas and weak aspects of the economy so as to balance the relationship between containing inflation and maintaining rapid economic growth and promote the economy to grow in a sound and rapid manner.

The year 2008 marks the 30th anniversary of China's reform and opening-up. In the past 30 years, China successfully transformed itself from a command economy to a market economy, from a closed and semi-closed economy to a fully opened-up economy, making outstanding economic and social advancements. China's GDP has been growing at an average annual rate of 9.7 percent, and foreign trade 17.4 percent, ranking the fourth and the third respectively in the world. People's living conditions have achieved overall well off. But China is and will stay in the primary stage of socialism for a long time. There are still a lot of poor people in urban and rural areas; urbanization is inadequate; the per capita GDP ranks behind the 100th in the world. Constrained by such a reality, the solution to many problems is a long-term and systemic project. When making policies, consideration should be given to China's national situation, development stage and affordability.

We have recognized that with increasing economic globalization, financial integration driven by financial innovation and diversification of transfer modes of financial risks, more regional and global problems will emerge, and the coordination of macroeconomic policies, monetary policy in particular, among different nations is becoming more and more important. Going forward, to address various problems, China will rely on itself and accelerate reform and development on the one hand, and pay attention to exchange and cooperation with other countries on the other hand. China is willing to continue to increase understanding, share experiences and strengthen cooperation with the rest of the world to create a favorable international environment that is conducive to the development of all countries.

Finally, I wish a complete success of the seminar. Thank you!