Su Ning: China's economic development and the current macroeconomic policy

Speech by Mr Su Ning, Deputy Governor of the People's Bank of China, at the Conference of Montreal, Canada, 9 June 2004.

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Honorable Mr. Chairman, ladies and gentlemen,

It is a great pleasure to come to the beautiful city of Montreal to participate in the conference to learn successful experience of other countries in economic development. I would also like to take this opportunity to share with you about the economic and social progress we have achieved over the past two decades as well as the current economic situation and monetary policy in China.

I. Reasons of China's rapid economic development in a quarter of a century

Since the beginning of 1970s, China has entered a historical period of economic reform, opening up and modernization. Within a timeframe of 25 years, the Chinese economy has consistently maintained its rapid growth momentum. During such a period, China's annual GDP growth rate was averaged at 9.4 percent, the income and living standard of urban and rural residents continuously improved, and foreign trade volume expanded by 16 percent each year. Utilized foreign direct investment reached USD676.9 billion and the official foreign exchange reserves increased from USD19.4 billion to USD403.3 billion. China now is the 7th largest economy in the world, with its overall economic strength markedly improved. Per capita GDP was quadrupled in 20 years up to the end of last century and is expected to be further doubled by 2010.

There are several reasons for the eye-catching achievements in terms of social and economic development in China.

First, steadfast in pressing ahead with the socialist market economic system reform. We have carried out restructuring of the public ownership system and instead established an economic system featuring the public ownership as the mainstay and co-existence of various economic sectors. Non-state sectors have experienced rapid development and constituted an important force in supporting economic growth and job creation in China. In the meantime, we have proceeded with reform of the rationing system seen in distribution and allocation of resources, property, income, production and sales under the planned economy, and come to have established an economic structure in which the market could play its fundamental role in resource allocation. Various markets including the capital market, technology market, real estate market and labor market have all mushroomed from nowhere to bring about a marked improvement of the marketization of the Chinese economy. The preliminary establishment of the socialist market economic system has laid a solid institutional foundation for China's rapid economic development.

Second, steadfast in advancing economic opening up to integrate into the world economic development. We have ended China's isolation from the world economic development and opened the Chinese economy to the outside world at different levels on a broad scale. Efforts have been made to take full advantage of both the internal and external resources and markets to effect China's competitive advantage in the global economy. On November 11, 2001, China joined the WTO, marking an important step forward for China's economic opening up and reform. In 2003, China's total goods trade volume amounted to USD851.2 billion, ranking the 4th place in the world. Inflow of FDI totaled USD53.5 billion, topping all the developing nations. Rapid growth of trade and continuous increase of FDI have not only contributed to the expansion of export and job creation, but also substantially increased the import of much needed scarce resources and equipments. Furthermore, the inflow of advanced technology and management skills has helped to boost China's technology and competitiveness, providing additional support to economic reform.

Third, we have always been conscious of striking a balance between reform, development and stability. China is a big developing country with a population of 1.4 billion and large disparities in terms of regional economic development. It is by no means an easy job to press ahead with economic reform and modernization and make everyone live a comfortable life in such a country. One important piece of our experiences is that adequate attention must be paid to handle the relationship between reform, development and stability. In our view, stability, namely the social, political and economic stability constitutes the prerequisite to ensure steady progress of economic reform and development. Since reform will more or less affect the interests of almost all the parties in the society, it is important to make the reform endurable to the individuals, enterprises and all other social sectors. Under the leadership of the Chinese Communist Party and taking into consideration of the Chinese situation, we have embarked on a path of reform gradualism to build a socialist market economic system with Chinese characteristics. That is to say, we will on the one hand stick to the mandate of socialist market economic reform, while on the other hand give full consideration to the endurance of all walks of life, and strive to make the reform benefit most of the people in the society. In practice, sweeping reforms are usually introduced when favorable conditions arise, and the pace of reform will be slowed down if conflicts intensify. All in all, in the process of economic and social development, we have always made the harmony between the strength of reform, the speed of development and the endurance of the general public a top priority, and targeted a persistent improvement of the people's living standard as the lock-point for handling relationship among the three factors. Such a consensus has contributed to the mutually re-enforcement of reform, development and social stability.

Despite the outstanding achievements mentioned above, we should remain clear about the fact that China is still a developing country with large population. Though large in absolute size, China's GDP measured by per capita is still very low, with the 2003 figure just exceeding USD1000. Myriads of problems, including slow growth of the farmers' income, pressures on employment and social security system, regional development disparity, widening gap of income distribution and degradation of environment etc., remain to be conquered on our way moving forward. Since these problems emerge in the process of development, they must only be addressed in the process of development.

II. Current economic situation and monetary policy in China

For the time being, the Chinese economy has broadly performed well. Thanks to efforts of several years, we have overcome the deflationary effects developed since the end of the Asian financial crisis and brought the economy back to the fast track. China's GDP grew by 9.1 percent in 2003, a total of 12.99 million jobs were created, CPI rose by 1.2 percent and trade volume expanded by 37.1 percent. The fast economic growth momentum shows no signs of abating this year as GDP grew by 9.8 percent in the first quarter, household income, business profits and fiscal revenues all witnessed large increase and foreign trade continued to grow strongly. However, in the process of accelerated economic development, some new problems such as over-investment and low-level duplicated constructions in certain sectors and regions as well as increasing bottlenecks seen in the supply of energy, transport and raw materials have also emerged. In the year of 2003, investment growth registered 26.7 percent, with the investment in steel, cement and aluminum sectors doubled. Entering 2004, the Chinese economy continued to be plagued with over-investment in certain sectors and regions despite the overall health of its operation. Fixed asset investment in the first quarter grew by 43 percent over the same period of last year, and investment in the steel, cement and aluminum sectors continued to grow rapidly. Over-investment has put strains on the supply of energy and transport and boosted excessive growth of money and credit. In the first quarter of 2004, broad money M2 grew by 19.1 percent, and new loans issued by the financial institutions surged by 20.7 percent over the corresponding period of last year, all beating the projected macro-control targets. In the meantime, the price level, in particular the prices of production materials and raw materials, experienced fast rise. The price of industrial production materials rose by 3.6 percent in 2003 and continued to grow by 4.8 percent in the first quarter of this year.

The Chinese government has attached great importance to resolving the emerging problems in the economic operations, and is taking comprehensive measures to bring them under control. In line with the decisions made by the State Council, the People's Bank of China has consistently improved financial management and applied various monetary policy instruments to adjust the monetary and credit aggregates and their structures, so as to prevent inflation and ups and downs of the economy. Measures taken by the People's Bank of China include:

- Strengthening open market operations to fully sterilize liquidity increase resulted from foreign exchange purchase in the market;
- Preventing excessive growth of money and credit through raising the requirement reserve ratio further by 0.5 percentage points from 7 percent to 7.5 percent based on the 1 percentage point hike in 2003; this action froze usable fund of the financial institutions totaling RMB110 billion yuan;

- Establishing positive incentives to introduce differentiated required reserve ratios for different financial institutions. The required reserve ratio applied to a financial institution will be linked to its performance indicators such like capital adequacy ratio and asset quality. The lower the capital adequacy ratio of a financial institution and the higher its NPL (Non-Performing Loan) ratio, a higher required reserve ratio will be charged. The differentiated required reserve ratio system is a special institutional arrangement based on the current financial system in China and will benefit monetary policy transmission;
- Floating central bank lending rates. Interest rates of central bank loans at various tranches were increased by 0.63 percentage points and the rediscount rate was also raised by 0.27 percentage points;
- Increasing window-guidance on loan extension for commercial banks. Risks have been warned for commercial banks and efforts were made to promote loan structure improvement and the establishment of loan restriction mechanism consistent with risk control capability and capital adequacy in the commercial banks.

While controlling credit fund flowing to low-level duplicated constructions and over-investment sectors, the People's Bank of China has encouraged and guided the commercial banks to increase credit support to the agriculture sector, small and medium-sized enterprises, consumer demand and job creation. In the meantime, constructions of corporate and individual credit information registration systems were strengthened and legislation related to promoting consumer credit was further improved. Moreover, administrative rules on small-amount guarantee loans for unemployed workers was enhanced and loan approval procedures were simplified to encourage banks to increase loan support to those qualified labor-intensive small businesses in which certain proportion of job vacancies are filled by laid-off workers.

Rapid growth of the Chinese economy and the following austerity measures taken by the government recently has aroused wide concerns of the international community. Some people are worried the Chinese economy may lose control and head for persistent overheating while others are concerned about the destabilizing effects a hard brake on the Chinese economy may bring to the world economy still on the course of recovery. Here, I would like to assure our friends that the Chinese government remains crystal-clear about the current economic situation and is taking timely, prudent and appropriate measures to address the problems. Some measures have already started to take effects, and we are fully confident that existing problems in the current process of economic development will be resolved and the good growth momentum will be maintained without ups and downs.

III. Sequenced gradual reform of the RMB exchange rate regime

Like the overall economic reform, China's foreign exchange rate system reform is also a gradual and sequenced process. Before economic opening up, management of foreign exchange earnings and expenses was centralized and RMB exchange rate was decided and adjusted solely by the government. After 1979, enterprises were allowed to retain foreign exchange earnings and a foreign exchange swap market was established to form dual exchange rates in China, namely the official exchange rate and the swap market exchange rate. With foreign exchange system reform introduced in 1994, foreign exchange purchase and sale was required to be effected through the banking system and a nation-wide inter-bank foreign exchange market was thus put into place, leading to the formation of the so-called managed floating foreign exchange rate system based on market supply and demand of foreign exchange. Such a system has since remained unchanged.

The RMB exchange rate has been allowed to fluctuate since 1994. During 1994-1997, the RMB appreciated from 8.7 yuan per US dollar to 8.3 yuan per US dollar. After the breakout of the Asian financial crisis, responding to the appeal of the neighboring countries and international institutions, China significantly narrowed the floating band of the RMB exchange rate and undertook not to devaluate the RMB, thus contributing importantly to the regional economic and financial stability. What China pursued at that time was a managed floating exchange rate within a significantly narrowed band instead of a fixed exchange rate.

During the past year, there have been much debates and discussions on the RMB exchange rate, with substantial different views from some of the world's famous economists. Some said that the RMB should be revaluated, while some believed that the RMB exchange rate should be kept stable. I would like to emphasize two points. First, with active participation in the global economic activities and close integration into the world economy, China has provided more and more low-cost and high-quality products to the international markets. This has not been achieved by the adjustment of RMB exchange rate. Instead, it has been benefited from China's huge labor force with low cost and improving skills. Also, the problems of trade deficit and unemployment in some countries cannot be resolved by the revaluation of RMB. Chinese government does not seek to maintain trade surplus, but hopes to keep a balanced current account. Export expansion will inevitably result in the increase of import, thus creating opportunities for other countries to increase their export. Trade partners should not blame each other for the adverse impact of others' products on their domestic industries. Instead, they should actively participate in the international division of labor and fully exploit their comparative advantages. Second, a stable and growing Chinese economy will benefit the stability and development of the world economy. Last year, with rapid growth of export, China's import also expanded rapidly. Import growth was 39.9 percent for the whole year. In particular, import from EU, United States and Canada grew by 37.7 percent, 24.3 percent and 20.6 percent respectively. Import growth accelerated to 42.4 percent in the first four months of this year, 10.5 percentage points higher than the growth of export, resulting in a trade deficit of over USD10 billion. Import from EU, United States and Canada in the first four months grew by 33.7 percent, 41.5 percent and 60.1 percent respectively. The growth of the Chinese economy has contributed importantly to the recent world economic recovery. Any improper change in the RMB exchange rate policy may create new uncertainties to the world economic development. Therefore, we should be extremely cautious.

Recently, some foreign friends have showed their concerns about the potential overheating of the Chinese economy due to the expansion of money supply as a result of the rapid increase of foreign exchange. I would like to reassure these friends by recalling our experience during the Asian financial crisis. At that time, China successfully maintained steady economic growth while keeping the RMB exchange rate basically stable. Today, we are confident that we will be able to prevent great ups and downs in the national economy while keeping the external value of our currency basically stable.

China's exchange rate reform is still underway. In light of the China's current stage of economic development, performance of the economy and developments in international payments, we will further examine and improve the mechanism for determining the RMB exchange rate and keep the RMB exchange rate basically stable at an adaptive and equilibrium level.

In pursuing the exchange rate reform, due consideration will be given to China's current economic and social development, the government's macroeconomic management capability and the progress achieved in various economic reforms and financial reforms including the improvement of financial supervision capacity. The reform of the RMB exchange rate cannot be carried out in isolation. Instead, it should be pursued in tandem with other reforms. Several preconditions need to be met before the RMB exchange rate can be freely floated. First, trade, particularly service trade, has been substantially liberalized. Second, progress has been achieved in the liberalization of capital account to adapt to a more flexible exchange rate system. Third, major breakthroughs have been made in the reform of the state commercial banks with substantial improvement in their competitiveness and resilience to shocks.

At present, balance between supply and demand in the foreign exchange market will mainly be achieved through relaxing the restrictions on the surrender and purchase of foreign exchange by enterprises and individuals. Major measures include: reforming the administration of foreign exchange accounts for current account transactions and allowing the enterprises to have greater flexibility in retaining foreign exchange; reforming the management of surrender and purchase of foreign exchange for non-trade transactions by multinational corporations, allowing qualified multinationals in Beijing, Shanghai and Shenzhen to directly make certain foreign exchange payment or to purchase foreign exchange with RMB to make the payment; reforming the policy governing the purchase of foreign exchange by individuals to meet the their reasonable demand for foreign exchange to make current account payment; actively promoting financial innovation to create more opportunities for foreign exchange investment (China Development Bank has issued financial bonds denominated in US dollar in the inter-bank market); introducing pilot reform program of foreign exchange management for overseas investment to gradually expand the channels for capital outflows.

We are confident that, with the steady advancement of the reforms, a RMB exchange rate system that is suitable to China's specific conditions and accurately reflects market development will be established, and the monetary policy will be playing an increasingly important role in macroeconomic management.

Canada is an important trade partner of China. The trade volume between China and Canada for the first time exceeded USD10 billion in 2003, representing a growth rate of 26.2 percent over the previous year, and the direct investment in China from Canada reached USD563 million. Financial cooperation between China and Canada has also been actively promoted. Two Canadian commercial banks have established four branches in China and the other four have set up representative offices. There are great potentials for trade, investment and financial cooperation between our two countries. We look forward to closer financial and economic cooperation with Canada.

Thank you.