

## Wu Xiaoling: Review of China's economy in 2005 and outlook for 2006

Speech by Ms Wu Xiaoling, Deputy Governor of the People's Bank of China, at the Expert Meeting on Analysis and Forecast of 2006 Financial Situation in China, Beijing, 18 March 2006.

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In 2005, under the leadership of the State Council, all regions in China followed a scientific development approach, further intensified macro-economic management and continued reform and opening-up. The GDP grew by 9.9 percent, fixed asset investment increased by 25.7 percent, and CPI moved up by 1.8 percent. The disposable income of urban and rural residents grew by 9.6 percent and 6.2 percent respectively. The registered urban unemployment was 4.2 percent. Trade grew by 23.2 percent, while the profits of statistically large enterprises rose by 22.6 percent. Broadly speaking, the national economy displayed a good momentum featuring fairly rapid growth, good return, stable price, and good dynamics. In 2006, the outlook of the Chinese economy is good and the forecast goals are expected to materialize, i.e. a GDP growth of 8 percent and a CPI increase of around 3 percent.

In 2005, the monetary and financial conditions maintained a good momentum of smooth performance in line with economic growth. M2 grew by 17.6 percent, RMB deposits by 19 percent, loans by 13 percent. The destination and maturity structure of loans became better. Short-term working capital loan and bill financing accounted for a substantially larger share, i.e. 47.7 percent, in the new loan. The excessive growth of medium and long-term loans were checked, its share in the new loan declining by 10.8 percentage points. The rural area, agricultural sector and farmers received stronger financial support. The exchange rate regime reform was implemented smoothly. Exchange rate moved in both directions and its flexibility increased gradually. Between July 21 and end of 2005, the highest RMB to dollar exchange rate when market was closed was 8.0702 yuan, while the lowest reached 8.1128 yuan. At end 2005, the exchange rate was closed at 1 dollar to 8.0702 yuan. On March 10, 2006, the RMB exchange rate was 8.0492 yuan to one dollar. In December, the 7-day repo rate at the money market was 1.56 percent. Preliminary results were achieved in capital market reform; the stock market saw a gradual recovery of confidence. At year end, the Shanghai Stock Exchange Composite Index reached 1161 points. The premium income of insurance companies totaled 492.7 billion yuan, up 14 percent year on year.

The year 2006 will see stability in the monetary policy. The M2 is projected to grow by 16 percent. The PBC will use a mixture of monetary policy instruments to preserve the general stability of interest rate and exchange rate.

In 2006, China will start to implement its 11th Five-year Program. The year 2006 will be a crucial year in our efforts to implement this program, further put into effect the scientific development approach, and consolidate the results of macro-economic management for realizing the 11th Five-year Program. It is also the last year of China transitional period after WTO accession. At the moment, the overall domestic and international situation is favorable for a steady and sound development in China. Yet, there are many uncertain and unstable factors.

In 2006, the world economy is expected to have a solid growth. According to forecast by international organizations, the growth rate of world economy will be around 4.3 percent in 2006, similar to that in 2005; growth of world trade will be 7.6 percent, slightly higher than 2005. Potential risks include imbalances, elevated oil price, trade protectionist action etc. For the Chinese economy, opportunities outweigh challenges in the international environment.

The domestic environment in 2006 is also conducive to economic growth. As a result of industrialization, urbanization and upgraded consumption structure, investment, consumption and export are expected to maintain robust growth. The performance of the economy has become more stable. Data revised following the economic census shows that macroeconomic indicators have improved, indicating sustainability.

Potential problems in the economic performance in 2006 include the following:

1. There is still potential for investment to rebound. The real growth of total fixed asset investment in 2005 was 23.7 percent, 3.8 percentage points higher than the previous year. The aggregate scales of projects being constructed, newly launched and being planned are still fairly large. As 2006 is the first

year of the 11th Five-Year Program, a group of major infrastructure projects will be launched and investment enthusiasm remains high.

2. As a result of the coexistence of resource price adjustment pressure and excess capacity, prices are under both upward and downward pressures. In particular, the upward pressure must not be neglected under the resource and energy constraint. Price hike of public service and resources will push up product and labor cost and the overall price level. Enterprises business operation and household consumption will be affected to some extent. We need to continue to monitor the impact of price movement on economic performance.

3. In order to have a balanced external account and address the problem of excess supply, we need to intensify structural readjustment, and pay attention to risks of unemployment and the quality of bank assets. Structural readjustment will bring strong pressure on employment. The reemployment of laid-off workers will draw popular attention. In the process of the upgrading of industrial structure, some inefficient and uncompetitive enterprises will gradually make their exit; this might cause bank loans to become NPLs.

In view of the problems in economic performance, monetary and financial policy should pay more attention the excessive liquidity in the market, facilitate fund, improve fund use efficiency and optimize fund allocation.

First of all, proper adjustment of market liquidity will be an important component in this year's macro-economic management.

In recent years, due to the increase in foreign exchange and large RMB positions acquired through purchase of foreign exchange, banks have the capability to expand their asset. In order to achieve an appropriate growth of money supply, the PBC issued central bank bills and strengthened open market operation to absorb excessive liquidity. In 2005, the total issuance volume reached 2.8 trillion yuan of central bank bills, 2.1 trillion yuan being outstanding volume at year end. In the first two months of 2006, a total of 825 billion yuan worth of central bank bills was issued with 2.4 trillion as outstanding at end February. Given the limited financing channels and CAR's restraint on business expansion of commercial banks, central bank bills became a good investment choice. But if situation changes, especially when more choices are available for investment by commercial banks and when they are more willing to lend, central bank bills will not be so well received. Between 2004 and 2005, state-owned commercial bank reform tackled the most difficult problems. Because of strict requirements including CAR, commercial banks became more prudent in lending. In the latter half of 2005 when commercial bank reform yielded preliminary result, the ability and motivation of commercial bank to lend increased remarkably. When financial institutions were better able and more willing to expand the business and foreign exchange continued to flow into China, an important challenge in front of us was to be more proactive in macro-economic management. While maintaining stability and the neutral stance of the monetary policy, the PBC will employ a mix of monetary policy instruments and adjust positions of commercial banks to an appropriate position.

Secondly, another priority for the monetary policy and financial policy in 2006 is to optimize the allocation of fund while adjusting the aggregate size.

Bank credit is of an excessively high proportion while direct financing channels are not readily available. This has become a bottleneck in economic performance. The PBC will continue to promote the development of bond market, encourage financial product innovation, build market infrastructure and improve the functions of market for the rapid and sound development of the financial market. We will gradually carry out piloting asset securitization business, and expand the issuance volume of enterprise short-term financing bills. Research on expanding the methods and ways of direct financing by enterprises at the inter-bank market will continue in order to launch new products at an appropriate time. Financial derivative products innovation will be promoted. We will also improve the market maker and broker system and build a bond registration and custody system.

The PBC actively supports the development of fund management sector, nurture institutional investors and gradually expand piloting project of bank invested fund management companies, improve security investment instruments that serve the public, help the transformation of deposits into investment and expand the channels for fund flow into the equity market.

Thirdly, the PBC will cooperate with the relevant authorities to promote the adjustment of economic structure and maintain external sector balance.

Rapid increase of foreign exchange reserve and the issue of RMB exchange rate has been the focus of people's attention. Rapid increase of foreign exchange reserve reflects the imbalance of external sector, and is a result of our policy of encouraging export and FDI inflow and restricting the outflow of capital. In order to achieve external sector balance, we need to promote structural adjustment through policies and gradually correct the imbalances. The first part of adjustment is to change the foreign exchange policy of restricting outflow and attracting inflow. The second part is to expand the channels of foreign exchange fund use, change the situation of foreign exchange held by the state and enable the people to hold more foreign exchange. Thirdly, capital inflow and outflow channels will be expanded gradually, and overseas investment will be promoted in a sound manner. A complete foreign exchange management system will be built to encourage overseas investment.

Exchange rate flexibility contributes to adjustment of BOP structure. Yet, large fluctuation of exchange rate is not conducive to sound performance of the economy. The PBC will adjust foreign exchange policy and release effective demand, control the abnormal foreign exchange supply, and create a good economic environment for the performance of new exchange rate regime. We will continue to allow the market to play a fundamental role in the exchange rate determination, improve the managed floating exchange rate regime, and keep the RMB exchange rate basically stable at an adaptive and equilibrium level. Foreign exchange management system reform will be expedited in order to establish a market mechanism and a management mechanism for BOP adjustment, and adopt the inflow and outflow balance management.

As interest rate and exchange rate are more market based, we will provide risk management instruments and explore interest rate swap experiment. We will intensify study on interest rate forward contract, and launch relevant piloting project at an appropriate time. We will gradually launch standard and non-standard contract of foreign currency/foreign currency, RMB/foreign currency derivative products. Enterprises and financial institutions need to adapt to the environment of changing fund cost, learn to manage risk with derivative instruments, change the traditional mentality of business operation, and improve business operation in response to market risks, adapt to a managed floating exchange rate regime in an incremental manner, and integrate in an increasingly competitive international environment.

In 2006, macro-economy and economic policy are expected to remain stable. The dynamism and flexibility of the economy are expected to be enhanced. The good momentum of economic development will move into this year. The PBC will continue the sound monetary policy, maintain policy continuity and stability, strengthen coordination between local currency and foreign currency policies, make the monetary policy more forward-looking and effective, maintain the steady growth of money and credit, promote financial reform and opening-up, preserve financial system stability, further reform foreign exchange management, improve the quality of financial service and contribute to the sustained, balanced, rapid and healthy development of the national economy.