Statement by Mr. Dai Xianglong on the stability of the Chinese yuan and on a number of other regional issues Statement by the Governor of the People's Bank of China, Mr. Dai Xianglong, at a press conference held on 16th January 1998, on the stability of the Chinese yuan, the lessons of the financial crisis in South-East Asia, the linked exchange rate system of the Hong Kong Special Administrative Region and the impact of the collapse of Peregrine on domestic business.

The commitment to hold the current yuan exchange rate steady

Judging from the balance of payments position and macroeconomic performance, there is no possibility for the Chinese yuan to depreciate. I believe that the yuan will remain stable and will not depreciate for the following reasons. First of all, over the past years, the value of the yuan has appreciated and the exchange rate at the end of last year stood at around yuan 8.29 for a dollar. The trade surplus of last year reached $43 billion, and capital inflow was as high as $60 billion, which, put together, contributed to the rise of foreign exchange reserves. Following a successive increase over the years, the total amount of foreign exchange was $139.9 billion. In addition, this reserve position does not include another $2.5 billion to support the South-East Asian countries to overcome their financial crisis and $2 billion otherwise retained by foreign trade corporations. In the wake of the drastic currency depreciation for a number of countries in South-East Asia, the pace of increase for China's foreign exchange reserves slowed down, which in the end reduced the upward pressure for yuan. Second, the macroeconomic prospects for this year look quite favourable. With continued price stability, GDP for this year is expected to grow over 8%, which can be seen as another contributing factor for a steady exchange rate. Third, the level of exchange rate is determined overall by foreign exchange demand and supply. It is true that the currency depreciation in some South-East Asian countries does increase the pressure on our export. But such a pressure is quite limited given the fact that commodities from China and their destination are different from those of South-East Asian countries. Fourth the labour cost in China is significantly lower in comparison with South-East Asian countries, and in fact 50% of our export is in the form of processing of imported material, which is not subject to the influence of exchange rate fluctuation. Indeed, Chinese export businesses can enhance their competitiveness via reducing cost and improving product mix. It can be said with a high degree of certainty that prospects for the country's exports this year will remain favourable. I would like to reaffirm our commitment to hold the yuan exchange rate steady with no consideration for depreciation and to stand ready for the test of the market. This commitment can be seen as our contribution to financial stability in Asia.

Over 8% GDP growth in 1998

The financial crisis in some South-East Asian countries will have some impact on the growth rate for China, for example trade between China and South Korea. However, China largely depends on its domestic market for growth. In 1998, China will continue to expand its export market and increase its domestic investment. With continued price stability, GDP is expected to grow over 8% in 1998. The slowdown of the GDP growth to 8.8% last year is attributed to international factors and the sluggish growth of township and village enterprises. We believe that supported by the vigorous measurers to address the adverse influence, we will be able to maintain GDP growth over 8% in 1998.

To be specific, first of all we shall continue to pursue a moderately tight monetary policy and make timely adjustment as necessary. Broad money will be expected to grow by

16-18%, narrow money by 17% and injection of cash by yuan 140 billion. More discount and rediscount activities will be expected for commercial papers. Second, banks will be expected to improve their services in support of new growth areas. The financing service for residential houses will be improved so as to strongly support the growth of the market for residential houses, to expand the scope of residential lending and remove the lending quotas imposed on public housing projects for less privileged people. Loans denominated in foreign exchange will be actively developed on the domestic market with a projected increase of 10-15% of foreign currency denominated lending. The input for agriculture, railway, highway and high-tech industry will be increased under the precondition of ensuring the service of loans. Finally, the interest rate instrument will be used appropriately to adjust the money supply, but at this moment the central bank has no intention to lower interest rates.

Toward the establishment of a modern financial system and a regulatory/supervisory system

In 1997 the financial sector functioned in a sound manner and contributed in a significant way to economic development and social stability. In 1998 we will continue to pursue a moderately tight monetary policy and make strong efforts toward the establishment of a modern financial system and a regulatory/supervisory system to the extent that all financial institutions will be properly regulated/supervised by law, and financial risks are properly reduced in the interest of significantly improving the order in the financial industry and promoting a high and steady growth of the economy. In so doing, the most crucial policy measure is to reform the organisational structure of the central bank. The number of provincial branches of the central bank will be reduced in a well-planned approach. A number of first-tier branches across the judicial administrative line will be created so as to enhance independence, authority and expertise of the central bank. In addition, with regard to commercial banks, their provincial branches and branches located in provincial capital cities will be consolidated gradually and the grassroots branches with overlapped businesses with their counterparts that have incurred sustained losses will be removed. When conditions allow, urban commercial banks will be created in 300 city centres with equity shares from local fiscal authorities with a view to establishing a multi-layered financial system comprising different financial institutions. The underlying nature of financial institutions requires the existence of a set of rules and regulations for the management of the institutions. All these institutions shall function in compliance with laws and regulations and no government agencies or individuals shall be allowed to interfere with the business management of financial businesses. Again, these institutions shall be required to assume managerial responsibility and risk inherent in the business. Their internal control system shall be strengthened. The supervisory board shall be established for all state-owned commercial banks. The lending quota imposed on these banks will be removed and they will gradually adopt the basic asset and liability ratios and risk management techniques for managing their balance sheets. With reference to internal practices and in consideration of the country circumstances, we will improve the existing system for asset classification and loan loss provisioning. Efforts will be made to improve the system for capital replenishment in order to increase capital adequacy of financial institutions. In maintaining the order in financial industry, we shall follow the principle of segregating commercial banking from securities and trust businesses and close all unlicensed financial institutions. All these measures will be phased in during the next three years according to a well designed plan. By the decision of the State Council, we shall build a modern enterprise system, a modern financial and regulatory system within a time framework of three years. I feel optimistic that state-owned commercial banks and other commercial banks will operate under an new mechanism at the turn of the century.

The lessons from the financial crisis in South-East Asian countries

Serious lessons can be drawn from the financial crisis in South-East Asian countries. This is also true for China despite the fact that the country started early in 1993 to cap the bubbles in the economy. The major lessons for us can be summarised as follows: first of all, it is essential to maintain an equilibrium for aggregate demand and supply, and especially to be on guard against the bubbles in the real estate and stock market; second, the structure of external borrowing should be proper and external borrowing by domestic businesses should be well regulated. Before the crisis, fiscal deficits were small, economic fundamentals were sound and central bank reserves were high. The underlying cause for the crisis is the over indebtedness of business entities, especially the large amount of short-term borrowing not necessarily reported to the central bank. Given what has happened, China will continue to favour foreign direct investment and long-term commercial borrowing as a general policy. At the same time, external borrowing by domestic businesses shall be reviewed very carefully and subject to a ceiling; third, efforts shall be made to actively pursue the development of capital market and gradually achieve capital account convertibility for the renminbi. On top of that, the country must maintain substantial foreign exchange reserves; fourth, a safe and sound financial system must be in place, and no government agencies or individuals should interfere with the business operations of commercial banks. In an effort to ensure the stability of financial industry and reduce financial risk, a dozen policy measures have been introduced. A better structured financial system is sure to emerge in China three years later.

A strong commitment to an open policy

We shall not abandon the open policy simply because of the financial crisis in South-East Asia. By the end of 1997, 173 foreign financial institutions were licensed to operate in China with total assets amounting to $36 billion. The Chinese banks, insurance and securities companies had 687 overseas establishments actively developing businesses abroad. We will continue to grant licenses for foreign banks and insurance companies and authorise more foreign banks to do local currency business on a trial basis. However, we would be more cautious in this regard.

China as a safe haven for foreign investment in Asia

With good reason, China can be expected to maintain its status as the second largest recipient for foreign direct investment. Although the contractual amount of FDI has decreased to a certain extent, the amount of actual investment has been on the rise, particularly by big multinational corporations. China has a stable political situation, a strong currency and a good climate for foreign investment and lower tariffs. A new policy was announced recently whereby the import of equipment by investing foreign businesses shall be exempt from value added tax for imports. Therefore, China is very attractive for foreign investment.

The commitment of the government of Hong Kong Special Administrative Region to hold the Hong Kong dollar steady

The financial crisis in South-East Asia is not over yet and the possibility of another attack on Hong Kong’s financial market still remains. So far, the government of the Hong Kong Special Administrative Region has introduced a number of measures to protect the stability of the Hong Kong dollar and its financial market, one of which is to maintain the Hong Kong dollar peg. The linked exchange rate system introduced more than ten years ago has contributed in a significant way to stabilising the Hong Kong economy. At present, Hong Kong has strong economic fundamentals, a sound banking system, large foreign exchange reserves and sufficient experience in regulating the economy. Therefore, the linked exchange rate system will remain unchanged and experience has shown that this can be done and will be done. In defending the exchange rate, interest rates in Hong Kong rose and caused the drop of prices on the stock market. Although banks' profitability has declined, the profitability ratio for Hong Kong banks remains the highest in the whole world. Indeed, 30% drop of the real estate price is a correction of overvalued real estate in Hong Kong and can prove to be conducive to improving the competitiveness of Hong Kong.