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## Session 1, Part 1

### Current Assessment:

Impacts of Current Global Economic Instability on China's Economy

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## **1. Overview of China's Economy Since 1978**

Ever since the launch of "Open-up and Reform" in 1978, China has enjoyed three decades of economic growth at an annual rate of 9%, accompanied by an average inflation rate around 6%. The outcome of this development is significant: One in five of human beings in the world are making their living standard higher year by year.

Thanks to the reform policies, including better-defined and protected property rights and other incentives to enhance productivity, a free market framework has gradually established. The open-up policy coupled with abundant low cost labor force and favorable policies given to foreign investment has made China one of the biggest FDI destinations (just second to the US in recent 15 years) in the world, helping China to become an "assembling center" of the world. The entry into WTO started a new era of open-up. China has been more deeply involved in the world economy than it ever had, and is becoming a major player in it. Annual amount of both import and export has tripled during 2001 and 2006, the first five-year since China became a member of WTO. Open-up is seen as one of the primary driver of China's economic development, as it is with the open-up that the industrialization and urbanization process is initiated. Urban job growth, rural and urban incomes rose rapidly throughout the country. That said, China is still in the early stage of development measured by GDP per capita, and the process of rapid economic growth also accumulated numerous structural problems in sustaining the growth, heavy reliance on export for economic growth and employment, heavy energy consumption and serious pollution problems, and relatively lagged social welfare system, to name a few. China is a beneficiary from the liberalization of global market. This determines that it will commit itself to further open-up and seek to resolve its structural problem in the process of integration into the world economy.

## **2. The Impact of Current Global Economic Instability on China's Economy**

Compared with the 1997 Asian Financial Crisis (AFC), the current financial crisis has a much more severe impact on China's economy. This is most clearly manifested in export slowing down, financial sector instability and inflation pressure. Although by far we have been managing the condition fairly OK, a big issue is that current global

economy situation creates a lot of uncertainty to China's economy. And it unravels the hidden structural imbalance that has long been accumulating in China's economy.

A) Export: Export growth has been slowing down due to a shrinking external demand, especially taking into account of the price factor. By far, this effect remains to be modest with the picking-up of the demand outside of the US in recent months. Given the volatility of the international financial market, however, one has reason to be worried about the prospect of export. SMEs in coastal area are the ones who are most seriously hurt. They are facing stringent condition of RMB appreciation, increasing cost of inputs, and shrinking demand. Policies originally set to fight against inflation posed further pressure for them to get loans from banks.

Though the structural problems hidden under the prosperous exporting sector had been well mentioned before the crisis, i.e. in the long-term China will face rises in production cost due to the increasing labor, capital, land, energy and environment protection cost, the rapid change of the global market brought this problem onto surface. To cope with the challenge, it is imperative for China to upgrade itself in the chain of division of labor.

B) Financial sector: Although the initial exposure to the sub-prime related securities is limited, it turned out that the second-round effect of the financial crisis and indirect effect of the global financial turbulence felt by the financial market is much severer than we had originally thought, and it dampened market sentiment. RMB exchange rate experienced a rapid appreciation early this year, and since then has been dominated by frequent fluctuation. Rapid capital inflow seeking better returns also became a big concern. Although trade surplus has been narrowing, China's FX reserves have been building up rapidly, mounting to over US \$ 1.8 trillion in June. The majority of the inflows may have come to China in official ways. Take for example, of the US\$ 228.4 bn increase in reserves in the first four months, FDI and the trade surplus contributed only US \$ 93.1 bn (Although there are other factors to explain the gap, a big portion of it remains unexplainable). The buildup of FX reserves has revived the debate on hot money associated with capital inflow, and it caused a lot of uncertainty to financial market such as the pressures on inflation and the risk that the withdrawal of capital could put on local financial system and etc. China's stock market experienced the biggest slump around the world in the past 10 months. It has been 70% lower than its peak in 2007. Stock market index is at a 7-year's lowest point.

As far as banking sector is concerned, Chinese banks' exposure to structured products remains to be manageable. Overall, balance sheets of Chinese banks are still dominated by straight forward lending commitment to households and corporations, with assets dominated by loans. And Chinese banks maintain the requirement of 70% loan-to-deposit ratio by supervisors. Banks are insulated from a squeeze in the money markets that tripped up banks elsewhere. That said, Chinese banks do feel pressures in several indirect ways. Tightening policies posed challenge for banks' profit, and real estate sector is also facing difficulties. If its price turns down, this would leave banks with more defaults in their mortgage loans.

C) Inflation pressure: Due to the reason of excess liquidity and increasing international fuel and commodity price, the rise of CPI hit 11 years high in February this year, to an annualized rate of 8.7%, and declined after which due to stringent policy measures adopted. CPI has been moderated to 4.9% in August. Given that PPI remains elevated, topping 10.1% in August, and China consumes fuels and commodities with a rising intensity, potential risks of inflation remains high.

Up to now, the effect on overall economy remains to be limited. GDP growth rate moderated from the peak of 11.4% last year but remained high, 10.6% and 10.4% in Q1 and Q2 respectively this year. Industrial production showed signs of moderation. The real growth rate of urban fixed assets investment is around 17% y-o-y in the January-May period compared with 21.8% y-o-y for the whole of 2007 and 23.6% in January-May 2007. However, what is encouraging is, despite elevated inflation, domestic consumption continues to support the economy. Retail sales are still growing at a pace of more than 15% in real terms. Looking forward, as demand and housing market weakens and cost increases, the trend for real economy should still point downward.

### **3. Policy Measures**

Policy challenges facing Chinese government is to strike two sets of balance. One is between slowing down the inflation and keeping a reasonable speed of growth, and another is between the deepening economic reform and solving the structural problems. Economic difficulties trigger the opportunity for structural change.

For the first set of balance, macro policy focus has experienced a shift from the first half year's emphasis on fighting inflation to the second half's tilt toward growth. Since the very beginning of this year, a series of measures have been implemented to cope with the soaring inflation, including increasing agricultural input, hikes of interest rates, increase in reserve requirement, stringent monitoring over capital inflow and price control etc. Although tightening policy also caused difficulties for some sectors, especially that of the real estate industry and SMEs, it proves the eased concern of inflation later on gives policy more flexibility for further fine-tuning, especially for the purpose of structural adjustment. With the inflation abated, and more importantly, the unfolding of the market volatility since Sep., policy emphasis has shifted to "maintaining economic growth while checking inflation". The government adopted a series of measures to stabilize the financial market and create a steady environment for economic growth by expansion of credit quota, rate cuts, slowdown of currency appreciation and export tax rebates etc. It is needed to point out that, this does not mean inflation is no longer a major concern. With PPI still elevating and gap between domestic and international energy prices still big, tightening policy will continue to be one of the primary concerns.

Here, I would like to talk a little bit about the pricing system. To cope with the hike of the fuel price in international market, China adopted price management in order to maintain a relatively stable price level for low-income people. However, we are aware that China has to ease price control, given China's huge demand for commodities such as iron ore and crude oil imports, the government has been burdened by soaring subsidies due to the widening gap between domestic and international commodities prices. So deregulation and reform in energy prices should be a direction. Reform of energy and other related production factor prices should reflect demand and supply, production costs and environmental costs. Another point is that those who consume the energy should bear the costs instead of the producers. What we will do is to pursue a smooth transformation, rather than a one-off liberalization, to avoid sudden shock to the society.

For the second set of balance, policy bias will be given to sectors and enterprises, which upgrade their structure, and with the target of increasing efficiency of energy utilization and environment protection. Although banks will continue to conduct tight credit policy, there will be some difference. On the one hand, banks are encouraged to lend more to

SMEs and enterprises with a clear plan for technology innovation, energy saving and environment protection; on the other hand, heavy energy consumption, high pollution enterprises will find themselves difficult to obtain funds. Similarly, fiscal stimulus will also be used to serve the purpose for structural transition and improving welfare system.

To sum up, China is on its way of economic transition. Potential is huge, while challenges are also multiple. China's economy is getting more and more integrated into the world. It is hardly possible for China to be immune from the global instability. Global instability caused a lot of ripple effects in China. The challenge is to stabilize market and create a steady environment for continued economy growth. So far, China has been managing well. While in the meantime, the global instability also makes it imperative for China to conduct the structural changes that have been becoming more and more of a bottle-neck for sustained economic growth. We see economic hardship as an opportunity to conduct the changes.