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China

Rebalancing Growth and Managing Transition

Briefing Note

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1. Executive Summary

The current report provides an economic assessment of the Chinese economy taking both domestic and external perspectives into account. The list of analyzed policies is by no means exhaustive, but attempts to reflect the remit of the European Parliaments' ECON Committee.

Status Quo of the Chinese Economy:

- **Growth performance** in China has been **very strong**, averaging at about 9.5% annually for the last 20 years.
- **China is powerful in the aggregate** (6th largest economy in 2005), but still **poor in the disaggregate**. About 17% of the population still live under 1 USD a day.[1]
- The **"New Socialist Countryside Policy"** attempts to share growth and welfare more evenly between rural and urban areas and to take environmental considerations into account.
- China has a **double surplus** of both the current and the capital account which has led to an accumulation of foreign reserves totalling at ca. 1 trillion USD.
- Certain sectors (e.g. real estate, vehicles, and raw materials) may be in danger of developing overcapacities.
- **Monetary policy** is bound to the straitjacket of the de facto peg to the US-dollar. Excessive credit growth and large capital inflows have created a liquidity problem. The effectiveness of sterilization is difficult to assess.
- Allowing greater flexibility of the **exchange rate** would allow to guard against the risk of further increases in inflation and to more easily adapt monetary policy to domestic issues.
- **Financial Services** have started to progress to a market-oriented economy but issues remain on liquidity of markets and corporate governance as well as level playing field for foreign entrants.
- The **fiscal stance** is healthy, debt levels are low and the budget deficit is moderate.

Future Challenges:

- **Rebalancing growth**: a key objective of the 11th Five Year Plan (2006-2011) is to change China's pattern of growth from capital and resource driven growth to technology and knowledge driven growth.
- Taking **growth sustainability** aspects into account, especially with regard to environmental effects of radical growth.
- **Preventing social unrest** by better public governance especially on the local level, proactively fighting corruption among officials.
- **Managing the balance of payments** and the revaluation of the pegged exchange rate in an orderly manner.
- **Preventing trade disputes** with the US and the EU in the light of growing tensions with respect to Chinese compliance to WTO rules.

[1] The poverty line according to World Bank data and definition.

- **In financial services**, the active management of **non-performing loans** will be key to the development of a healthy banking system.
- The **development of insurance products** to complement state pensions will be key to Chinas welfare system.
- The **development of a more mature capital market** will help SME growth and corporate governance.
- **Retail banking**: the opening of the market in 2007 will bring expansion and foreign entrants to retail banking.

The following table **presents selected macroeconomic statistics** for China:

Table 1: Macroeconomic Statistics[2]

	2005	**2006 est.**
GDP (USD, billions)	2,234.1	2,554.2
GDP p.c. (USD)	1,708	1,943
GDP p.c. in PPP	7,198.4	8,004.1
GDP growth	10.2%	10.0%
Inflation (CPI)	1.8%	1.5%
Current Account Balance (% GDP)	7.2%	6.1%
Population	1,307 million	-

[2] IMF World Economic Outlook September 2006

2. General Economic Outlook

Harmonious Socialist Society

In March 2006 the National People's Congress launched a new policy, the so called **"New Socialist Countryside Policy",** incorporated into the 11th 5-year plan (2006-2011). The new policy plans an increased role for social and environmental questions, amending the purely growth-oriented strategy of the past years.

While the **main challenge of the government remains to lift its people out from poverty**, it is now widely accepted that this can no longer happen at the expense of increasing rural poverty, environmental damages and following social unrest. Massive funding is therefore planned for the countryside in form of subsidies and abolishment of ancient agricultural taxes, to name a few measures.

Motivated by numerous cases of social unrest caused by local government corruption cases, the Communist Party has also recognized that it needs to promote more morally sound governance among its own officials. This strategy took the form of **"eight virtues and eight disgraces"** by President Hu Jintao, listing a moral basis for harmonious socialist rule (covering issues such as patriotism, hard work and plain living).

Strong growth persisting

Economic growth in China has been rapid, averaging at ca. 9.5% in the last two decades.[3] This has practically meant a **doubling of national income about every 8 years.** It is likely that growth continues at the same pace, representing the most rapid and sustained economic transformation in the world economy in the last 50 years.

The IMF predicted China's economic growth would reach about 10 percent for both 2006 and 2007.[4] The Economist Intelligence Unit predicts 9.5% for 2006 and 8.1% for 2007.

Some sectors in danger of producing overcapacity

Inflation has remained low despite high investment and high growth levels. Production capacity in total expands in line with demand. Overcapacity in specific sectors (real estate, manufacturing, raw materials) is a major concern for Chinese policymakers. Many of these sectors are dominated by municipal and state enterprises.

Many Chinese provinces recorded investment growth of 35% in 2005.[5] Fear of overheating, calls to reduce investment by the government have become stronger during 2006. There has been particular resistance by local authorities to do this, e.g. many inefficient coal mines continue to operate. **Moderate growth would therefore**

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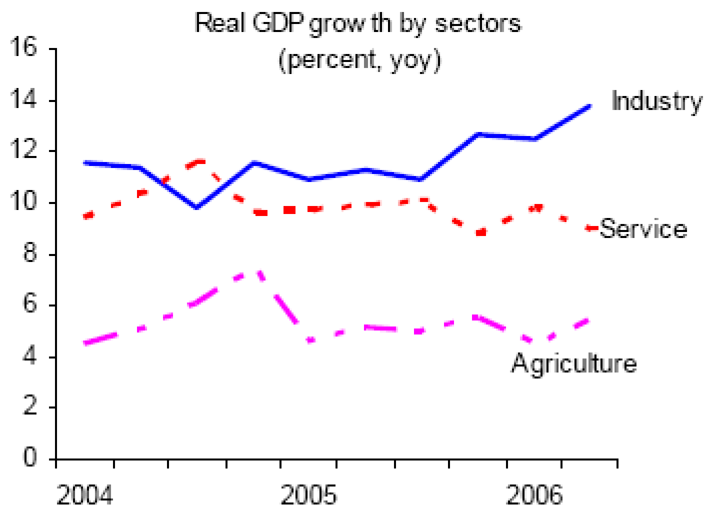
[3] IMF World Economic Outlook 2006
[4] IMF World Economic Outlook September 2006
[5] World Bank, Quarterly Update, August 2006

be desirable as the high investment boom coupled with losses and bad loans causes concerns about efficiency.

A key objective of the 11th Five Year Plan is to change China's pattern of growth from capital and resource driven growth to technology and knowledge driven growth. A shift of GDP growth towards the services sector would therefore be desirable, a development yet to emerge. The following graph displays the sources of GDP growth in China:

Figure 1:



Source: National Bureau of Statistics, World Bank

State owned enterprises

In general, **the number of loss-making state enterprises has been decreasing, although many inefficient companies still persist on the markets**. They account for less than one third of GDP (2005[6]). Counting the municipal firms (which are officially recorded as private), the state however continues to be the monopolist or the dominant player in most important markets, including steel, energy, automotives, transportation, banking and telecommunication.

Although some successes have been made in the past years in restructuring state enterprises and less state control, the bulk of the enterprises continues to be inefficient and indebted. In the past, the Chinese policy to manage this has been to simply let new companies emerge instead of actively restructuring existing ones. In this way, the importance of the state enterprises has declined. However, **the losses of state owned enterprises are covered by credits from state-owned banks**, which again find themselves under pressure to provide loans.[7] This explains the high amount of bad loans in the Chinese banking system (cf. chapter 4).

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[6] Siebert, Horst (2006): China, Understanding a new global economic player, Kiel Institute for World Economics Working Paper n° 1278

[7] Although most investment is financed from profit rather than credit, the repercussion of bad loans in these sectors is a possible source of trouble also for the banking sector.

Government promoting market forces

China has undergone numerous reforms in recent years on its way to become a full market economy:

- Price regulation was essentially dismantled in 2000.
- Changes to company law allow private ownership of limited liability companies.
- FDI has been facilitated (China accounts for ca. 9% of world FDI).[8]
- The state export trading monopoly has been abolished.

The private sector is the source of the majority of new jobs. The OECD describes the change in the ownership structures as "substantial".[9] It is estimated that around 60% of value-added is generated in the private sector (OECD).

Cooling down of the economy to prevent overheating

Monetary tightening by absorbing liquidity over the inter-bank market has become necessary to prevent overheating. Administrative measures have attempted to limit investment e.g. notably in the real estate sector, and capital controls have been loosened on outflows. However, these measures will take some time to have an effect on the real economy.

In addition, there is a fear of bad loans accumulating due to artificially low interest rates. The government raised benchmark interest rates in the spring and summer in order to counter strong credit growth.

However, too much slowdown in investment without simultaneous domestic consumption growth is not desirable due to its enhanced positive effect on the trade surplus.

The balance of payments remains a challenge

China has a large **"double surplus"** in both the current account and the capital account, resulting in strong accumulation of foreign reserves. The current account surplus is estimated to narrow from ca. 7.2% in 2005 to 5.2% in 2007, mainly due to the opening of the Chinese services sector abroad.[10]

As can be seen in Table 2 below illustrating the net Chinese investment position, **two thirds of foreign assets in China are in the form of foreign reserves**[11]. Holding enormous amounts of foreign reserves is not generally considered to be efficient due to their rather low rate of return. However, it seems that this policy, consisting to a large part of purchasing US-government treasury bonds is purely strategic as it helps to finance US consumption (of Chinese exports).

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[8] Figure from "A political and economic introduction to China, Research paper, The Library of House of Commons, 06/36, 19 June 2006"
[9] OECD Economic Survey, China, 2005
[10] Economist Intelligence Unit estimate, Country Report China, 2006
[11] Estimates in the Table for end of 2005. end of June estimate for reserves equals 941 billion USD (World Bank), the number is strongly approaching 1 trillion USD.

Table 2: China's International Investment Position (end-2005, USD bn)

Gross Foreign Assets	**1218.5**	**Gross Foreign Liabilities**	**930.7**
Equity	64.5	Equity	673.8
o.w. FDI	64.5	o.w. FDI	610.2
Debt	327.9	Debt	256.9
Reserves	825.7		
Net Foreign Assets	**287.5**		

Source: World Bank, State Administration of Foreign Exchange, China

Foreign FDI into China has been gradually facilitated, and recently whole ownership of firms by foreign investors was also allowed. Western style corporate governance is also slowly finding its way into China. Thus **two thirds of foreign liabilities is inward FDI**. In recent years, EU companies have invested considerably in China (new annual flows of utilised FDI of around USD 4.2 bn on average in the last 5 years), bringing stocks of EU FDI to over USD 35 bn.[12]

The high level of foreign reserves has induced a reform of capital controls, allowing qualified domestic companies to invest in world capital markets. The reform of May 2006 allows qualified domestic investment institutions (QDII) to invest in foreign equity and bonds. This should help to improve the composition and returns of foreign assets in China and thus reduce the pressure on monetary policy caused by the build-up of foreign reserves. This reform has indeed lead to a significant increase in outward investment turning the net capital account into surplus. As can be seen in the debt positions in Table 2, **China now is also a net creditor to the rest of the world.**

3. China in the World Economy

In many ways, China's growth is merely a re-emergence of past power. Until 1820 China accounted for 1/3 of world GDP. Today, **Chinas share in world GDP is about 16%.**[13]

3.1 Trade and composition of exports

Net trade boosted growth in China, and the trade surplus hit an all-time high in 2005. **Contrary to popular belief, China's trade is diversifying and moving up market**. It is no longer purely low-skilled labour-intensive production.

China now has an export basket that is significantly more sophisticated than other countries on a comparable level of development.[14] **27% of Chinese exports are already high-tech exports.** In this respect, China plays in the same league as Finland (24%), Japan (24%) and the US (31%), to name a few.[15]

[12] European Commission, DG Relex
[13] IMF World Economic Outlook Database, September 2006
[14] Dani Rodrik, (2006): What's so special about Chinas exports?, Harvard University Working Paper n° 11947
[15] According to World Bank classification, from Siebert, Horst (2006): China - Understanding a new global economic player, Kiel Institute for World Economics Working Paper n° 1278

In a paper analyzing Chinese exports, Dani Rodrik (2006)[16] from Harvard University concludes that **what matters for China's future growth is not the volume of exports or its relation to GDP, but the "quality" of exports**. China sells products that are associated with a productivity level much higher than "normal" for its income level. This helps understand why advanced economies so often consider China as a threat, because it increasingly moves into production segments occupied by them.

Active government policies have helped domestic production potential in electronics and other more advanced areas. **Does this imply a revival of classical industrial policies in China?** The answer is yes and no. The classic criticism against industrial policy is that governments are not able to "pick winners" and therefore should not even try. In the Chinese case however, not "picking winners" but "letting go of losers" might turn out to be a viable strategy. According to Rodrik (2006), this is also the more appropriate yardstick against which industrial policies should be measured.

3.2 Is China to blame for the US trade deficit?

The massive surplus in Chinas trade account has led to growing tensions with its trade partners. While voices from the EU have also repeatedly called for a Renminbi revaluation, US authorities have been particularly outspoken on the issue.

The US blames China for being largely responsible for its high current account deficit by artificially keeping the Renminbi undervalued. The Chinese counter these allegations by saying that the imbalance is caused by the US-ban on high-tech imports from China as well as the low domestic savings rate in the US, thus denying responsibility for the US-deficit.

Growing tensions have also been visible in trade negotiations between China and both the EU and US. Anti-China trade tariffs (Grassley-Baucus bill, Schumer-Graham bill) were widely debated in US Congress lately, but were ultimately dropped.

3.3 China and the WTO

After 15 years of negotiations, China acceded to the WTO 2001. However, it will still be treated as a non-market-economy in anti-dumping matters in WTO for 15 years.

Reviewing Chinese performance in 2006, **the WTO gave a generally positive assessment of Chinese trade policy.** It applauded growth in China, and critical comments included concerns about growing income disparities, resource constraints and environmental problems as well as over-reliance on low-skilled labour-intensive production and exports. Furthermore, reform in the financial sector was identified as critical.

China was subject to 16 anti-dumping measures in the first quarter of 2006 alone, some of them relating to the textiles disputes with the EU. The monitoring of China’s WTO compliance will be a major EU priority in the years to come, and it will be

[16] op.cit. Dani Rodrik, ref. 13

coupled with a number of EU assistance programmes designed to facilitate Chinese compliance with WTO rules.

3.4 EU-China Relations

In the EU, there is a growing perception that incomplete implementation of WTO obligations is becoming the main obstacle for EU-China relation. In general, China has not played a too active role in the WTO. **Peter Mandelson has repeatedly urged China to recognize its "pivotal role" for the world economy which "comes with duties and obligations**". Before some important anti-dumping questions are solved, the EU is unlikely to grant China the status of market economy in the WTO.

The "1985 EC-China Trade and Cooperation Agreement" remains the main legal base for economic relations with China. Since then, an important agreement is on customs cooperation (2004), facilitating trade and the fight against piracy and counterfeiting. New dialogues in intellectual property rights (IPR), enterprise policy, macroeconomic and financial issues are ongoing. **Intellectual property rights** concerns remain a priority for the EU. Although the Chinese government has lately started to take these concerns more seriously, much remains to be done.

In **competition policy**, China is in the process of developing many competition policies and to restructure its industries to make them more competitive. Since 2004, a structured dialogue between the EU and China has taken place to promote exchanges and cooperation between China and the EU.

China is the EU's 2nd biggest trade partner after the US. For China, the EU is the leading commercial partner, accounting for 19% of Chinese foreign trade. Whereas the EU-China trade balance was positive in 1980, it has since 2000 been grossly in deficit from an EU perspective, as demonstrated by the table below. This is currently the highest bilateral trade surplus China has with any trading partner in the world.

Table 3: EU-China Trade Statistics (€bn)

	2000	2001	2002	2003	2004	Average growth 2000-2004 (%)
EU25 Merchandise Trade with China					(millions of euros)	
Imports	74.369	81.619	89.606	105.397	126.737	+14.3
Exports	25.758	30.554	34.869	41.169	48.039	+16.9
Balance	-48.610	-51.065	-54.737	-64.228	-78.698	

Source: Eurostat

According to latest figures by DG Trade, the EU-China trade deficit reached a record 106 bn EUR in 2005, approaching the massive US-China trade deficit (approx 160 bn EUR).

Peter Mandelson has also warned China that if it does not open its markets more and allow **greater foreign competition in sectors such as agriculture and services** (construction, banking, telecommunication etc.), Europe will make use of the WTO dispute settlement mechanisms and might even lose some interest in engaging with the country. In a survey among European companies, the main concerns voiced were Chinas complex legal system and unfamiliar business environment, as well as its failure to enforce intellectual property rights.

4. Financial Services

China's accession to the WTO in December 2001 was highlighted by the promise to open closed domestic markets for services. Of those, the liberalisation of the banking system is the most complicated and fraught with pitfalls.

The East Asian crises in 1997/98 had already pre-warned the Chinese government regarding the vulnerability of China's banking system and it was clear urgent bank reform was needed especially in the non-performing loans areas. In 1998 the government shipped bad loans from the credit portfolio of the major state-owned commercial banks (SCBs) and consolidated them in asset management companies. It also injected large amounts of new capital into the SCBs**. The WTO deadline for elimination of all the restrictions on business activities in Financial Services is due to lapse in December 2006.**

This chapter will <u>not</u> deal with the historical narrative of the structure of Chinese financial services, (this has been covered by the Commission's briefing paper) but rather will highlight the most important issues in financial services that could be useful for ECON in their meetings.

4.1 Banking

Overall banking profits are set to grow at a rate of 10% p.a. to 2013 as a recent study of the McKinsey Quarterly stated.[17] McKinsey also estimates that personal lending products will grow by 30% per annum.[18] In 2013 banking profits will be 50% due to retail business.

Why should this be so? **Increased prosperity and a move to a more market-oriented economy will demand a boost for retail lending products, such as car loans, credit cards and mortgages.**

Demand for traditional corporate bank products will fall (deposits and straight bank loans) as Chinese companies are increasingly using centralised cash management systems and the capital markets instead of deposits for optimizing their spare cash. This has an effect on retail banking as it leads to further sophistication of banks in managing their assets and liabilities.

Chinese companies rely almost entirely on bank financing but by 2013 more and more will use the capital markets. Also the Chinese government, although slow in deregulation thus far, will proceed with the opening of the market and in 2006, has increased the momentum.

[17] The Mc Kinsey Quarterly 2006 special edition: Serving the Chinese Consumer
[18] Mc Kinsey: Retail Banking in China 2004

a) Retail Banking

There is a good possibility for foreign banks to tap into the Chinese market, especially that of affluent customers, which are highly concentrated geographically. 75% of the affluent customer base is in Beijing, Shanghai and Guangzhou. **This will facilitate access to this segment as they (chinese banks) lack risk assessment skills in retail lending and a sales service culture.**

It is therefore crucial for foreign banks to create wholly owned branch networks so as to allow expansion into the retail segment. Citibank and HSBC are building own networks, and in 2007 they will be free to offer local currency deposits and credit cards in Renminbi. **Credit card development in China will rise by 50% in 2013**[19]. In the beginning phase, partnerships can help as for foreign banks, the less affluent retail segment is very loyal to home grown banking names. This will change as customer confidence develops and attractive new banking products are coming onto the market. Chinese banks need foreign banks in developing customer databases tracking risk and profitability. **Local banks currently have no centralised customer data or risk control**. This potentially can lead to enormous risk; see the South Korean crisis of 2003 where many of biggest credit card issuers had to write off huge losses through lax risk controls and unfocussed marketing tactics.

HSBC has reached a partnership with Bank of Shanghai, teamed with Ping An Insurance to acquire a small bank in Fujian (Southeast) and is in final discussions with the Bank of Communications (Shanghai).

b) Lending to SMEs

The Chinese government is aware that SMEs are the backbone of their society's development and a series of actions are showing their commitment to help develop this sector;

- The China Bank Regulatory Commission has recently held a workshop on better lending to SMEs.
- New guidelines have been published in bank lending to small enterprises (2005).
- Local banks have been developing special teams and client score cards to streamline credit approval which was very slow and cumbersome.

Developing SME lending is of great significance for remote regions, which are lagging behind the great cities, in order to create a balanced economy. Hence the importance of risk analysis, streamlined services, performance assessment of loans and loan officers and good loan practices. In all of these, foreign banks can give example by good practice and work in partnership with the authorities.

c) Nonperforming Loans ("NPL"s)

The official outstanding percentage of **NPLs** in the total loan portfolio of Chinese banks is **7.53%[20], although the actual figure could be much higher.** The Chinese authorities have taken several measures to redeem the potentially explosive situation, leading to a decrease of 1.6% since the beginning of 2006.

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[19] Mc Kinsey Quarterly 2004.

[20] China Banking Regulatory Commission first half 2006 report.

Improvements:

- The Chinese Banking Regulatory Commission (CBRC) continues to guide banks to optimise loan portfolios and contain expensive NPLs.
- Increase focus on risk management and corporate governance.

Loan Portfolio management[21]:

- Chinese banks are also improving the liability structure as in the first half of 2006, short term loans exceeded mid/long term loans for the first time.
- **Increasing loans to SMEs (+14.7%) and consumers (+10.9%) year on year.**
- Fee based income increasing, up 46% year on year (increase in wealth management, which is also one of the top targets for foreign entrants.

However, further close control of NPLs is needed as they develop. How can this be done?

- First of all by establishing a culture of penalising bank officers, senior management in cases of fraudulent/ negligent lending decisions, going in some cases to revoking qualifications.
- Commercial banks need to **focus more on capital adequacy and reserves for loan losses; this can be enforced more by the Regulatory Authorities.**

It will be crucial to the Chinese economy and banking system to clean up the non performing loans. By the end of 2004 the NPLs had reached 13% (officially) although unofficial figures stated this figure to be more in the region of 30% of total assets![22]

So far, loyalty of Chinese customers has proved remarkably resilient keeping their deposits in technically insolvent banks. **Savings contribute 40% of GDP** and so are crucial to the economy. Chinese authorities have also demonstrated a willingness to avoid bank failures by injecting funds of USD 22.5 bn into both the Bank of China and the China Commercial Bank (CCB) (two state owned institutions weighed down by NPLs). However the founding of the asset management companies which took on large portions of the NPL portfolio has not yet been fully efficient as only a small portion of the loans transferred has been sold (this could be due to inexperience in selling off credit exposures, lack of a deep capital market and lack of securitisation).

It will be essential for the Regulators to manage the NPLs actively as, should the economy slow down dramatically, this might lead to a serious banking crisis. There will be a need to improve on corporate governance, cut state lending influence (i.e. more risk control) and make credit officers accountable.

Corporate governance[23]:

Regulators will need to contribute to the tightening of corporate governance by setting stricter standards for audit and risk control. It will also be essential to promote greater transparency regarding NPLs within the banks themselves, as this increases the likelihood of a loan being recognised quicker as non-performing and hence being able to build up reserves quicker. The new loan classification system has

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[21] IMF and Bank of Spain, China's Banking reform 2005, IMF Working Paper WP/06

[22] China Banking Regulatory Commission

[23] McKinsey Quarterly 2005: How to fix China's Banking system

helped to progress on these issues through the establishment of different risk classes. **The application of Basel II by 2010 is therefore a must**. Chinese regulatory authorities can learn from other South East Asian countries like South Korea in the setting up and application of an active performance and risk based system. This in turn will lead to a further opening of the market to foreign investors and avoid large scale systemic financial crisis.

4.2 Securities[24]

a) Regulatory Framework[25]

A few years ago the financial community speculated on whether the Shanghai Stock Exchange would overtake Hong Kong. This has not happened, why? Authorities seem to have been working on a gradual approach, developing a financial culture able to deal with an open market. Reforms such as share reform, opening the market in commercial papers and the allowing the use of derivatives has helped. Confidence remains weak, however, due to weak corporate governance and corruption issues (for example when the government had to shut down due to corruption, 30 out of the 130 brokerage firms).

There are, however, crucial issues between Western and Chinese philosophy in the capital markets which need to be resolved, one of which is the primacy of shareholder value (and hence of property), a concept that needs to grow in China. Good corporate governance aligns the interests of the firm's management with its owners, the shareholders. In order to ensure management operates correctly; different norms are prevalent in the US and the UK, for example the capital markets and the board of directors hold an overseeing function; whereas in Japan and Germany it has traditionally been banks and institutional investors. The Chinese industrial sector is in transition which means that ownership culture and corporate governance is still evolving. **The stock market is in a very immature stage, not equipped to provide effective corporate governance and the corporate bond market is in its infancy (very small and illiquid). Financing is therefore predominantly bank financing for 80 % (corporate bonds represented 1% and shares 3.9% in 2003).**

b) Share Reform

By the end of April 2006, 2/3 of Chinese shares have started to split. This is the first part of a process that started in 1992, as international investors have been allowed to invest in China's 'B' shares since then. In 2002, upgrading happened with the introduction of the Qualified Investor Scheme allowing limited ownership of 'A' shares (for more detail see Commission briefing paper). Even more important has been the opening of the market allowing foreign companies to take over Chinese listed companies (from 2002).

Servicing the institutional investors has been slower, although by the end of 2005, 20 joint venture fund management companies had been granted a licence. The two main laws applicable i.e. the Company Law and the Securities Law have both been amended end 2005 (effective as of 1 January 2006). The China Securities Regulatory

[24] China Securities Journal 2006 and World Economic Forum, China Business Summit 2006
[25] China Securities and Futures Markets report 2006 and Deutsche Bank Research March 2004: Enterprise Reform and Stock market development in mainland China

Commission ("CSRC") has also now published additional regulations, guidelines and codes protecting investors (2005 – creation of the Securities Investor Protection Fund).

The reform of non-tradable shares (which are state owned shares but account for 64% of total shares in the Chinese market, of which the State owns 75 %!) was necessary to solve issues of price distortion, diverging interest for different classes of shareholders in corporate governance issues and lack of product innovation, as well as thin illiquid markets. A listed company reforming its non-tradable shares will pay goodwill to the holders of tradable shares in return for the right to trade in its originally non-tradable shares. The price is determined by the different classes of shareholders subject to a vote in the shareholders meeting. By the end of March 2006, 768 listed companies had completed the reform (i.e. 57% of the total); the reform is expected to be complete by the end of 2006.

c) Off shore investors

The decision to allow offshore investing by commercial banks on behalf of their clients will have a big impact on financial reform, through the spreading of risk and raising returns on asset portfolios.

d) Initial Public Offering (IPOs)

At the end of 2005, listed companies in China had issued a total of 596.6 bn 'A' share raising RMB 858 bn. The 'B' share market is subscribed and traded in foreign currencies, which has been crucial in opening the market. At least 25% of the company's total shares must be floated unless the company's share capital exceeds RMB 400 million in which case this can be reduced to 15%.

Case Study[26]:

On October 16, 2006 the Industrial and Commercial Bank of China (ICBC) launched an IPO that looks set to be the world's biggest listing (in excess of USD 20bn). Out of the USD 20bn, more than USD 16 bn will be raised in Hong Kong showing the lead this Stock Exchange still has in retail/institutional investor demand over Shanghai. The IPO for this Bank was helped by the fact that its NPL portfolio was cleared up by the state, reducing it to 5.5%.

e) Bonds

Generally the issuance of bonds is controlled by to the government and not the CSRC. However convertible bonds and bonds of securities' companies are subject to approval of the CSRC.

f) Clearing and Settlement

At the end of 2005, the market capitalization of China's stock market reached RMB 3,243 bn or 18% of China's GDP. Tradable shares represented about 5.8% of that total and bonds including convertible bonds represented 5.9%

Trading is done through computer matching ("price precedence and time precedence" principle) but also through block trading and collective bidding. Securities companies

[26] Financial Times 17 October 2006-10-23

act as brokers and are paid not more than 3% of the trading value. Stamp duty is for both sellers and buyers (1% of trading value).

Clearing of securities is centralised through the China Securities Depository and Clearing Corporation (" CSDCC"). Settlement for A shares is T+1 and for B shares T+3.

g) Derivatives

Financial derivatives are still in their infancy, the only one used, warrants, are quoted on the Stock Exchange. Trading of Treasury futures was attempted for a brief period but halted mid 90's due to the lack of a clear regulatory framework. However, markets in China are changing and recent years have seen wide price fluctuations which should lead to the development of derivatives in order to manage risk and stability in portfolio management. The CSRC is pushing for the founding of a financial futures exchange in Shanghai.

h) General Securities

Corporate Governance issues essentially fall under article 4 of the Securities Law (M&A, information disclosure) and chapter 4 of the Company Law (directorship, board, shareholdings).

The CSRC joined International Organisation of Securities Commissions (IOSCO) in 1995 and has been on the Executive Committee since September 1998. The Shanghai and Shenzhen Stock Exchanges joined IOSCO as affiliate members in 1996.

In June 2004 the CSRC established a think tank; the International Advisory Council (IAC) consisting of 10 international experts. The mission of the IAC is to collect the advice of international experts regarding the reform and growth of China's capital markets and to keep the CSRC informed of global trends.

4.3 Insurance[27]

a) Foreign Entrants[28]

The regulator is the China Insurance regulatory Commission ("CIRC"). It has been trying to open the markets, however issues remain which prevent development. Regulation could be improved as in Banking and Securities especially in order to secure a level playing field for foreign insurers (i.e. on the establishment of branches and solvency requirements). It is crucial to have good lines of communication with CEIOPS as this will aid in clarification of outstanding points. Some of the outstanding points such as best practices on capital requirements for asset management companies and specialty insurance companies which are currently penalised when the company in question is foreign funded.

b) Pension reform and the role of Insurance[29]

[27] China Insurance Regulatory Commission paper 2006
[28] Insurance Working Group position paper 2006 on the Chinese Insurance industry
[29] Deutsche Bank Research February 2006: China's pension system

Where in banking and securities, the markets have benefited from a need for fresh capital, insurance is still in a stranglehold. Regulatory measures hold back foreign investment and development. **Yet issues such as China's pension time bomb, similar to the EU (ageing society with a pay-as-you-go system) need the input of EU insurance companies in order to address this issue.**

The government is aware that insurance can play a key role in social stability and progress. The life insurance industry will address these both for customers but also through using its assets in providing long term finance for infrastructure projects through private placements which are less onerous and rigid than the bond markets.

Regarding social welfare, currently China spends just 3% of its government budget on social welfare and the need will keep rising due to the one child policy which means that a working child will need to provide for 2 parents and 4 grandparents! Wage growth is limited in China due the vast supply of labour. China's pension profile resembles that of mature economies but combines this with a low median income level. European life insurers have long experience in the development of annuity schemes and could thus provide a much needed injection of knowledge into the Chinese Insurance market.

c) Asset investment of Insurance Companies

Long term assets of insurance companies should be more focussed to investing in long term infrastructure projects. **However for foreign insurers a relaxation of the rules regarding the setting up of insurance affiliated companies is extremely onerous** (for example at least 75% of the company has to be held by a Chinese registered insurance company). The insurance affiliated companies can only manage funds from its shareholders and insurance companies controlled by them. These conditions favour large domestic insurers over foreign entrants.

5. Currency Regime and Monetary Policy

5.1 The Renminbi

The People's Bank of China is responsible for maintaining the RMB exchange rate basically stable at an adaptive and equilibrium level, so as to promote the basic equilibrium of the balance of payments and safeguard macroeconomic and financial stability.

Public Announcement of the People's Bank of China No. 1(2006)

Renminbi or Yuan?

The renminbi (literally "people's currency") or the yuan (literally "round", after the round shape of ancient Chinese coins) is the official currency of the People's Republic of China. It is issued by the Chinese central bank, the People's Bank of China (PBC). The official abbreviation is CNY, although the abbreviation RMB is also commonly used. The symbol is ¥.

The Chinese currency itself is called renminbi, i.e. this is the denomination of the currency that is then used vis-à-vis the external world. Yuan is a measure word for money. The yuan is the basic unit of the renminbi, as the dollar is the basic unit of the US currency. In the Chinese language, yuan is in fact the base unit of a currency; for example, the US dollar is translated as Mei yuan.

One yuan is divided into 10 jiao, and one jiao is divided into 10 fen. So 3.45 yuan would be spoken of as "3 yuan 4 jiao 5 fen", as opposed to "3 yuan 45 fen". In colloquial usage, other names are frequently employed for the different units.

The renminbi (RMB) was first issued shortly before the Communist Party took over power in China **in 1949**. One of the first tasks of the new government was to end hyperinflation that had plagued China near the end of the Kuomintang era. A currency reform occurred in 1955 with the old yuan being exchanged at the rate of 1 new (renminbi) yuan = 10,000 old yuan.

During the era **prior to the opening of the economy, the value of the RMB was set to unrealistic values** in exchange with western currency and severe currency exchange rules were put in place. With the opening of the Chinese economy in 1978, a dual track currency system was put in place. The RMB could only be used domestically, and foreigners had to use foreign exchange certificates. The unrealistic artificial exchange rates led to a strong black market for currency.

In the late 1980s and early 1990s, China made efforts to make the RMB more convertible. Through the use of swap centres, the exchange rate was brought to realistic levels. The dual track currency system was subsequently abolished.

In **1994 the Chinese currency was devalued** from 5.8 to 8.3 RMB/USD. This decline preceded the devaluation of further East Asian currency in the wake of the 1997 crisis by some time and was principally an adjustment of official rates to market rates.

Since 1995 the RMB has been maintained at a fixed parity relative to the US dollar in what was officially classified as a managed float with a 0.3% range around the central parity. In practice, however, the rate remained fixed and the system was in effect a hard peg to the dollar.

After 1997 other exchange rates with the dollar in East Asia adjusted downwards generally being aligned with the Chinese currency (with the exception of the Hong Kong, Singapore and Indonesia). **By 2003 the real exchange rates for China and most other East Asian countries were about half the level of ten years earlier** suggesting that exports from this region had by that time become supported by a substantial real depreciation of exchange rates.

Intervention to maintain a stable exchange rate against the dollar started in 2001 and has been large in scale since with reserves rising to 32% of GDP by end 2004. **China's foreign reserves are now the largest in the world** having overtaken Japan's in February 2006 and totalling almost 1 trillion dollars. **Intervention has been effective in stabilizing the nominal exchange rate** allowing a depreciation of the real effective exchange rate.

On 21 July 2005 the RMB was appreciated by 2.1% relative to the US Dollar. At the same time, the government announced that the **Chinese currency would now be managed in a managed float against a basket of currencies** the composition of which initially was not revealed and the weighting of currencies included remaining secret.[30]

[30] China subsequently revealed the composition of the basket: Major currencies are the US dollar, euro, yen and Korean won. Smaller currencies are the Singapore dollar, pound sterling, Malaysian ringgit, rouble, Australian dollar, Thai baht and Canadian dollar. The weightings are based on the trade flows which means the US dollar will remain to dominate. Some sources estimate the following weightings: US dollar 52%, euro 15%, yen 13%, won 8%, all others around 2%.

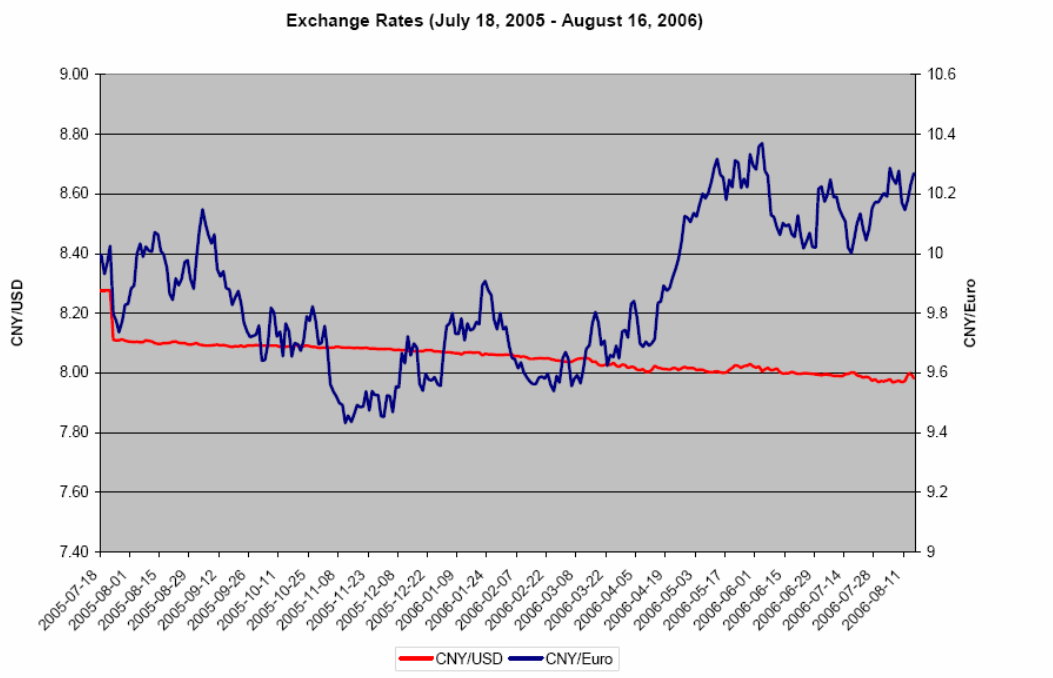
This regime allows for fluctuations up to 0.3% around the central parity against the US Dollar. In theory, such drift could appear every day allowing for significant appreciation/depreciation. However, in practice, **the RMB has barely moved against the dollar since** then, showing only a modest appreciation. There is also little evidence of pegging to a basket, rather the RMB continues to closely track the dollar.

Some sources expect the appreciation to accelerate for the remainder of this year as the institutional structure is now in place for more flexible trading and the PBC has gained the reputation of being willing to defend the new system against speculation with political pressures and movement in the dollar exchange rate possibly complicating the trend. **Estimates set the average rate for the RMB at 7.90 RMB/USD for 2006.**[31] On 18 October 2006 the exchange rate stood at 7.90770 RMB/USD.

Between the exchange rate regime reform on 21 July 2005 and 31 July 2006, the accumulative appreciation of the RMB exchange rate against the US dollar was 3.8%, the accumulative depreciation of the RMB against the euro 1.5%.

The following graph illustrates the development of the RMB exchange rate in relation to the dollar and the euro. The difference in development of the two exchange rates is striking with the dollar rate staying more or less stable with a slight appreciation of the RMB while the **RMB is clearly depreciating against the euro –** a result of fixing the RMB rate to the dollar: as the dollar depreciated against the euro, the RMB had to follow suit.

Figure 2: Exchange Rates CNY vs. USD and EUR



31 Economist Intelligence Unit, China Country Report, June 2006.

Source: Testimony of Brad Setser before the US-China Economic and Security Review Commission[32]

The following table lists some benefits and problems of fixing the RMB exchange rate to the dollar:[33]

Benefits	***Problems***
If a peg is credible, speculation will be discouraged.	The peg limits the independence of monetary policy contributing to pronounced macroeconomic fluctuations in recent years.
The peg is serving as a price anchor.	The resulting monetary expansion is fuelling inflationary pressures and excessive fixed asset investment.
	The peg can fuel protectionist measures in the US and elsewhere.[34]

Is the Renminbi undervalued?

There is **widespread consensus in the literature that the RMB is undervalued** although some literature maintains that this is not the case. China's capital controls clearly complicate the analysis if the exchange rate. Estimations of the undervaluation hence vary between 0% and more than 80% according to the methodology used to carry out the estimations. The following table gives some examples on the possible undervaluation:

Approach	***Short description***	***Estimated undervaluation***
Underlying balance approach	What level of the real effective (trade-weighted) exchange rate would produce an equilibrium in which the underlying current account position is approximately equal and opposite in sign to the normal net capital flows?	20-40%
Comparison of purchasing power	based on discrepancies between market- and PPP-adjusted income	83%
Alternate unit value approach	Sectoral unit value ratios compare the unit value of output in the total manufacturing and major production sectors between China and the US	results differ greatly by sector, e.g. just above 50% in textiles, but only just above 10% in transport equipment[35]

[32]http://www.uscc.gov/hearings/2006hearings/written_testimonies/06_08_22_23wrts/06_08_22_23_setser_brad.pdf
[33] As discussed in the literature, namely Laurenceson, Qin (2005): China's exchange rate policy: The case against abandoning the dollar peg, Tilburg University Working Paper
[34] See, for instance, the Schumer-Graham and Grassley-Baucus bills in the US Senate.
[35] Data from "Bai et al (2001): A new benchmark comparison of manufacturing productivity, China-USA, 1995", data refers to 1995 but it is found likely that relative values have not greatly changed since.

Goldstein and Lardy (2006) find that taking a broad view at the evidence across several methodologies; **it looks like the RMB is undervalued in real, trade-weighted terms by 20-35%**.[36]

5.2 Consequences of the exchange rate policy for monetary policy

> *The objective of the monetary policy is to maintain the stability of the value of the currency and thereby promote economic growth.*
> People's Bank of China Monetary Policy Objective

The ability of the Chinese central bank to run an **independent monetary policy has been limited by the exchange rate policy** which means that in its policy, in order to remain credible, the bank has to defend the exchange rate which may be to the detriment of its fight against inflation.

Primary Instruments of Monetary Policy used by the PBC:[37]

- **Open market operations**
- **Changes in the discount rate and reserve requirements**
  Reserve requirements have recently been used quite extensively being raised to 8.5% on 15 August 2006 intended to control the lending growth and liquidity problem.
- So-called **"window guidance"** (administrative measures)
  Keeping the banks from excessive lending and thus fuelling the investment growth has required the growing use of administrative controls. Base deposit and lending rates of the state banks have traditionally been set by the PCB with prior approval of the State Council.

In its latest move on the benchmark one-year lending rate the **PBC lifted this rate from 5.85 to 6.12% while increasing the deposit rate from 2.25 to 2.52%** in August 2006 in order to discourage demand for further borrowing thus limiting the excessive credit growth and dampening overinvestment. However, question marks remain over the effectiveness of such moves. **Banks still face few risks associated with lending** as the state is still expected to shoulder the burden of non-performing loans. This problem may lead to **"window guidance" taking on a more prominent role** as the authorities will try to control the application of the administrative measures more tightly seeing that in the past such guidance was not always effective due to conflicting interests at national and regional levels.

Large double surplus in the balance of payments

Excessive credit growth and large capital inflows have created a domestic liquidity problem particularly fuelled by the large balance-of-payment surplus (160.818 billion USD equalling 7.2% of GDP at end 2005). The current-account surplus is mainly driven by the trade surplus and a shift from deficit into surplus in the capital balance that occurred between 2004 and 2005 itself derived from Chinese investments in foreign assets including foreign exchange reserves. The government is

[36] Morris Goldstein, Nicholas Lardy (2006): China's exchange rate policy dilemma, Institute for International Economics Working Paper, Washington.
[37] Marvin Goodfried and Eswar Prasad (2006): A Framework for Independent Monetary Policy in China, IMF Working Paper WP06/111, Washington.

encouraging such investment both for strategic reasons as well as a possible way to reduce the domestic liquidity.

Boosted by the surpluses, **China's foreign exchange reserves have soared and are by now (September 2006) the largest in the world with USD 987.9 billion (€788 billion)**. Besides serving as a means to reduce domestic liquidity, these may also be needed as a signal to speculators that China's central bank has the necessary reserves to defend the RMB exchange rate against speculation and may sustain such defence for a protracted period.

The USD that China buys on the market are deposited in the international banking system as they are used to buy US securities, USD-denominated securities of other countries as well as other reserve currencies. Such flows tend to keep US interest rates lower than they would have otherwise been. **A US Treasury survey suggests that US interest rates have been lowered by between 30 and 40 basis points due to this development.**[38]

Sterilization

The purchase of USD on the foreign exchange market in interventions aiming to fix the exchange rate injects Chinese currency into the economy. **The authorities have attempted to isolate the economy from this effect and large capital inflows through a policy of sterilization.**

The percentage of reserves that could be sterilized and the effectiveness of sterilization have varied over the past few years and different figures show up in the literature as it is not straightforward to assess how much sterilization has taken place. **The primary instrument for sterilization is now the issuance of PCB bills**, changes in the reserve ratio of banks are another instrument. China's underdeveloped domestic bond markets and regulated interest rates, however, significantly limit the extent to which bonds can be absorbed in practice.[39]

Inflation

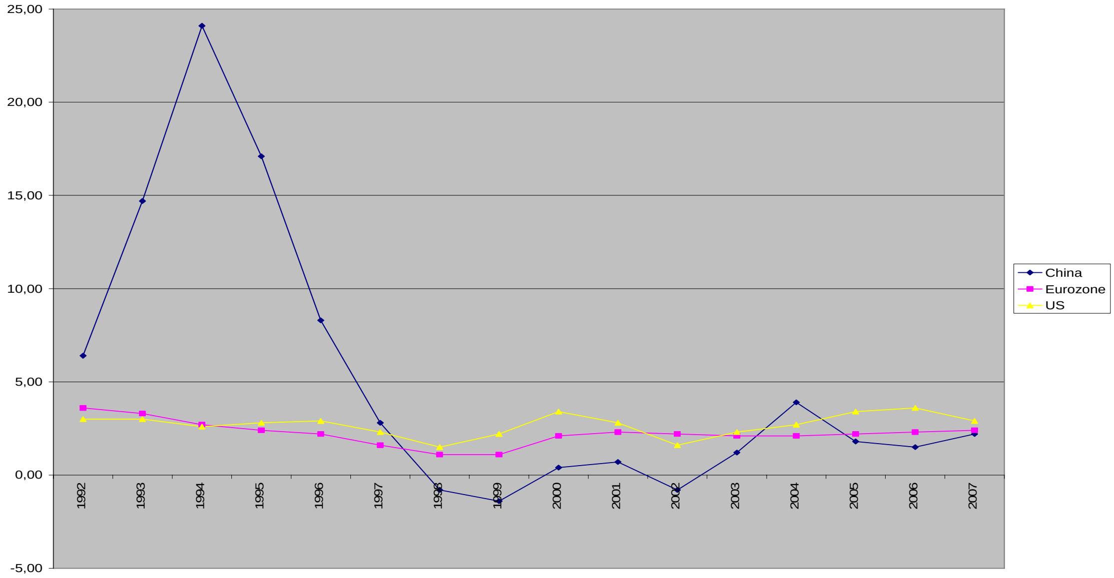
The PBC has the objective of maintaining the stability of the value of the currency. With respect to inflation this aim is being increasingly achieved. The average yearly inflation rate was 1.2% in the period 2000 to 2005.[40] However, **the inflation rate has been much more volatile than in other areas.** The relatively fixed exchange rate to the dollar has exposed the economy to inflationary and deflationary impulses stemming from fluctuations in the effective exchange rate of the dollar. The graph below illustrates the volatility in comparison to the US and the Euro zone.

[38] Testimony of Brad Setser before the US-China Economic and Security Review Commission, August 2006.

[39] Laurenceson, Qin (2005): China's exchange rate policy: The case against abandoning the dollar peg, Tilburg University Working Paper.

[40] Calculation based on IMF annual data.

Figure 3: Inflation in China, 1992-2006



Source: IMF World Economic Outlook, September 2006.

The variability of inflation is to a large extent linked to the conduct of monetary policy, though other factors such as the high weight of food in the Chinese consumer price index may play a small role too. Higher food, oil and commodity prices lead to a marked increase in inflation in 2004. **Downward pressure on prices is coming from overcapacities in certain sectors** leading to oversupply. On the other hand**, increases in state-controlled prices** such as water and power are expected to filter through in the coming few months **posing an upward risk**.

How could monetary policy become more effective domestically?

The authorities have started to develop foreign exchange and derivatives markets in line with the policy of increasing the use of market-based instruments to control the monetary environment. **Allowing greater flexibility of the exchange rate would allow the authorities to guard against the risk of further increases in inflation and to more easily adapt monetary policy to domestic issues.** Market forces could then also play a greater role in determining bank interest rates.

6. Fiscal Policy

6.1 Fiscal Stance

The **general government budget deficit for 2005 is 1.8%** (IMF, 2006). The IMF forecast for 2006 estimates 1.5%.

High levels of GDP growth ease the pressure on public finances in the short term. The **level of public debt is fairly low at 23.5% of GDP** (OECD, 2005).

In the medium and long-term, however, the government is expected to **increase spending on social welfare and development of rural areas** in line with the "rebalancing growth" strategy. In order to smooth social pressures ahead of the Communist Party Congress in 2007 and the Olympic Games in 2008 in Beijing, spending is also expected to increase leaving the budget deficit at an **estimated 2.7% for 2007**.[41]

Public Expenditure: Relative to OECD levels, public spending as percent of GDP is rather low at 26% (OECD, 2005) owing to less developed social transfers. The OECD proposes that public spending may also need a shift away from capital spending towards more education and health spending.

Government Revenue: Revenue stands at ca. 25% of GDP (OECD, 2005). Taxation has been kept low and has generally taken a pro-growth stance. However, the OECD still states that in the medium term, corporate tax rates do need to be lowered as do the high marginal tax rates on labour (45% top rate, albeit low average rate). The following tables presents a source based account of Chinese government revenue:

Table 4: Sources of Tax Revenue, OECD and China (in % of GDP)

	Direct Taxes (DT)	DT Households	DT Business	**Indirect Taxes**	VAT	Other Ind.	**Social Security**
OECD average	**34.7**	25.0	8.2	**30.2**	18.4	7.7	**28.4**
China	**34.8**	9.2	23.4	**42.8**	32.3	2.8	**19.5**

Source: OECD, 2005

As can be seen, the share of direct taxation in China is about the same as the OECD average, albeit starkly skewed towards corporate taxation, whereas the OECD countries rely more on household taxation. The major single source of revenue is VAT, and indirect taxation in general is the highest contribution in terms of tax revenue.

6.2 Challenges for Public Finances

Shifting expenditure from capital spending to social spending: In international comparison, China spends just over 5% of GDP on culture, education, health and science whereas the OECD average is over 13%. At the same time, expenditure for capital formation and gross fixed capital run at ca. 10% of GDP, whereas the OECD average is about 3%. Managing this shift is one of the central challenges.

Fiscal decentralization: Expenditure is much more decentralized than revenue, making regional governments more dependent on transfers. Improving accountability and bringing expenditure responsibilities in line with financial resources at the local level is one of the biggest challenges for Chinese public finances in the future.

Although at present fiscal policies and taxation are not in the forefront of reform, this may become necessary in the medium and long-term, when more and more citizens rise into higher income classes.

[41] Economist Intelligence Unit (2006) estimate.

7. Challenges Ahead

7.1 Internal: Rebalancing the growth patterns

Overcapacity in certain sectors makes concerns about efficiency legitimate. The high investment pattern gives rise to a capital stock that might not be viable in the long run as interest rates are distorted downwards. To correct this, demand reducing measures as such are however dangerous as a slowdown alone would lower imports and contribute to an even worse current account imbalance.

- **The macroeconomic challenges** therefore include the following:

On the supply side: rebalancing growth away from industry to the services sector.
On the demand side: enhancing domestic consumption to take pressure from exports and investment as growth drivers.
Changing China's pattern of growth from capital and resource driven growth to technology and knowledge driven growth is the nut-shell of all challenges.

- **On the social side, more equally shared growth between urban and rural areas and more environmentally sustainable growth is desirable**.

The New Socialist Countryside Policy foresees measures toward the poorer western and central provinces and the poorer sections of the population.

7.2 External: Imbalances in Current Accounts

The main potential danger scenarios are a sharper than expected slowdown of the US economy together with a disorderly resolution of global imbalances. Both these scenarios could damage large parts of Chinese exports in an abrupt manner which would certainly be undesirable.

All challenges need to be tackled with a combination of monetary and exchange rate policy, fiscal policy and institutional reform. In international discussions, there seems to be wide-ranging consensus on the necessary first steps. Although long-term policies (such as growth rebalancing) take a long time to be effective, there is a certain overlap between short-term and long term policies:

The case for the currency revaluation: The case for a stronger (and more flexible) exchange rate is imminent. Various studies confirm that the Chinese renminbi is undervalued at present. A stronger exchange rate could help to dampen domestic growth and lower the current account surplus at the same time, measures that could be very healthy.

Especially, a stronger exchange rate would also make the non-tradable sector (services) more attractive, thus helping the rebalancing of the economy. Also, it would take pressure from future appreciation expectations and thus mitigate capital inflows.

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