China International Financial Services Convention and Expo

The Financial System and Economic Development: Challenges and Opportunities for China

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It has been an enriching experience to attend this conference and hear many views and opinions on China's economy. I have been asked today to look at some of the changes in the global economy and what implications this has for future development in China.

We are living in an unusual period in history in that today there is only one world economic superpower, the USA.

It is unusual because at almost any date in history there have been two, or more, economic superpowers co-existing. And for probably 18 out of the last 20 centuries, one of them has been China.

Indeed, China has been the world's largest economy for most of recorded history. People in Europe are very aware of the glory that was Rome. But they tend to overlook the fact that the contemporary Han Dynasty was comparable in size, population and wealth.

unparalleled achievement

And for maybe 15 of the last 20 centuries, China's GDP per capita was higher than Europe's. In 1820, China with just over a third of the world's population was responsible for around a third of global GDP.

We are living today in a period where China is re-emerging as an economic superpower. Since China took the decision to reform its economy 25 years ago, its progress has been astonishing, and, of course, widely discussed. 1.3 billion people with a real per capita income seven times that of 1978 is an unparalleled achievement.

Today, China is the world's manufacturer. There is not a manufacturer in the world that is not either manufacturing in China, sourcing in China, or thinking about it.

The variety of goods manufactured in China now ranges from the most basic through to the most sophisticated. And of course as a result, China is a major consumer.

Let me quote from the Asian Development Bank 2004 report on China.

"It is the world's biggest consumer of copper, tin, zinc, platinum, steel and iron ore; second biggest of aluminium and lead; third largest of nickel... It is now the world's second-largest oil consumer [after the United States], and accounted for 35 percent of the global rise in oil demand in 2003."

China also produces 50 percent of the world's cameras, 30 percent of air conditioners and TVs and 25 percent of washing machines.

And there are any number of forecasts about when China will become the world's largest economy, measured by GDP. We do not know exactly when it will happen, but I think the consensus is clear that it will. There is even a Goldman Sachs report that puts the year at a rather exact 2039. China is already the sixth-largest economy and at the present rate of development will overtake Britain and France in the next year or two.

We should be explicit that we are talking in absolute terms, not GDP per capita. Clearly, for China to approach the GDP per capita of the West is a rather longer-term undertaking.

And it is also clear that the emergence of China, and Asia more generally, alongside the US, Japan and Europe means the world will be a more multiplex place than before.

This is a consequence of the interacting forces of globalisation where the free flow of capital, and advances in technology, transportation and communications, combine with deregulation to increase the development of trade and services around the world.

One striking feature of this multiplex world is that China's economic development is becoming closely integrated with the global economy. For instance in 2003, of the top 200 exporters in China, 99 were foreign-invested with names Motorola, Nokia, Dell and Siemens prominent.

The WTO and its predecessors have played an important role in the process of globalisation and China's accession to the WTO will be an important factor in its continued development.

The typical pattern for the transition from developing to developed economy is for growth to be based initially on trade and, particularly, exports. This often attracts capital for investment in the form of FDI, which creates the infrastructure for further trade. There is also an increase in the complexity and sophistication of goods traded, as investment upgrades manufacturing capabilities and more sophisticated skills are acquired.

But at some stage a new phase of domestic consumption begins. The workers who create the goods and services themselves become the market.

One classic example of this is perhaps that of Henry Ford. In 1914, the founder of the Ford Motor Company effectively doubled his workers' wages to US$5 a day. Together with increases in productivity that reduced the cost of his Model T from over US$800 in 1908 to around US$400 in 1914, he created a mass consumption society where workers could afford to buy the products that they were making.

We have seen the same pattern of workers becoming affluent consumers in Asia over the past 50 years; in Japan, in Hong Kong, Singapore, Malaysia and many others.

Given its size, it is clear that the potential in China's domestic market is the largest in history. That is a major part of the reason why China is the world's favourite destination for FDI and why the world's manufacturers are not only sourcing goods for export, but looking at the domestic market.

The development of a major consumer market is an inevitable and important consequence of China's position as the world's manufacturer. The creation of over 10 million jobs a year to absorb new entrants into the urban private-sector labour-market is of course a significant challenge, but it is also one with significant opportunities.

It is clear that many companies here in China, both domestic and foreign, recognise the potential in the domestic market. Already, companies like Philips, the electronics producer, sell a third of their US$4 billion production domestically. And Dell, the US computer maker, says that local demand is so strong that its Chinese plant produces computers almost exclusively for local markets. Indeed, the challenge now for many manufacturers is the creation of domestic distribution networks that allow access to the burgeoning consumer market.

Where the distribution networks exist, manufacturers see huge potential. The commitments made recently by companies like Volkswagen, General Motors and Ford to increase capacity, demonstrate this, even in a market that the Wall Street Journal described recently as being in a slump.

What they actually meant was that sales growth in autos was down in April from May, and has only increased 21 per cent for the first five months of the year, compared to the 75 per cent growth of 2003. We would all like to be in businesses with "slumps" like this!

There is one important implication of the development of this consumer market that I would like to look at specifically: namely the challenge for the country's capital markets and banking system. China is a country with one of world's highest savings' rates, often quoted at 40 per cent, which is high even in a region with high savings' rates.

It also has about a third of the US$1.2 trillion of central bank foreign exchange reserves which sit in Asia (not including Japan).

significant opportunities

This has very positive implications for China.

Access to capital is not an issue for China today. China is, of course, a significant beneficiary of FDI, forecast by the Institute of International Finance at over US$50 billion this year.

As China grows, its high savings' rate will inevitably mean the creation of ever-larger pools of investible domestic capital, alongside the huge inflow of FDI and a strong reserve position. This creates a huge opportunity.

To give some idea of the size of that opportunity, today US household financial assets stand at around US$34 trillion and Chinese household savings deposits at US$1.4 trillion.

Chinese assets are growing at 18 per cent per year; US assets at 7 per cent. At those rates, Chinese assets will match American assets in 33 years. Of course, the rates may well vary and the Chinese figures exclude assets like shares so I don't use these figures as an accurate prediction, but rather as a directional guide.

What this means is that there is a great opportunity for China to mobilise this domestic capital to complement the inflow of external capital.

The challenge here is for this pool of savings to be recycled and invested efficiently. In the next few years we expect to see the emergence of more sophisticated capital markets in China to handle the process of intermediation efficiently.

We are already beginning to see the emergence of a wide range of new financial markets and structures. At the moment about 90 per cent of the funds raised in the equity markets and 100 per cent in the bond market go to SOEs and the public sector. It is clear that the private sector will need to develop mechanisms for accessing capital other than through FDI. So we can expect to see further development of the domestic bond and equity markets.

Already plans are in step for the unification of interbank and stock exchange bond trading to create a better bond market platform.

And the development of deeper and more liquid markets will be aided by an increase in bond market participants, such as social security funds and housing foundations.

The authorities' plans also include the introduction of futures contracts and other derivatives to promote better risk management and the further reform of domestic interest rate trading, alongside the creation of more liquid money markets.

innovative techniques

Especially important is the decision to replace annual quotas of government bond issuance with a system of managing debt more actively. The issuance of short and medium-term bonds will create more financial instruments and therefore more policy options for the People's Bank of China in the management of the monetary supply-demand equation. The creation of a liquid interest-rate market with a full spectrum of interest rates - short, medium and long-term - creates the ability to manage the economy with more policy options for flexible control of the financial environment than are available today.

We can also expect to see similar forward-thinking developments in equity and associated markets designed to create the deep, liquid markets necessary for efficient capital allocation and for wider access to equity funding for the non state-owned sector.

Going hand-in-hand with development of the capital markets will be the development and reform of the domestic banking system, so that it can play an effective role in managing savings efficiently and in balancing demand between competing users of credit.

The process of transition to an efficient banking system has been accelerated by WTO membership with its roadmap for completing reform. We should remember that the recent role of the banking system has not been solely to pursue commercial banking objectives, but also as an important mechanism in mitigating the effects of change on workers in the SOEs in a state of transition.

This social role has been very successful but, going forward, for the banking system to support the economy more efficiently, it needs to allocate capital in ways which generate a good economic return.

The recent decision to recapitalise two of the major state banks as a precursor for corporatisation and stock market listing of state banks demonstrated the authorities' resolve to reform the banking system for the benefit of the country's long-term economic development. China is adopting and developing innovative techniques to manage the banks' historic non-performing loan problems, such as their sale to foreign buyers and their auction domestically, and it is clear that significant progress is being made in strengthening balance sheets.

The process of working out the non-performing loans in the banking system is, of course, important and necessary, but the authorities also recognise that it will have to be accompanied by reforms in corporate governance and management in order to ensure that credit decisions are based on a sound commercial basis in future, thus avoiding a new generation of non-performing loans.

This has implications for the continued development of legal infrastructure; corporate governance; credit control; liquidity control systems; risk management; in fact all aspects of modern commercially-focused banking practice.

Forgive me for making the point here that just as China has accessed foreign know-how, as well as capital, in the creation of its manufacturing industries, so it makes sense in a knowledge-intensive business like banking for China to learn from, and make best use of international experience.

We certainly welcome the decision to raise the permitted level of total foreign participation in domestic banks to 25 per cent.

What is at stake is of enormous importance for China. It is critically important to ensure a healthy and dynamic banking system for sustainable economic development and employment creation. Weak banking systems sooner or later hobble the real economy; we can see this by looking at countries at very different stages of development who have had difficult experiences. I think of Russia and Japan as two recent and very different examples.

Let me end with a brief summary. Today is a transitional period in the global economy. It is clear that China is in the process of re-emerging as an economic superpower, as is its rightful place in history.

The structure of the global economy and trade imperatives increasingly necessitate the development of sound financial infrastructure to support economic development. The development of capital markets goes hand-in-hand with the development of a banking system that intermediates between the sources and users of capital in a transparent and efficient manner.

It is clear that China's policy development is forward-looking and there is a roadmap in place to show the way. What is also abundantly clear is that China is extremely well-equipped to manage this process, I hope with a little bit of help from its friends.