THE IFF CHINA REPORT 2016

Insight and opinion from China's top leaders, policy-makers and financiers

- Transforming China's growth model through structural reform
- Financial deepening and market reform
- International trade, investment and development co-operation
- The renminbi and the international monetary system

In asscociation with:

CENTRAL BANKING

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HRH Prince Turki bin Abdullah bin Abdulaziz Al-Saud is co-chairman of the IFF Fund Committee and former governor of Riyadh in the Kingdom of Saudi Arabia.

HRH Prince Turki bin Abdullah was a military officer and a jet pilot at the Royal Saudi Air Force. He is also head of the board of directors of the Saudi Equestrian Fund. He was appointed deputy governor of Riyadh province on February 14, 2013, replacing HRH Prince Muhammad bin Saad. On May 14, 2014, he was appointed as governor of Riyadh at rank of minister.

HRH prince Turki bin Abdullah graduated from Lackland Air Force Base in Texas, USA. He was also trained at King Fahd Air Base in Taif. He holds master's degrees in both military science and strategic studies. He is a PhD candidate in international strategic studies at the University of Leeds.

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Welcoming remarks

Following the success of the *IFF China Report 2015*, we are pleased to introduce the *IFF China Report 2016* to our readers.

Since 2015, economic and financial reforms in China and the rest of the world have entered a critical period of transformation. China's presidency of G20 in 2016, the Belt and Road Initiative, the launch of the Asian Infrastructure Investment Bank and other initiatives have brought new opportunities and changes in world economic growth and financial reform.

In the first year of the Thirteenth Five-Year Plan, how can the Chinese economy achieve its goals in the midst of an ever-changing international landscape and domestic reform? What are the uncertainties and obstacles? Given the continuous adjustment and impact of international politics, economics, and science and technology, the journey towards strengthening multilateral cooperation, reforming the financial framework and enhancing economic development has become the major focus for China and for global growth.

This report, drafted by the International Finance Forum and published in collaboration with Incisive Media's *Central Banking*, collates views and perspectives on China's development from top Chinese leaders, policy-makers and financial experts during the past year. It provides readers with a unique insight into the inner workings of China's economic development and financial reform.

The *IFF China Report 2016* comprises four sections: the transformation of China's Growth model; financial deepening and market reform; international trade, investment and co-operation development; and the internationalisation of the renminbi and its impact on the monetary system. Each section contains a series of analytical articles reviewing the scope of the relevant topics, as well as interviews and contributions by leading decision-makers and experts on more specific aspects.

We are, once again, privileged and grateful for the support of global leaders, policy-makers, finance experts, business leaders, politicians and scholars who supported the publication of this report. We would like to give special thanks to HRH Prince Turki bin Abdullah bin Abdulaziz Al-Saud for his patronage of this report and its related events.

The aim is to offer readers a thorough understanding of the situation and challenges China faces as it embarks on the next phase of its economic transformation during the Thirteenth Five-Year Plan. We are thankful for your interest in the report and hope it provides you with important insights and a fresh outlook.

Zhang Jizhong
Executive director and secretary general, IFF

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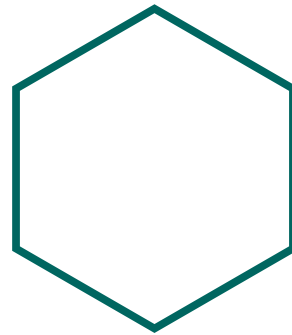

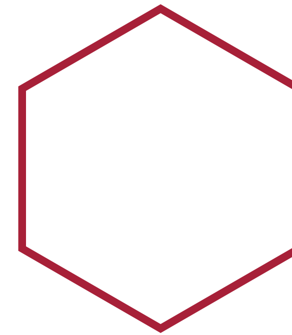

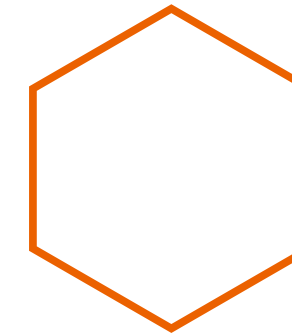

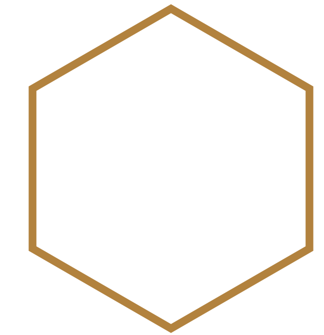

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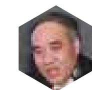

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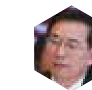

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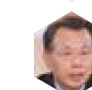

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About IFF

The International Finance Forum (IFF) is an independent, non-profit and non-governmental international organization, founded in Beijing in October 2003 under the initiation of over 20 primary international organizations, such as the U.N., and financial institutions. As a standing high-level dialogue host, research institute, strategic and diplomatic financial platform, and the leading think tank of China and other emerging economies, the IFF has been supported by more than 200 political and financial leaders around the globe, and has established partnership with over 30 countries and regions, 50 international and regional organizations. Playing the full role of non-official G20, the IFF has, therefore, been reviewed as the “F20” in the global financial field.

Our Mission

Following the mission of “Comprehensive and Sustainable Development – New Capital, New Value, New World”, the IFF is committed to becoming a world-class academic think-tank and multilateral dialogue platform with strategic insight.

Our Goals

IFF operates on the basis of open, transparent and fair mechanism, to ensure its independence, objectivity, foresight and inclusiveness and to facilitate global financial operation and exchanges. Through in-depth research on global finance, IFF is committed to promote sustainable development of China’s economy and the world’s economy. Our targets include:

1. Global Financial Strategic Dialogue Platform
2. Global Financial Cooperation & Exchange Platform
3. Global Financial Innovation & Practice Platform
4. Global Financial Think Tank Platform
5. Global Financial Extraordinary Talents Platform

TRANSFORMING CHINA’S GROWTH MODEL

The growing role of China in an interconnected world

With global economic health ever more reliant on Chinese growth, *Wang Yan*, deputy director of the IFF Institute, looks at how structural reforms can help the world's most populous country take a leading role in the years to come

The past seven years have represented the most treacherous economic recovery since the Great Depression. In 2015, global economic activity remained subdued; although emerging market and developing countries still accounted for more than 70% of global growth, the US economy slowed in the fourth quarter of 2015 to a 1% increase in GDP, and 2.4% for the year as a whole. Europe and Japan are still not out of the woods, where quantitative easing and negative interest rates are still on the policy agenda. Some economists are discussing the possibility of 'secular stagnation'[1] and the International Monetary Fund has issued warnings on prolonged period of low growth and high unemployment as the world's 'new normal'. Three main factors underlie the global outlook: first, the gradual slowdown and structural changes in China; second, dramatic decline in the prices of oil and other commodities; and third, a gradual tightening in monetary policy in the US, which has resulted in capital outflows from developing countries into the north American superpower.

In early January this year, the world received a wakeup call in the form of stock market turmoil and currency depreciations, often attributed to concerns about a Chinese hard landing. The events in January demonstrated the world is increasingly more interconnected and the Chinese economy is playing a more important role than before. China's fundamentals remain quite strong, as shown below. Given its large economic size, with annual GDP of $11 trillion, second only to the US, its economic growth, even though slowing to 6.9% in 2015, accounts for a significant amount of global growth. In the first quarter of 2016, China's GDP grew at an annual rate of 6.7%, with other indicators such as transport and electricity consumption strongly supporting this data. China's strong growth has built confidence in the global economy.

Figure 1 shows China's GDP growth rates compared with those of the developing countries and industrial countries. It shows a wide divergence – indicating a three-speed global economy, with China outperforming developed and other developing countries during the past 20 years. While China's secondary industry (manufacturing) growth slowed to 6.0% in 2015 from 7.3% in 2014, tertiary industry (services) expanded by 8.3% last year, up from 7.8%.

In Figure 2, using GDP in purchasing power parity terms as the weight, it can also be seen that China's GDP growth has accounted for an average 30% of global GDP growth since the 2008 financial crisis. As a result, during the global financial crisis, the Chinese economy served as the strongest pillar without which the global recession would have been a global depression. Even now, with the Chinese economy gradually slowing, due to its large size the incremental nominal GDP of more than $700 billion per annum adds another 'Switzerland' each year to the world economy.

The *IFF China Report 2015* stated that Chinese leaders were already determined to implement "accelerated and deeper structural reforms to the economy". Since then, significant progress has been made in China's structural transformation, whether it is in consumption, services and export structure, or innovation and green financing. There is also more reform on the way, as outlined in China's plan for the next five years – the Thirteenth Five Year Plan. The aim during the next five years is to achieve more balanced, innovation- and consumption-driven, inclusive and sustainable development. A particular focus for China's reform and investment strategies includes – but is not limited to – its One Belt, One Road strategy, which will have an impact that will be felt around the world.

1 Summers 2014

Rationales for structural transformation

History since the industrial revolution has shown that structural transformation is critical to economic development. However, mainstream economics has paid little attention to structural transformation and industrialisation during the past two decades. Insufficient amounts of resources have been invested in economic and industrial infrastructure, especially in many developing countries. As a result, many countries have suffered from deindustrialisation. Africa, for example, has seen its share of manufacturing in GDP terms stagnating for 40 years. Only a few developing economies that industrialised and grew dynamically after World War Two – most of them in east Asia – followed an export-oriented development strategy.

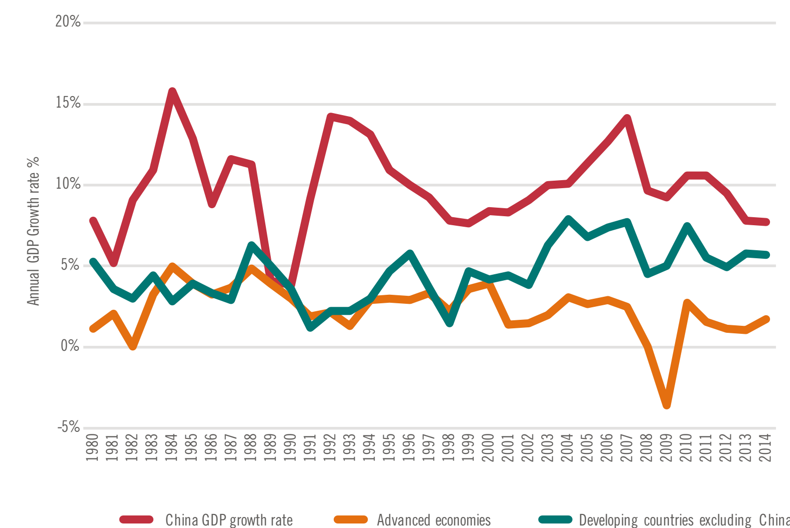
In the interconnected world, structural transformation is even more critical and difficult because goods and services are relatively freely traded across borders, yet 'factor endowments' such as physical, human and natural capital (eg land), face barriers or are either completely immobile across borders or facing barriers. Many developing countries have attempted to catch up with industrial countries but failed; some appear trapped in the position of natural resource and primary product exporters, unable to diversity their economies. During the last half a century, only 28 countries were able to close the income gap with industrial countries by 10% or more. Among these 28 countries, only 12 were non- European and non-resource-based countries.[2]

Industrialisation and its upgrading were recognised as one of the main engines of economic growth, especially in the early stages of development. The manufacturing sector, in particular, offers new possibilities for the production of tradable goods, including technology. Manufacturing plays a crucial role in employment generation. In 2013, there were more than 500 million jobs in manufacturing, allowing for greater inclusiveness and gender equality, according to the United Nations Industrial Development Organization's *Industrial Development Report 2013.*

New structural economics, which attempts to combine structural economics and neoclassical economics and is promoted by economists such as former World Bank chief economist Justin Yifu Lin, starts with the observation that the nature of modern economic development is a process of continuous structural change in tech-

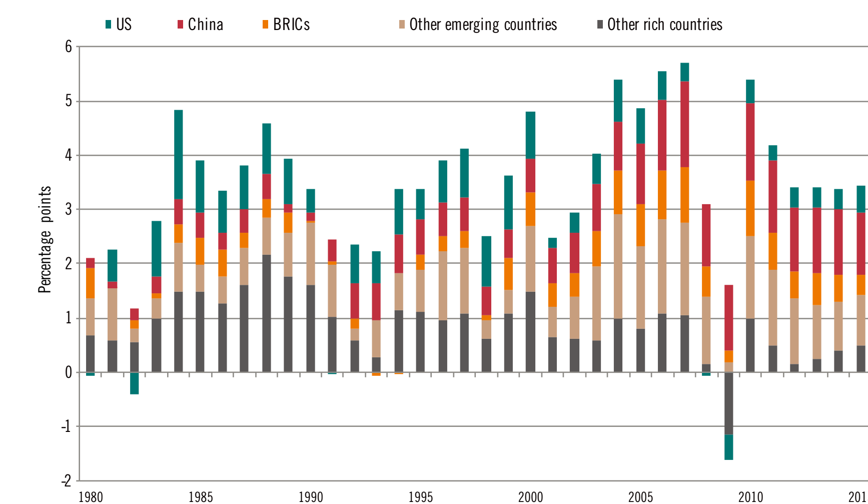
2 Justin Yifu Lin 2012a. *The Quest for Prosperity: How Developing Economies can Take Off*, Princeton University Press, Princeton, New Jersey

Fig 1: GDP growth rates – China, developing and advanced economies



Source: World Bank indicators database

Fig 2: China contributes to 30% of global GDP Growth, 2008-2014



Source: Author based on IMF dataset

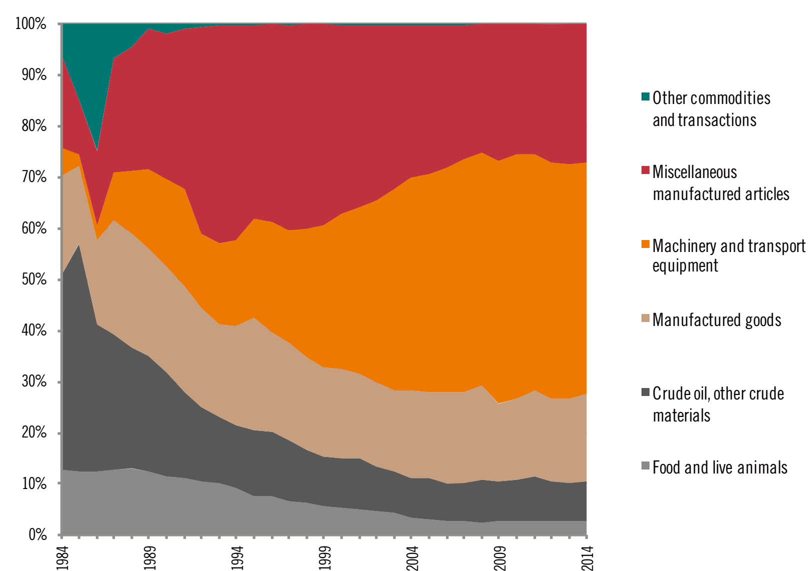
nologies, industries and hard and soft infrastructure. This makes the continuous increase in labour productivity and per capita income in an economy possible. The optimal industrial structure in an economy at a specific time is endogenous to its comparative advantage, which in turn is determined by the economy's given endowment structure at that time.

Economic development is therefore a dynamic process marked with externalities and requiring coordination. While the market is a necessary basic mechanism for effective resource allocation at each given stage of development, governments must also play a proactive, enabling role to facilitate an economy to move from one stage to another. Policymakers must intervene to allow markets to function properly. They can do so by: (i) providing information about new industries that are consistent with the new comparative advantage determined by change in the economy's endowment structure; (ii) coordinating investments in related industries and the required improvements in infrastructure; (iii) subsidising activities with externalities in the process of industrial upgrading and structural change; and (iv) catalysing the development of new industries by incubation or by attracting foreign direct investment to overcome the deficits in social capital and other intangible constraints.[3]

Because the optimal industrial structure at any given time is endogenous to the existing factor endowments, a country trying to move up the ladder of technological development must first change its endowment structure. With savings and capital accumulation, the economy's factor endowment structure evolves, pushing its industrial structure to deviate from the original structure determined by its previous level. If the economy follows its comparative advantage in the development of its industries, its industries will have the lowest possible factor costs of production and thus be most competitive in domestic and world markets. As a result, they will gain the largest possible market share and generate potentially the largest surplus. Capital investment will also have the largest possible return.

Structural transformation is not new – China has achieved a dramatic structural transformation during the past 37 years of opening and reforms. As mentioned in section three of the *IFF China Report 2015*, when China started its economic transformation in 1978, it was an agrarian economy with per capita income of $154. China was also an exporter of primary products – as late as 1984, 50% of China's exports were concentrated in crude materials including crude oil, coal, food and animals, and other agricultural products (Figure 3).

Fig 3: China's export structure: from raw materials in the 1980s to labour-intensive manufacturing products in the mid-1990s and machinery in the 2000s



Source: Lin and Wang (2008) updated by Wang Yan using Comtrad data.

China's structural transformation and 'moving up' the value chain involved an industrial upgrade in 1986, when exports of textiles and clothing exceeded crude oil. The second upgrade happened in 1995, when China's export of machinery and electronics exceeded textiles and clothing. The third upgrade happened after China's accession to the World Trade Organization (WTO) in 2001, when high and new tech exports grew rapidly and the level of product sophistication increased. Central and local government conducted regulatory reforms to improve the investment climate. Some exporters have become integral parts of the global supply chains of multinationals in automobiles, computers, cell phones, and airplane parts. China has grown to be the 'world's workshop'.

> *"The fundamental goal of the 'supply-side reforms' is to raise the social productive level and to implement the people-centered development theory"*
>
> *Xi Jinping, president of the People's Republic of China*

During the transition process, China adopted a pragmatic, gradual, dual-track approach. China's industrial upgrading is continuing at an accelerated speed. Secondary industry, or manufacturing, grew at a slowing rate of 6% in 2015 but service sector growth hit

3 Lin, Justin Yifu. 2012b. *New Structural Economics: A Framework for Rethinking Development and Policy*, World Bank, Washington DC.

HISTORY IN THE MAKING

Yu Hongjun explains why the One Belt, One Road initiative is a historic opportunity to integrate the interests of various nations and build new international relations

Compared with the initial regional cooperation between China and its surrounding nations in the past, which was extensive but low quality and small scale, the One Belt, One Road initiative adopts a far more advanced concept of partnership. This builds on the experience China has drawn from the past, and the stock of capital and talent it has accumulated.

China has built eight road ports and two railway ports connecting central Asia with a surge of goods exchanges, personnel exchanges and capital flows. The trade volume between China and central Asia has reached $45 billion. The China-Kazakhstan oil pipeline, China's first transnational oil pipeline, has transported 80 million tons of crude oil to China; and the Turkmenistan-China gas pipeline transports natural gas to coastal areas in southeast China, meeting the region's huge demand. These efforts serve as a demonstration in facilitating inter-connectivity between China and central Asia. Through such broad, high-level and multi-dimensional cooperation, China has obtained a better understanding of regional cooperation and thus proposed the strategic vision of the Belt and Road initiative.

Promoting 'south-south' cooperation

There are many mechanisms and platforms for 'south-south' cooperation. But the imbalanced development among such different countries and regions has hindered efforts. In addition to the China-Africa Cooperation Forum and the China-Latin America Cooperation Forum, China has recently launched the China-Pacific Island Countries Economic Development and Cooperation Forum. Based on such platforms and partnership frameworks, the Belt and Road initiative not only mobilises more than 60 countries along the path, but can also incorporate countries far away in the South Pacific; Latin America; north, west and east Africa. Furthermore, the many enthusiastic responses to the establishment of the Asian Infrastructure Investment Bank were beyond China's expectation. So, the Belt and Road initiative will promote and reform south-south cooperation.

Innovative efforts in international relations

Although China has been highlighting the importance of building a more impartial and reasonable international political and economic order since the 1970s, unreasonable, unfair and unhealthy components still exist. Therefore, building a new, fair and reasonable order is a common issue faced by all countries.

China has proposed some new concepts and visions through its diplomatic practices in recent years. It has proposed a partnership network with global coverage and a new type of international relations. This requires shared development, prosperity and progress. Through creating common interests and missions, the Belt and Road initiative integrates the interests of various nations and builds new international relations along the path.

As the international community has higher expectations of China, the country will shoulder more responsibilities. Promoting and implementing the Belt and Road initiative is a historic opportunity and China should grasp this moment to play its part in global affairs and take its rightful place in the international community as a major developing country and as one of the world's oldest civilizations. It should fulfill new missions and responsibilities in the progress of humankind.

Yu Hongjun is an IFF Advisory Committee member, member of CPPCC Sub-committee of Foreign Affairs, and vice-minister of the International Department of the CPC Central Committee.

8.3% in 2015. Now, services account for more than 50% of GDP. In addition, household consumption has also risen strongly, accounting for 66.4% of GDP, increasing 15.4% during the previous year. In particular, the middle-class has grown to be more 109 million people, outnumbering that of the US at 92 million. Their consumption is expanding rapidly and become more selective; demand for high quality and safe products is growing fast.

China's rapid upgrading of its services export

In the *IFF China Report 2015*, it was stated that China has committed to continue to liberalise its trade policy and the composition of its trade in services has been changing This trend continued in 2015. Last year, China formally accepted the WTO's trade facilitation agreement and became the sixteenth member to accept this protocol, demonstrating its commitment to support the multilateral organisation's agenda.

Although the share of low-end service export such as travel has fallen significantly, the share of high-end, knowledge-intensive services has risen significantly. These high-end services include:

- Financial services (micro-enterprise development, scientific innovation, green economy, cross-border operations of enterprises, new service formats such as online trading, as well as innovative financial products and services models) exports rose from 1% of total service exports in 2005 to 4% in 2014.
- High-tech services (information services, software development, information systems integration services, internet value-added services, information security services and digital content services) rose from 3% in 2005 to 8% in 2014.
- Business services (accounting, auditing, taxation, engineering, consulting, standards certification and accreditation, credit evaluation, brokerage, management consulting, market research and other professional services) rose from 22% in 2005 to 29% in 2014.
- Construction services exports rose significantly from 3% in 2005 to 6% to 2014, doubling the share in this sector and demonstrating China's comparative advantage in this sector.
- Transport services remained roughly the same share from 17% to 16%, while the share for goods-related services, especially logistics services have declined significantly from around 20% in 2005 to 9% in 2014. This is due to the weak global demand for trade in goods. Again, this indicates that export of goods is no longer a powerful engine of growth, as we had shown in our 2015 report.

Dual economy: successful vs failing parts

The experiences of developing countries – including China – during the past few decades indicate that both the pace and the quality of growth are critical for achieving welfare improvements. China has achieved the fastest poverty reduction in the world: more than 660 million people have lifted themselves above the international poverty

line of income exceeding $1.25 per person per day. In 2015, personal per capita disposable income increased by 7.4% in real terms, overtaking the economy's growth rate. In rural areas, greater alleviation efforts have reduced the number of people living in poverty by 14.42 million last year and more than 100 million in the past five years in total. However, while fast economic growth is essential to poverty reduction, some growth patterns are more effective than others in reducing poverty, improving wellbeing, promoting equity and stimulating innovation.[4] That is why improving the quality of growth has been placed so high on the policy agenda.

The *IFF China Report 2015* highlighted that China's unique central-local governance system has facilitated many institutional innovations, such as special economic zones and a central-local revenue sharing system that have motivated local governments, state-owned enterprises, private companies and households to pursue growth through a trial-and-error approach. As a result, "35 years of high growth have created a dual economy, with both successful and failing parts", the report stated. During the past year, the structural imbalances of the dual economy in China have become more apparent. They can be summarised as structural, financial and systemic.

It has been long recognised that the institutional barriers discouraging rural-urban migration (*hukou*) are major impediments for poverty reduction, and contribute to inequalities in health, education and employment opportunities, as well as mounting social problems of 'left-home children' and dismantled families. The fragmentation of social insurance systems is also a major impediment for labour market mobility, economic efficiency and social fairness. It is also a major barrier for urbanisation and the integration of urban and rural migrant populations.

Institutional barriers between rural and urban dwelling are now largely dismantled, after many years of gradual reforms. All major cities have established a scoring system to gradually integrate rural migrant workers into the urban system, providing them with residential rights, social insurance and rights for their children to be educated in the cities. Pension systems are also being unified. Based on reforms unveiled in early 2015, insurance for workers in government agencies and public institutions will now be paid by both workers and the organisations, instead of just by the organisations or from central finance as in the past. The aim is to build a system for government and public institutions that is similar to the one employed by the private sector, facilitating a more free flow of staff between private and public agencies. In January 2016, urban residents' basic medical insurance integrated with new rural cooperative medical system, and a unified urban and rural residents' basic medical insurance system was established. Under the new medical insurance scheme, residents can purchase insurance according to the unified policy and enjoy treatment, no longer restricted by the identity of urban or rural residents.

The State Council has also cut red tape by streamlining a number of regulations and reduced the number of licenses that need to be issued and approvals granted. According to the newly delivered *Report on the Work of the Government*[5], last year alone saw the delegation of power or cancellation of the requirement for government review for 311 items. In the past three years, the State Council has delegated the power or cancelled the requirement for government review for 618 items in total, about 40% of the original items, of which 491 items are completely cancelled. A lot of cancelled items are directly related to the operation of enterprises, benefiting a wide range of projects, thus greatly stimulating the economic and social development.

In the past two years, the State Council has cancelled 258 non-administrative review items, accounting for 57% of the original. The rest of the non-administrative review items are adjusted to either administrative review items or internal government approval items. The State Council has put a complete stop to the practice of non-administrative review, after reducing the number by 57% in the past couple of years. The number of items that require government approval for new businesses prior to registration was cut by 85% and the system of a separate business license, organisation code certificate and taxation registration certificate was replaced by a unified business license with a unified social credit code.[6]

In May 2015, 49 non-licensing examinations and approvals items were cancelled after the motion of sharply decreasing the non-licensing examinations and approvals items in the earlier stage. Last year, the State Council cancelled the requirement for verification or approval for 123 professional qualifications and in 2016, 62 certifications were further cancelled to reduce obstacles to the employment of young people. Professional qualifications will not become the employment threshold. By changing management ideas and simplifying procedures, China can encourage talented people to show themselves, enhance labour and working qualities in various industries, and promote public entrepreneurship and innovation.

There are, however, a number of areas where further institutional reforms are needed, most importantly in finance (see section two) and in state-owned enterprises.

Supply-side policy reforms

Most economists agree that after seven years of expansionary monetary policy by central banks around the world, including zero interest rates and multiple rounds of quantitative easing, Keynesian economic policies focusing on aggregate demand have reached their limit. As a result, some Chinese economists have turned their focus to supply-side economic policies. Other economists believe both demand-side and supply-side factors must get attention.[7] For example, at the twelfth meeting of the Central Leading Group on Financial and Economic Affairs held on January 26, 2016, President Xi Jinping emphasised: "The fundamental goal of the 'supply-side reforms' is to raise the social productive level and to implement the people-centered development theory. We should moderately expand the total market size and at the same time reduce overcapacity, reduce inventory, reduce leverage, lower administrative burdens, lower production and transaction costs and strengthen where there is deficiency. High quality supply in the production field should be strengthened, reducing ineffective supply and expanding effective supply. The adaptability and flexibility of the supply structure and the total factor productivity should be improved, so that the supply system can better adapt to the demand structure."

Prime Minister Li affirmed at the Thirteenth Five-Year Plan's preparation forum, which gathered experts at home and abroad, that: "China has been promoting the structural reform these years, without strong stimulation, which is a very tough process. In the future, we would improve both supply side and demand side, and accelerate the structural reform."

The supply-side structural reforms appear to include, but are not limited to, the following elements:

- Reducing the tax burden for enterprises, especially for SMEs and for new ventures. This is what the government has been doing for quite some time with the reform to "replace the Business Tax with a value-added tax" will be expanded on August 1, 2016 in service sectors. Premier Li said: "We will ensure all sectors face a reduced burden." A total of 85% of China's tax revenue has been collected from enterprises and their tax burden needs to be reduced. According to a recent paper by Sheng Songcheng, China's corporate tax rate is high compared with international level. And the corporate tax rate grows faster than income, meaning the tax burden continues to increase, especially for SMEs. Measures such as cutting corporate tax, increasing subsidies or more effective implementation of structural tax cuts can be adopted to reduce the tax burden of SMEs as well as strengthening the microeconomic vitality of Chinese economy. Sheng proposes a reduction in indirect taxes and an increase in direct taxes, reducing taxes on goods and services while expanding income tax, and increasing corporate subsidies and tax concessions based on national development strategy.[8]
- Reducing excess capacity and eliminating outdated and polluting industries – by closing down some steel plants and coal mines. About 500,000 steel workers are set to be laid off because their steel mills will be closed to reduce overcapacity in the steel sector. Across many provinces, hundreds of small and medium-sized coal mines have been closed down. A document issued by The Bureau of Energy in 2015 stated that 1,052 coal mines with backward technology will be closed. Heilongjiang Province has already closed 233 coal mines and Guizhou Province closed 200. Nuer Baikeli, head of the Bureau of Energy, mentioned that in 2016 more than 1,000 outdated coal mines will be closed and in the following three years from 2016, the Bureau will suspend the approval of new coal mining projects. During the past three years, China has cut production capacity of more than 90 million tonnes of steel and iron, 230 million tonnes of cement, in excess of 76 million weight cases of plate glass, and more than one million tonnes of electrolytic aluminum. With active structural adjustment, high-tech industries and equipment manufacturing grew

'NEW NORMAL' OBSTACLES AND TRENDS

Zhang Yansheng looks at five obstacles China must overcome in its transition from old normal to new normal…

China is embarking on a major transition. Many practices and procedures adopted in the past 35 years will have to change as the country moves from the 'old normal' to the 'new normal'. It must contend with numerous difficulties, deal with increased risks and avoid imbalanced economic growth. At the same time, new opportunities will emerge. The coming years will be a critical period for the country.

Five obstacles to transition:

- China will need to move up the value chain. There is a key distinction that separates business models in east Asia – on one hand, there is original equipment manufacturing (OEM), known as the small-country model; and on the other, there is original brand manufacturing (OBM), adopted by developed countries such as Japan and the Republic of Korea. China must abandon OEM and adopt OBM.
- The country must find a new niche in the international division of production. India has 400 million young people aged 15 to 35. They will put an end to China's low-cost advantage when they begin to play a part in economic globalisation as India's infrastructure improves, its manufacturing sector becomes more productive and its investment environment develops. Upgrading China's manufacturing industry requires technology, talent, brand, capital, experience and capacity – things the country still lacks.
- China has to achieve the transition from copying and imitation to innovation, especially technological innovation. This requires transformative changes in education, the environment and individuals.
- China must abandon the mentality of "crossing a river by groping the stones along the way", in favour of normative practices based on the rule of law. This transition will be harder now than 35 years ago.
- The economic model relying on exports and attracting investment will not endure. In the Fifth Plenary Session of the 18th CPC Central Committee it was proposed that, to be deeply integrated into the world economy, China has to build a new, open economy on a higher level.

While it will take time to reach the 'new normal', five trends are already emerging that are likely to persist as the transition continues.

Five emerging trends

- The ratio of R&D expenditure to GDP is constantly rising. From 1.75% in 2010, it increased to 1.98% in 2012 and is expected to exceed 2.1% in 2015 (including more than 4% in Shenzhen). Of the R&D expenditure, 76.6% is contributed by enterprises, which shows they are starting to attach importance to investment in R&D, innovation, consulting and human resources.
- China is increasing the amount of value-add in its output. In the services sector, the ratio of value-add to GDP is constantly rising. It rose from 44.6% in 2012 to 51.4% in the first half of 2015.
- The contribution of consumption to economic growth is on the rise, accounting for 58.2% of growth in the first three quarters of 2015.
- China is experiencing a new type of urbanisation. The percentage of China's population living in urban areas is 55% – and it is expected to reach 70%. Hence, the country is entering a period of accelerated development.
- Income disparities between urban and rural areas, among residents and across regions within China, are narrowing rapidly. The ratio of urban income to rural income fell from 3.33x in 2009 to 2.84x in the first half of 2015, and the Gini coefficient is also falling. To narrow the gap across regions, China should prioritise the development of its western regions.

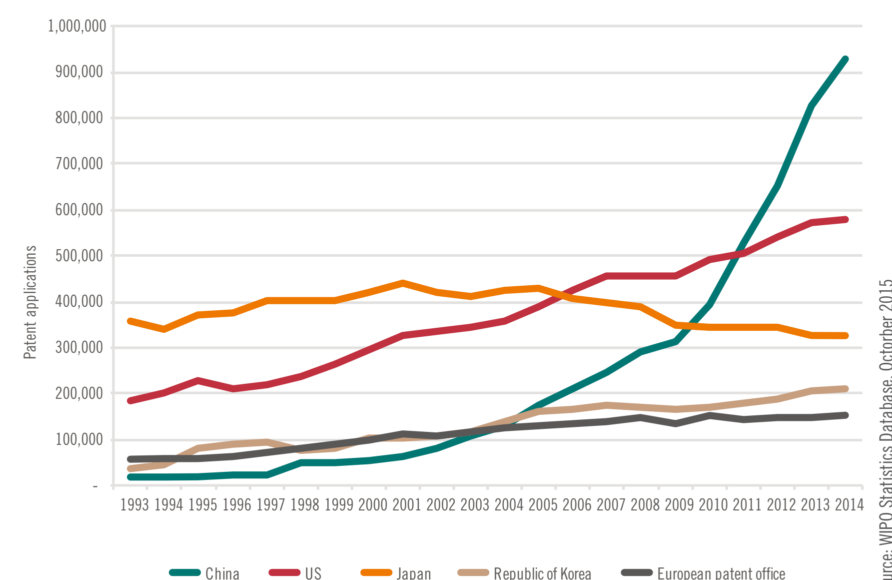
Zhang Yansheng is an IFF Academic Committee member and secretary general of the Academic Committee, National Development and Reform Commission.

4 López, Ramon E, Vinod Thomas and Wang Yan (2008). *Fiscal Policies for the Quality of Growth*, IEG Working paper 2008/6, The World Bank.
5 State Council, March 2016
6 State Council March 2016
7 Xiao, Geng. 2015. Project Syndicate papers, *Studies on Fu Shan*
8 Sheng, 2016

faster than other industries and energy consumption per unit of GDP fell by 5.6% last year – and 18.2% in the past five years.[9]

- Deleveraging via debt restructuring. Deleveraging will be achieved through closing down some debt-ridden state enterprises in dirty and polluting industries and sectors with overcapacity. In addition to the four largest asset management companies (AMC) for debt restructuring, some provincial governments have established their own AMCs and some localities have used the internet to sell ‘poisonous assets’ at a discount.
- Enterprise restructuring by allowing some ‘zombie enterprises’ to go bankrupt, encouraging mergers and acquisitions and mixed ownership reforms. However, the concrete measures and procedures are yet to be made clear. According to Zhen Fang Sheng: “The key to restructuring zombies to have capital restructuring, which relies on the entrepreneurs who are willing to conduct it. Implementing the Bankruptcy Law is the best way for capital reallocation.”
- Improving product quality to meet consumer demand for high quality products and safe food. There is a ‘quality premium’ or ‘brand premium’ opportunity to be seized.

Fig 4: China has grown to be one of the top patent applicant countries – showing the spirit of innovation



Source: WIPO Statistics Database, October 2015

Learning and innovation

China’s past success was in part due to learning and utilising the ‘advantage of backwardness’. This has reached its limit. China must rely on its own ingenuity and innovation in the future. Can this be achieved? According to Premier Li, last year: “Business startups and innovations by the general public flourished, with the number of newly registered businesses rising by 21.6% in 2015, or an average of 12,000 new businesses per day. New driving forces played a major role in keeping employment stable and pushing ahead industry upgrading, and are now driving profound economic and social change in China.”[10] A recent report by McKinsey Global Institute in 2015 assessed China’s capacity for innovation and indicates it can adjust – China spent more than $200 billion on research and development in 2014, the second-largest in absolute terms (and above 2% of GDP). Its universities graduate more than 1.2 million engineers each year – more than the next five countries combined. China also leads in patent application, with more than 730,000 in 2013, according to a McKinsey study.[11] This can be seen in Figure 4.

Indeed, major headway was made in the development of 3G nuclear power technology, China’s self-developed C919 large jetliner rolled off the assembly line and Tu Youyou was awarded the Nobel Prize for Physiology or Medicine. In addition, R&D spending has increased dramatically and some private sector enterprises such as Huawei, ZTE and others are already successful in terms of innovation. However, when looking at the actual impact of innovation – as measured by the success of companies in global markets – the picture is mixed:

- In industries where innovation requires original inventions or engineering breakthroughs, such as branded pharmaceuticals and automobiles, China has a small share of global markets.
- In industries where innovation is about meeting unmet consumer demand or driving efficiencies in manufacturing – appliances and solar panels, for example – China is doing very well.

The McKinsey research, based on an impact-driven view of innovation, concludes that China does have the potential to become a global innovation leader. China has made the necessary investment in R&D and education to improve its performance in science- and engineering-based industries; one example is China’s success in high speed rail and telecommunication equipment.

To be successful in innovation in the next decade, China needs to:

- Implement the right policies to support entrepreneurism
- Encourage market-based competition in more industries
- Make China more attractive to top science talents.

Green finance for sustainable development

China continues to face severe challenges of air and water pollution, heavy metal pollution in soil and acute water shortages. The root cause of the escalating environmental crisis is the combination of a rapid expansion in energy-intensive heavy industries with predominantly coal-based energy use, inadequate policies and institutional measures and weak enforcement of environmental regulation.

To tackle these severe challenges, the government has adopted clear objectives, stating it “intends to achieve the peaking of CO_2 emissions around 2030 and to make best efforts to peak early and intends to increase the share of non-fossil fuels in primary energy consumption to around 20% by 2030”. A number of environmental regulations have been enacted and enforced more rigorously.

9 State Council, March 2016
10 State Council March 2016
11 McKinsey Global Institute, 2015. *The China Effect on Global Innovation.* McKinsey & Company

GLOBAL ECONOMIC DEVELOPMENT AND CHINA’S PROSPECTS

Zhu Guangyao’s view on how China plans to maintain its growth momentum against a complex international backdrop

Last year, we saw the global economy endure its most severe and complex situation since the global financial crisis of 2008, as demonstrated by the following observations:

Challenging landscape

First, the global economic growth rate fell. The International Monetary Fund (IMF) cut the rate four times in a row last year, from 3.8% to 3.1%, suggesting the global economy remains perilously close to another recession.

Second, global trade growth declined. The World Trade Organization (WTO) revised it down from 3.1% to 2.8%, nearly half the average of 5.2% during the past 20 years. The fact that 2015 saw trade expand more slowly in developing countries than developed countries – 2.4% compared to 3%, according to the WTO – is particularly alarming.

Third, global interest rates reached their lowest level since World War Two . The European Central Bank, the Bank of Japan and the Swiss National Bank have all implemented negative interest rates. Nevertheless, since liquidity expansion does not appear to support the real economy, small and medium-sized enterprises are still facing financing difficulties.

Fourth, monetary policies in advanced economies are further diverging. The US Federal Reserve has started to raise interest rates while the central banks of the eurozone and Japan have continued to expand their quantitative easing policies. China should monitor how the major advanced economies develop monetary policies, and the impact of their severe divergences on the world’s economy and financial markets.

Fifth, commodity prices kept falling. This trend looks poised to continue and will influence both importers and exporters in 2016.

Sixth, emerging economies that underpinned international economic growth following the global financial crisis of 2008 are struggling – particularly Russia and Brazil. According to IMF data, Russia’s economy shrank by 3.4% and Brazil’ s by 3% in 2015. These challenges must be addressed as soon as possible.

Last but not least, geopolitical risk has increased, putting downward pressure on financial markets.

Against this international backdrop and facing the arduous task of domestic structural reform, China maintains its growth momentum while pushing ahead with reforms. China’s economy grew by 6.9% in 2015 and continued to contribute about 30% of global growth.

China’s integration to the world economy

The Thirteenth Five-Year Plan explicitly emphasises a growth strategy with a philosophy of innovative, coordinated, green, open and shared development. President Xi Jinping has also indicated that China’s annual growth rate should not be less than 6.5% in the next five years, underpinned by inclusiveness and sustainability. And China’s 2010 GDP and per capita personal income will be doubled by 2020. For the first time, the Belt and Road initiative is included in the Five-Year Plan explicitly, combined with a domestic economic development plan, showing China’s blueprint for future development both domestically and internationally.

Zhu Guangyao

President Xi Jinping has emphasised the openness, diversity and win-win nature of the Belt and Road initiative, which welcomes all countries to join the effort by various forms of cooperation, with the same goal of common development. The Belt and Road initiative is not a private route for any particular country but rather an avenue for all joining hands. On this basis, China will strengthen its cooperation with all countries to achieve common development.

Zhu Guangyao is China’s deputy minister of finance.

Significant progress has been achieved in the past five years, especially in structural transformation that is environmentally friendly. For example, services and green industry have been growing more rapidly, with domestic consumption now accounting for more than 50% of GDP. More than half of the population now resides in urban areas. In parcular, “energy consumption per unit of GDP has dropped by 18.2%, and the emissions of major pollutants have been cut by over 12%”, according to the State Council (March 2016).

In addition, the PBoC has established China’s ‘green financing system’, establishing it as a guiding principle in all lending strategies and lending principles. The PBoC report studied measures to: reduce the cost of green investment by establishing green banks, green bonds and green funds; increase the cost of polluting projects by establishing green ratings; and to bolster social responsibility by setting up a public non-profit information system, monitoring environmental cost. Concretely, the PBoC’s recommendations included:

1 Building a green finance system that allows green banks to fully leverage their expertise, scale and risk management in green credit and green investment.

2 Promoting the development of green industry funds through public-private partnership arrangements, thereby inviting private capital to make amplified equity investment in green sectors.

3 Requesting institutions such as the Silk Road Fund, the AIIB and the New Development Bank to adopt or reference the ‘equator principles’ and establish a system for environmental risk management with metrics no lower than those set by the World Bank and the Asian Development Bank. Environmental information should be promoted to the fullest extent, overseas green investment promoted, and China should present the image of an environmentally and socially responsible country.

4 An additional set of 10 recommendations cover fiscal and financial policies. The Ministry of Finance, the PBC, CBRC, CSRC and other government agencies will collaborate and take leading roles in implementing them.[12]

With the recently approved Thirteenth Five-Year Plan by the National People’s Congress, there is confidence and optimism that China’s structural transformation will continue. Even though there will be a few bumps in the process, the direction of reforms is clear and actionable. ■

12 Green Finance Working Group, PBoC, *Establishing China’s Green Financial System*, China Financial Publishing House, 2015

A complex trading picture

China's minister of commerce *Gao Hucheng* reveals four central opportunities that will arise in the course of the Chinese market's development

In 2015, the world economy as a whole was rather weak, with divergence across major economies' development and a sharp drop in commodity prices. Similar to the two preceding years, the growth rate of global trade volume was again lower than that of the global economy, meaning that has now been the case for three consecutive years – unprecedented during the past three decades.

It was also a tough and complex year for China's trade. China's total foreign trade volume was $3.95 trillion, a year-on-year decrease of 8%. The export volume was $2.27 trillion, a drop of 2.8%, whereas the import volume was $1.68 trillion, down by 14%.

Despite the overall decline, there are several highlights to reflect on. China is the largest trading nation and the biggest exporter in the world. It has the largest online retail revenue of physical commodities and the second largest total retail sales of consumer goods.

The country's trade structure has also evolved. High-end manufacturing products account for a much greater proportion of exports. The export of large-sized complete sets of equipment increased by 10%, among which the export of rail transit, aerospace engineering and capital-intensive commodities all increased by 15% and the export of rolling stock increased by 30%. Communication equipment has been exported to more than 140 countries around the globe. Electric power equipment has entered into the middle- and high-end market in Europe. The export of railway equipment has covered six continents. According to the Asian Development Bank[1], China's share in the export of high-end technology products in Asia rose from 9.4% in 2000 to 43.7% in 2014.

Notable progress has also been made in two-way investment. China achieved something near parity for the first time in 2014, while foreign investment attracted to China reached new highs in 2015. China's outbound investment has risen consecutively for 13 years, with the total amount exceeding $1 trillion.

As a result of the China-Republic of Korea and China-Australia free-trade agreements, tariffs have been lowered for the second time. Moreover, steady progress has been made in negotiations to promote bilateral investment between China and the US, and between China and Europe.

In 2015 the Shanghai Free-Trade Zone was expanded, while three other free-trade zones were established in Tianjin, Fujian and Guangdong provinces. They have adopted the 'negative list' approach and the practice of pre-establishment national treatment. The zones have also implemented the single-window international trade system, a credit system for the third-party inspection and verification of institutions, and other trade facilitation measures.

Gao Hucheng

To open and assist innovation in the financial system, the free-trade zones have adopted measures such as setting up free-trade accounts and steadily improving capital account convertibility, as well as supervisory measures both during and after necessary procedures. High-end industries such as financial leasing, scientific and technological research and development, venture capital investment, e-commerce and modern logistics are, significantly, forming clusters in the pilot free-trade zones.

Foreign capital still favours China

Foreign investment has made great contributions to China's reform, opening up and modernisation, while enabling foreign enterprises to gain a generous return from China's development and construction. In recent years, some parties have said China's investment environment is no longer friendly and that foreigners have started to lose confidence in China. But foreign investment still favours China. While global transnational direct investment dropped by 8% in 2014, China bucked the trend by utilising the largest amount of foreign investment in the world. Meanwhile, industries that have utilised foreign capital have significantly improved their industrial and regional structures.

The supply-side of China's economic factors has changed significantly. In the past, China was relatively abundant in land and labour resources and thus had more room to utilise foreign investment. Nowadays, investment in traditional industries is relatively saturated, so extensive foreign investment in land development is no longer feasible. In the context of the 'new normal', the Chinese government will be more active in using foreign capital and will focus more on creating the soft environment, including elements such as laws, institutions and policies.

Lujiazui Financial and Trade Zone, part of the Shanghai Free-Trade Zone

Future policies will focus on three aspects. First, further widening the thresholds of market access for foreign investment. The focus will be on expanding the service sector and opening the general manufacturing industry, and also easing the industrial limitations and joint venture cooperation requirement. This will be the biggest modification of the catalogue for guidance of foreign investment industries in history.

Second is improving the foreign investment regulation system. Under a new registration system, all joint ventures will be put on file but the authorisation process will be simplified and streamlined. Furthermore, the management of supervision both during and after necessary procedures will be strengthened. The safety review mechanism for foreign investment will be improved with greater standardisation and transparency.

Third is achieving the integration and combination of the current three laws into one, as well as the adoption of the pre-establishment national treatment and 'negative list' management. And, based on the 'negative list', the restrictions on the market access in the service sector for foreign investment will be further relaxed. The ultimate goal is to create a more stable, transparent and predictable legal environment for all kinds of market entities.

Four development opportunities

There are four central opportunities that will arise in the course of the Chinese market's development. One entails establishing a unified market access system and gradually implementing the practice of 'negative list' management. The government will make a list of industries and businesses that are prohibited and limited from entering certain sectors, and all market entities will have fair and legal accesses to the areas that are not listed. By promoting this practice, the government wants to significantly narrow its scope of conducting examination and authorisation procedures, reduce discretion and establish a fair market access environment. This requires the government to create business and development opportunities for all kinds of market entities, including foreign enterprises.

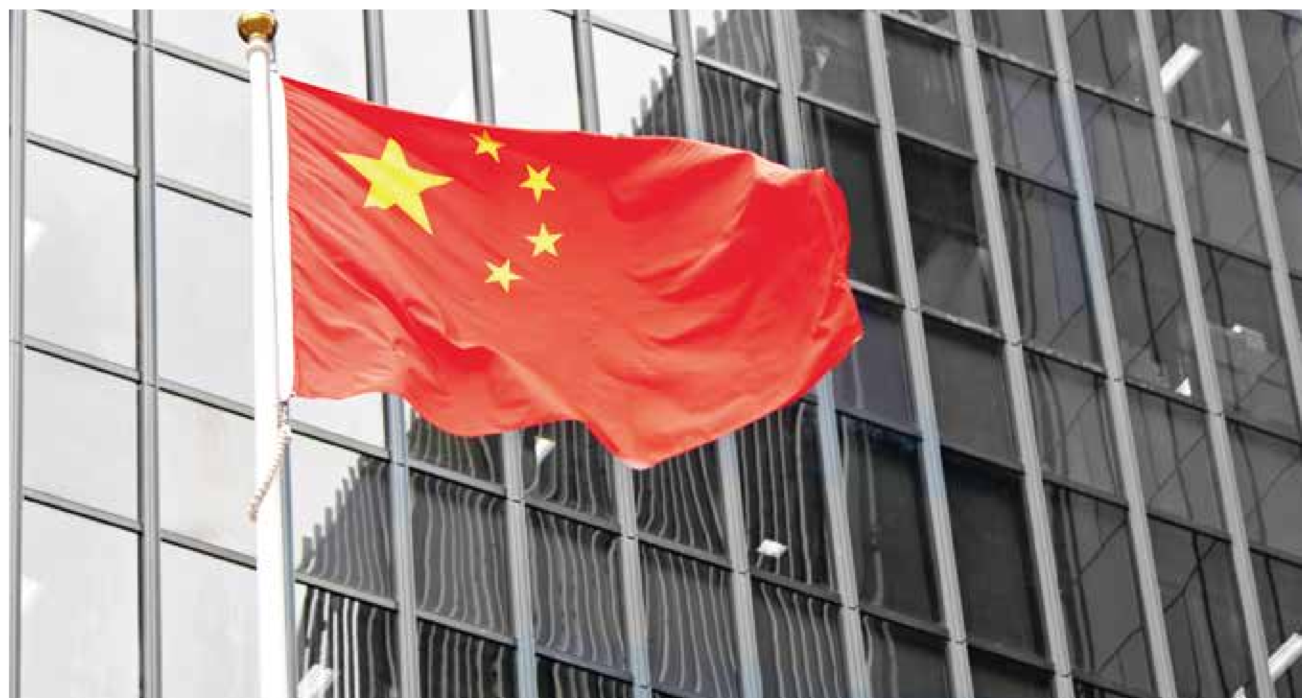
There will also be opportunities for business innovation. As information technology has penetrated production and daily life, different kinds of industries have become integrated. Miniaturised manufacturing, digitalised circulation and individualised consumption have become new features of the industrial organisation. Online trading has expanded from daily necessities to products such as fresh food, medicine, vehicles and properties, as well as to financial industries and cultural and creative fields. China's business model is undergoing profound changes. China encourages enterprises from all countries to participate in this innovation, as well as competition between different business models, which will ultimately develop together with the Chinese market.

Another set of opportunities relates to further opening the service industry. In the future, China will cultivate consumption growth: promoting pension and domestic service consumption; enlarging consumption of information; promoting tourism, leisure consumption and green consumption; stabilising housing consumption; and enlarging education, culture and sports consumption. In all these aspects, foreign investment will be of great use.

Finally, there are opportunities for imports. China is the largest trading partner of 120 countries and regions in the world, and also one of the top three largest trading partners of 15 countries in the G20, importing commodities of more than $2 trillion on average per year. With continuous improvement of living standards, demand from Chinese citizens for imported high-end commodities will grow. At present, consumer goods account for less than 7% of China's total imports. The figure for developed and even some developing countries lies between 15% and 20%. During the Thirteenth Five-Year Plan period, China's consumption structure will evolve further. The potential to import consumer goods will be further fulfilled, so more foreign enterprises will benefit from China's consumer markets. ■

1 http://www.adb.org/sites/default/files/publication/177205/asian-economic-integration-report-2015.pdf

Transforming China's growth model



Tackling China's structural challenges

Minister of finance *Lou Jiwei* reflects on how China is tackling four long-term roadblocks that threaten stable economic growth

China's economy is being affected by three overlapping dynamics: a change in its growth rate, structural adjustments and the digestion of earlier stimulus policies. In particular, the economy is grappling with the rise of long-term structural challenges that can act as a drag on total factor productivity and stable economic growth.

The structural issues are mainly manifested in four different forms. The first is related to labour. China faces an ageing population and declining 'demographic dividend', with labour costs growing faster than productivity. Another is the decline in the marginal efficiency of capital. Investment returns are falling, the investment structure is imbalanced and there is a serious overcapacity problem. Furthermore, China has a high leverage ratio. The country's debt is growing as a proportion of GDP and some regions face high solvency pressures. Finally, institutional mechanisms hinder the efficient allocation of resources. The existence of industry monopolies and industry access barriers, the lack of high-skilled and innovative talents, the restraint on population flow, the complicated approval process, the difficulties in land expropriation, the sluggish progress of investment projects and the lag of rural land reform all act as obstacles.

To solve these problems, China is promoting supply-side structural reform, with a view to cutting down excessive production capacity, digesting unreasonable inventories, deleveraging and reducing costs. Meanwhile, the reform of key systems and mechanisms is also being stepped up. Reform is conducted with due consideration to the philosophies of innovation, coordination, the environment, openness and win-win development. The aim is to unleash potential productivity and nurture new growth momentum.

Establishing a modern fiscal pillar

A key element of China's development is establishing a modern fiscal pillar. This will require a comprehensive, standard, open and transparent modern budget system to improve the governmental budget. This will entail improving the transfer payment system and enhancing budget implementation.

Lou Jiwei

It will also require setting up a tax system in favour of scientific development, social equity and market integration. China should reform its value-added, consumption, resource and real estate tax. It should also establish environmental protection and personal income tax systems.

Adjusting the fiscal relationship between the central and local governments is also important. China should set up a system that matches the authority of office with the responsibility over financial affairs. The central government can entrust the local governments with part of the authority and responsibility over financial affairs through the transfer payment system.

In international exchanges, it is important to not only learn about current international norms but also to exercise major economy influence by taking an active part in improving these norms. We must defend China's territory and identify key national interests. It is also essential to understand our international counterparts and take proactive actions. We must urge developed countries to fulfil their due responsibilities and obligations in safeguarding the global economic order, opening up wider and boosting the world's economic recovery. The major economies' fiscal systems should help promote balanced and sustainable development, coordinate the domestic and overseas markets and identify the future trend of new technological revolution. It should also promote and expand outbound investment by encouraging enterprises to go global as well as achieving global industrial distribution.

Overcoming the middle-income trap

Other areas of the economy must also be reformed for China to overcome the middle-income trap. This includes agriculture. China should reduce the overall grain subsidies and encourage agricultural imports. Specifically, agricultural subsidy policies should be reformed to address the overuse of pesticide and chemical fertiliser, and to reduce distortions in the agricultural market. The food demand gap can be filled by imports while the agricultural ecosystem and resources can be restored through land retirement and crop rotation. By expanding the scale of agricultural operations, new skilled farmers can be trained, while more of the labour force can be transferred to non-agricultural sectors. In addition, to remove the barrier to labour flows, the government should look to provide educational and medical resources. It should also pursue household registration reform. The barriers of residence transfer should be broken down to allow for household registration with rented apartments.

Labour relation reform is also important. The Labor Contract Law should be adjusted in a timely manner to improve the flexibility of the labour market. To be more specific, China should promote the free flow of labour among various regions, industries and enterprises. It should ensure compensation is fairly determined between labour and management. Policies for gradually postponing the retirement age should also be studied and formulated to enhance labour force participation. Moreover, to improve labour quality, China should establish a modern vocational education system. It should also promote the integration of production and education and the cooperation between schools and enterprises, as well as enhance skills training among the working population.

Another area is land reform. Relevant regulations on the expropriation and compensation of houses on state-owned and collective-owned land should be modified to promote investment programmes. The transfer, leasing and pooling of collective land for construction and commercial use in rural areas should be encouraged as long as it is in line with relevant planning and usage control policies. In regions with favourable conditions, the land quota system should be implemented. China should also encourage and guide farmers who have settled in urban areas to conduct paid transfer of their land contract right, land use right and collective income distribution right in accordance with the law.

> *"Finance is the foundation and an important pillar of state governance"*
>
> *Lou Jiwei, Minister of Finance*

There is also a need for social security system reform. The reform of the pension insurance system should be accelerated. China should establish an incentive and restraint mechanism that matches the amount and duration of insurance payment with that of insurance earnings. It should also set up a more transparent and straightforward receipt and payment system.

The medical insurance system should also be reformed. China should establish a reasonable and sustainable financing mechanism for the medical insurance system by developing the medical insurance payment policies for retired personnel. A medical insurance treatment adjustment mechanism should also be set up in accordance with the level of financing. To that end, China should implement a critical disease insurance system comprehensively in both rural and urban areas and reform the payment method of medical insurance. By integrating basic medical insurance systems, administrative reform can be carried out in public hospitals.

With the new urbanisation process, China should make improvements to hospitals at county and village level to establish a well organised, tiered diagnosis and treatment system. ■

Gu Shengzu: Unleashing innovation to support growth

Vice-chairman of the Financial and Economic Affairs Committee of the National People's Congress *Gu Shengzu* discusses five key elements in China's economic transformation

What do you view as the key elements in China's economic transformation?

China's economic transformation during the period of the Thirteenth Five-Year Plan will centre on five aspects. First, economic growth will be driven by innovation rather than factor investment. Second, structural transformation will mean greater focus on consumption and services. Third, economic growth will be underpinned by 'green development', a concept put forward during the fifth plenary session. Fourth, China will continue to globalise its economy by exporting capital and expanding overseas business rather than merely attracting foreign investment as occurred in the past. And fifth, China will strive to make its growth model more inclusive.

In China, the service sector has now surpassed manufacturing in size. A growth agenda, emphasising innovation, coordination, openness, sharing, and green development, has been presented. But more needs to be done. China must upgrade its industries from low-end to mid- and high-end. Ultimately, the country should transform itself from a major exporter of products to a major exporter of capital – from 'Made in China' to 'Owned by China' and 'Created in China'.

Since China opened up its economy 35 years ago, the country's GDP has grown 142 times. This growth, however, has neither been inclusive nor balanced. Urban residents' disposable income grew 71 times during the same period. Rural residents fared worse still. Yet recently, this has begun to change. In 2015 disposable income of both urban and rural residents grew faster than GDP; such momentum should be strengthened during the next five years.

Gu Shengzu

Can China really hit a target of more than 6.5% GDP growth per year?

Many foreign economic and financial institutions doubt whether China will achieve growth of 7% in the coming years. Two strategies could help prove them wrong: the 'mass entrepreneurship and innovation' strategy and the Belt and Road initiative.

President Xi Jinping sees innovation as the new engine of national development. As Premier Li Keqiang has pointed out, innovation will be the key driver of a Chinese shift from low-end to mid- and high-end industry.

In the US, President Barack Obama has championed a structural shift away from the excessive reliance on finance that led to the global financial crisis, toward high-end manufacturing. It does indeed appear that the technology sector, symbolised by California's Silicon Valley, has served as the engine of US economic recovery following the crisis. The top five US companies in terms of market value – Apple, Google, Microsoft, Amazon and Facebook – are all based near Silicon Valley.

> *"Ultimately, China should transform itself from a major exporter of products to a major exporter of capital"*
>
> *Gu Shengzu, National People's Congress*

Notably, they rely heavily on foreign talent. Immigrants account for 36% of Silicon Valley's population, compared to 13% for the US as a whole. Some people even joke Silicon Valley is built by 'ICs' – Indian and Chinese. Arguably, workers from India and China are the engine of America's quintessential tech hub. Chinese tech workers are playing an important role at home as well. The world's second largest tech hub, measured by companies listed, is Beijing's Zhongguancun.

How can China optimise entrepreneurship and innovation?

As China looks to offset slowing growth through entrepreneurship and innovation, certain aspects become crucial. Most important is to optimise the entrepreneurship and innovation ecosystem by lowering entry barriers for startups, establishing habitats for entrepreneurship and innovation, and facilitating synergies between the two.

China also needs to foster a culture of innovation. Tolerance of failure and job-hopping among professionals are typical features of Silicon Valley culture. Moreover, China should offer entrepreneurial education, encourage large enterprises to lead the way on innovation, and cultivate innovative finance and more efficient capital markets. The prosperity of Silicon Valley is, after all, supported by Wall Street.

For innovative businesses, institutional innovation outweighs technological innovation; talent motivation outweighs technological development; the creation of a favourable environment outweighs the aggregation of production factors; and culture outweighs plants and machinery. Fostering innovation is, therefore, a long-term commitment and short-term speculative behaviour should be avoided. Unlike the seeding of a lawn, which is relatively short term and can produce quick results, planting trees requires a long-term view. Our innovators should bear in mind that they are 'planting trees' and should focus on the long-term process and the early stage of the incubation programmes.

Silicon Valley is teeming with talent and capital but, more importantly, it benefits from an ecosystem of entrepreneurship and innovation. Beijing's Zhongguancun is on a par with Silicon Valley's Sand Hill Road in this regard. Zhongguancun now contributes more than 40% of Beijing's economic growth and has formed a comprehensive, innovative system supported by the cooperation of government, enterprises, universities, research institutes, financial institutions and intermediary organisations.

Zhongguancun now has 260 listed companies and is a cluster attracting talent and capital. Both Beijing and Shenzhen are comparable to Silicon Valley in other ways too. One third of Chinese venture capital firms are based in Beijing's Zhongguancun and another third in Shenzhen, a similar ratio to Silicon Valley.

How important is the internet in terms of fostering innovation?

The internet is the most vital platform for entrepreneurship, creating both a fairer playing field for businesses and more active investors. It has become 'the fifth domain' after land, sea, air and space and the new internet economy has become the biggest growth pole. China is likely to supersede other developed countries in becoming a leading internet power; the US now has six of the top global internet companies while China has four. ■

Gu Shengzu is vice-chairman of the Financial and Economic Affairs Committee

Difficulties and prospects facing the economy

Ning Jizhe, deputy director, National Development and Reform Commission, examines what lies in store for the China economy during the coming year

In 2015, the Chinese economy experienced stable yet difficult growth due to the challenge of sustaining investment, boosting external demand, bolstering business development, increasing fiscal revenues, implementing economic reforms and addressing risks in the financial sector.

Growth of investment in fixed assets has been slowing down. As investment in traditional manufacturing becomes saturated, the inventory of commodities held in storage has grown and infrastructure investment faces numerous constraints as lacklustre market confidence hits investment. Meanwhile, the shrinking profitability of enterprises and the mismatch of demand and supply of capital are also leading to a drop in investment capacity. Furthermore, it will take time for countering policies to have a substantive impact on investment activities. Therefore, the sustainability of investment remains a serious issue.

Since 2015, the performance of export-related indicators has been particularly poor. Due to weak demand in external markets and increasingly fierce competition, early indicators such as the Exporting Leading Index and the PMI New Export Orders Index continue to slip back, making it very difficult to reverse the trend of declining exports in a short period of time. Weak demand in both domestic and foreign markets has directly affected the production and operation of enterprises. The price slump of industrial products exacerbates the plight of existing business operators and the ex-factory price of goods has been declining for 40 consecutive months. It is quite common that the capacity utilisation rate is falling and workers are being put on short time.

There is also a difficulty in increasing fiscal revenues. Due to economic slowdown, shrinking corporate profitability and structural tax reductions, the growth of Chinese fiscal revenues decelerated in 2015 and the revenues from usufruct transfers of state land also declined, which resulted in negative growth of fiscal revenues in some provinces. China also faces a challenge implementing reform policies and measures. Due to factors such as deficient supporting policies, unsynchronised reform attempts and the inaction and abuse of authorities, some policies and reform measures are belated and hard to be implemented in practice, which makes it hard for them to produce immediate and timely results. The risks in the financial sector have also manifested in 2015 and featured excessive production capacity, local government debt and housing bubbles. As the risks in some sectors are interrelated, the spillover effect is more likely to happen than before.

Ning Jizhe

New five-year plan

At the end of October 2015, China revealed the initial draft of the Thirteenth Five-Year Plan, which includes a number of important points. First, China shall maintain a medium and high growth rate in the next five years, meaning that China's GDP and per capita income of Chinese residents in 2020 will double from 2010 levels. To fulfil this 10-year target of doubling the economic aggregates and income of residents, the annual GDP growth rate should reach at least 6.5%, which is impressive in absolute terms. Meanwhile, China should move forward in economic and industrial upgrading, aiming at a medium-high level.

Second, China's target urbanisation rate should be more than 55%, calculated with permanent population, and should reach 45% calculated with household registration population. In China, there is a gap between the permanent population and the household registration population – there are more than 200 million migrant workers living and working in cities that have not gained residency. They move back and forth between urban and rural areas and serve as an important source of labour that makes an important contribution to Chinese society.

Third, China needs to strongly enhance entrepreneurship and innovation. China should formulate plans to promote the strategy of 'Made in China 2025', so that achievements made in new economies, new industries, new technologies, new development

Transforming China's growth model

Xinjiang desert, Western China

models and new types of business can be built upon. More importantly, China should advance reforms in administration, management and business registration systems, as well as adopt other structural reform measures.

Additional reforms

China should also invest more in public goods and services, which are not sufficient, especially in areas such as social security, education, sanitation, basic healthcare and infrastructure (particularly in mid- and west China and other remote areas). The government and market entities should make a joint effort to propel infrastructure modernisation and invest more in projects such as water power, railways, roads, waterways, airways, communication, power, municipal administration and environment. Though China ranks first in terms of high-speed rail, it still ranks second in terms of expressway and railway operating mileage. Therefore, infrastructure development in China, especially in central and western areas, is not adequate and needs additional investment.

There is a need for a coordinated strategy to develop the west of the country, revitalise the northeast, boost the rise of the central region and ensure that coastal areas take the lead in developing the Silk Road Economic Belt, the 21st Century Maritime Silk Road, the Beijing-Tianjin-Hebei region and the Yangtze Economic Belt. Those strategies will narrow the gap among different regions in China and provide more opportunities for future economic growth. Since nearly 50% of the population lives in mid- and west China, those areas have great potential for economic development. Furthermore, coastal regions should continue to take the lead in reform and opening up. For example, pilot free-trade zones have been established in Shanghai, Tianjin, Fujian Province and Guangdong Province. Their successful experiences will be replicated and scaled up in other regions in the future.

At the same time, China must promote green, low-carbon and clean economic growth. The environmental protection industry in China has great potential and we should draw on the successful experience and advanced technology from developed countries. There is also a need to pursue shared economic growth and reform the current system of income distribution. The goal is to take targeted measures to help the 70 million rural residents who live on less than $1 dollar a day, to lift them out of poverty by 2020. And those who are not able to do so will be covered by the social security system.

China has already become the world's second largest consumer market, worth $13-14 trillion, which is expected to become even bigger as the Chinese middle-class keeps expanding.

> *"Infrastructure development in China, especially in central and western areas, is not adequate and needs additional investment"*
>
> *Ning Jizhe, National Development and Reform Commission*

China must also adhere to foreign policies promoting peaceful development. Chinese outbound tourists amounted to more than 130 million in 2015 and the number is expected to keep growing in the future.

While China continues to attract foreign investment, it should also promote its overseas investment. In 2014, China's direct overseas investment reached $120 billion. Furthermore, China has reached consensus with many countries in promoting international production capacity and equipment manufacturing cooperation. In addition, the Belt and Road initiative has resonated well in the world and can be integrated with the development strategies of many countries. ■

The role of innovation and consumption

By as early as 2020, China could become the third major country of the post-war era to transform from a low-income to a high-income economy. Former World Bank chief economist and founding director of the China Center for Economic Research *Justin Yifu Lin* analyses the benefits of such a shift for the country itself and the wider global landscape

In October 2015, the Chinese Communist Party's Central Committee proposed that the country's Thirteenth Five-Year Plan should aim for medium-high economic growth, later defined by Premier Li Keqiang as a rate of more than 6.5% annually. This rate would allow China to double GDP. However, China should aim to achieve 7%. This is because the Eighteenth Party Congress's target was to double GDP and per capita income by 2020, compared to 2010 figures. The population growth rate, meanwhile, is 0.5%.

There are several ways to achieve the second goal. One is to maintain the growth rate at 6.5% with greater income redistribution to households. But this may hurt business profitability, potentially creating a vicious cycle whereby slower growth leads to more redistribution, weaker profits and so on. The result would be higher unemployment and potential financial market instability. Aiming for 7% growth, therefore, seems more apt.

At close to 7%, Chinese GDP per capita would most likely exceed $12,600, the threshold for a high-income economy, by 2020, so long as the renminbi appreciates about 10% from the current level. It would be the third major economy of the post-war era to transform itself from a low-income to a high-income economy, following in the footsteps of Taiwan and the Republic of Korea. It would represent a significant milestone.

Global benefits

It would also benefit the global economy. The developed countries have yet to recover fully from the 2008 financial and economic crisis; in the past few years, China has been the major driver of global growth. A slowdown in China could create new, unexpected challenges for the world economy. At 6.5% growth or higher, China would continue to contribute around 30% of growth annually, thus remaining the major driver of the global economy.

There is concern inside China and particularly outside the country about whether or not China can meet its new growth targets, especially as growth has fallen to 6.9% in the third quarter of 2015 versus an annual growth rate of 9.7% until 2010. Some believe China's economic growth rate might decline further from current 6.9% to 6%, 5% or even 4%, due to structural impediments.

As a student of the Chinese economy, I take issue with the notion that the current slowdown is fundamentally structural. That is not to say there are no structural issues to be resolved – China is still, after all, a developing economy in transition. Nonetheless, it should be noted that other emerging economies, such as Brazil, Russia and India, and other high-income, high-performing economies, including Singapore, Taiwan and the Republic of Korea, have registered lower growth than China since 2010.

The most likely explanation for this common trend is external headwinds. Domestically, China is in better shape than external observers give it credit for. It is exports that have suffered. Annual export growth slowed in 2015 after averaging 16.3% during the past 30 years. This, however, is not unique to China. Rather, it is a problem shared by all economies whose growth rate depends largely on exports, and one that owes much to the slow recoveries in the US, Europe, and Japan.

Meanwhile, as the global economy has yet to fully recover, investment will obviously be affected. This, again, is an international problem and not unique to China. Finally, consumption in China is growing at a relatively stable pace of 8-9% annually, significantly higher than in other countries and regions. That is why China has been enjoying more than 7% economic growth in the past few years while other countries and regions have had much slower consumption growth rates – and thus much slower economic growth rates compared to China.

Domestic demand

In the future, it might be relatively harder for developed countries to achieve robust recovery as they find it difficult to implement struc-

Justin Yifu Lin

China Mobile booth at the CHITEC expo, Beijing

testing / Shutterstock.com

tural reforms. So a significant pickup in exports to these countries appears unlikely. So during the next five years, Chinese growth will be driven mainly by domestic demand, underpinned by both consumption and investment. Many international experts emphasise the former, suggesting China's hitherto investment-driven growth model cannot be sustained. I do not accept this view. Consumption is surely an essential part of the story. But the premise for long-term, sustainable growth in consumption is an ongoing increase in revenue, which relies on continuous innovation in current industrial technologies and the emergence of increasingly high value-added industries.

Technological innovation, industrial upgrading and infrastructure improvement all rely on financing. Therefore, the premise for strong increases in consumption is investment. Smart and efficient investment will grow employment and income – and thus, consumption.

Do good investment opportunities still exist in China? Certainly, there is overcapacity in infrastructure-related industries such as, steel, cement, glass and aluminum. But these are medium to low-end industries. The opportunities for upgrading and investing in medium to high-end industries with high returns remain tremendous. Moreover, while China has invested heavily in infrastructure, connecting one city to another through highways, rail and ports, there is still a severe shortage of infrastructure within cities, including in underground transportation and pipelines. Investments in these areas would generate high economic returns.

With a current urbanisation rate of 54%, which is expected to exceed 80% as it develops into a high-income country, China still has a long way to go. Unlike in high-income countries such as the US, Europe and Japan, whose industries are at the technological frontier and as such are experiencing diminishing returns, opportunities for catchup growth are prevalent in China.

Proactive policies

China still has huge space for proactive fiscal policies. Government debt, both central and local, makes up less than 45% of GDP – one of the lowest rates in the world. In addition, private savings make up nearly 50% of GDP – one of the highest in the world. Government investment could be used to leverage private investment. Domestic savings and ample foreign exchange reserves set China apart from many other developing countries.

By matching investment opportunities and resources, China can retain high investment growth, in turn boosting employment, revenue and consumption. The dual targets of doubling GDP and per capita income during the next half-decade can be achieved. China should become a high income country by around 2020.

> *"During the next five years, Chinese growth will be driven mainly by domestic demand, underpinned by both consumption and investment"*
>
> *Justin Yifu Lin, China Center for Economic Research*

This is good news for people across the globe. High income countries currently account for 15% of the world's population, a figure that could double in the next five years as China continues to provide economic opportunities not just at home but abroad. As President Xi Jinping urged in Vietnam in November 2015: time to board China's express train of development. ■

Growth through technology

Ma Weihua, executive vice-president of the IFF and president of the National Fund for Technology Transfer and Commercialization, explains why the time is ripe for innovation

The current slowdown in Chinese economic growth represents an opportunity for the country to shift from a growth model based on cheap labour and long working hours to an innovation-driven one. It is particularly noteworthy that innovation leads the list of the five major concepts highlighted in China's Thirteenth Five-Year Plan. It is vital to improve the quality of GDP growth through technological innovation as low quality growth does not generate competitive advantage.

In recent years, the Chinese government has already stepped up efforts to promote technological innovation by encouraging the whole society to unleash its creativity through "mass entrepreneurship and innovation".

Innovation in China is, however, not without its challenges, the biggest of which is financing. Chinese SMEs, especially high growth ones in the technology sector, are daunted by difficult, expensive financing options. Compared with their US counterparts, Chinese SMEs receive far less financial support. Starting out small, American companies like Microsoft, Yahoo and Cisco would not be as successful as they are without venture capitalists and lenders from Wall Street and Silicon Valley. By comparison, traditionally it has been difficult for high growth technology companies in China to borrow from banks because their intellectual property is not eligible collateral for loans under China's stringent commercial banking law.

New measures to support high-tech SMEs

High growth technology SMEs are the most motivated of all businesses to pursue innovation and embrace technology and thus have an important bearing on China's high quality future growth. Nowadays, both the government and banks are making efforts to provide more support to China's SMEs, especially high growth ones in the technology sector.

The Ministry of Science and Technology no longer funnels funding through layers of government to growth companies. Instead, it now partners with well-established, qualified private funds. Under such partnerships, sub-funds are created and investment is shared between private capital and public finance at a 70:30 ratio. To engage private capital, the partnerships are structured in such a way that the government stops receiving dividends on exit from its sub-fund. In addition, the State Council has convened a number of meetings to encourage banks to support SMEs by providing capital reserves, loan-to-deposit ratios and even loan guarantee services.

Banks themselves have developed many financial products targeted at SMEs and growth companies. For instance, China Merchants Bank (CMB) launched its 'eagle' program, in which a list of high growth technology SMEs is selected from the existing clients of CMB and then referred to private equity (PE) funds for further selection, evaluation and investment. The screening by PE funds is essentially a risk assessment process. CMB then fulfils the remaining financial needs by providing the loan. For even better risk control, banks can offer financial counselling to SMEs as they prepare to become listed companies. With a combination of investment and lending, CMB has supported nearly 10,000 high growth technology SMEs.

Ways to support high-tech SMEs

China could focus on the following four aspects to support high growth technology SMEs.

- Fostering and developing a financial service system to boost technological innovation: a) Support bank lending and implement differentiated regulation, reserves and taxation policies; b) enhance capital market support so that capital would be more accessible to technology SMEs, with, for example, relaxed Growth Enterprise Market listing requirements; c) encourage lender-investor cooperation between commercial banks and PE funds; d) form a well-functioning equity investment mechanism to leverage venture capital, risk capital, the National Guiding Fund for the Conversion of Scientific and Technological Achievements, and other resources; and e) establish small and medium-sized, privately-owned technology banks following the model of Silicon Valley Bank.
- Perfecting the loan guarantee system for technology SMEs: Establish a variety of loan guarantee companies that meet the needs of different sectors that provide services to technology SMEs, help banks to develop innovative credit products and grant more technology companies access to loan financing.
- Establishing a business credit information network accessible by the whole financial system: China could create a business credit database of technology SMEs by combining the existing Bank Credit Registration and Consultation System with the credit information from the Ministry of Science and Technology, the Ministry of Industry and Information Technology, the State Administration of Taxation, the General Administration of Customs, and other government agencies. Meanwhile, establishing a credit rating system for technology SMEs would also be beneficial.
- Forming a counselling system for technology SMEs: It would be advisable to form a counselling system for technology SMEs. With local governments playing a leading role and cooperation from commercial banks and other relevant stakeholders, a counselling system for technology SMEs would offer an inclusive package of advisory services in financing, management, marketing, and other related areas. ■

Opportunities and risks from economic recovery

Former prime minister of Japan *Yukio Hatoyama*, chairman of the IFF Advisory Committee, welcomes the shift in China's direction towards sustained growth through structural reforms

The policies of the US and China have a profound impact on the state of the global economy. In the US, robust domestic economic growth is expected to continue for the time being, which should drive personal consumption and an increase in disposable income. Declining crude oil prices are also good news for American consumers. In China, President Xi Jinping has noted the economy is entering a 'new normal', with less emphasis on the specific rate of growth. Economic structural adjustment will be treated as a vital priority, with further reforms and opening up planned.

I heartily welcome such a shift in China's direction away from the high growth rates stressed in the past – pursuing, in its place, sustained growth through structural reforms. The establishment of the Asian Infrastructure Investment Bank (AIIB), the One Belt, One Road vision and other efforts are also important. It will, however, take a certain amount of time for such institutions and ideas to function. In that sense, I look forward to the introduction of policies, such as the creation of new jobs through online shopping, mobilisation of the stock market and other areas in which China offers dynamic potential, to infuse even greater vigour into the nation's economy.

Yukio Hatoyama

The Association of Southeast Asian Nations (Asean), meanwhile – soon to celebrate its fiftieth anniversary – is acclaimed as the world's most successful regional cooperation association of developing nations. In December 2015, the Asean Economic Community was launched. In addition, the expanding ranks of the middle-class, along with redoubled innovation, promise to pave the way to further high added value for the Asian economy at large.

At the same time, there are also areas in which the future remains uncertain. They include issues inherent to the economies of the US and China themselves, the international monetary system and other sectors. Questions remain, for example, of how the crisis in Greece will eventually be resolved and what the future holds for the eurozone. There are also serious political issues, capable of heavily impacting global economic endeavour. The tense situation in Ukraine, the Iran nuclear development issue, the Syrian refugee crisis, the deadly threat of the so-called Islamic State of Iraq and the Levant, and many other dilemmas far too numerous to mention in full here.

> *"I look forward to the creation of new jobs through online shopping, mobilisation of the stock market and other areas in which China offers dynamic potential"*
>
> *Yukio Hatoyama, former prime minister of Japan*

Managing the transition

Over the long term, future progress depends upon effective management of transitional periods for the international economic and monetary system, the transformation of Bretton Woods system in the post-World War era, realigning peaceful and constructive settlements with newly rising powers, and other demands.

Gouqi Island, East China Sea, looking towards Japan

From that point of view, the position of China, which this year launched the AIIB and advocates the One Belt, One Road vision, is extremely important. Reforms in the renminbi currency will become a pressing issue, and the responsibilities for Chinese leaders will certainly grow increasingly more demanding from here on.

It is essential, therefore, to expand the opportunities presented by economic recovery on multiple levels, while concurrently moving in directions capable of avoiding deadly risk. In such terms, the roles to be played by both Japan and China will certainly become more significant. This refers to the critical need to expand Asia's middle-class; through trade investment, as well as cooperation on the monetary front.

Naturally, we cannot overlook the importance of the Regional Comprehensive Economic Partnership, essentially a free-trade agreement between Japan, China and the Republic of Korea. We must likewise recognise that the Trans-Pacific Partnership (TPP), a goal now reportedly actively pursued by China as well, harbours the potential to buoy the economic foundation of the entire region – essentially as a 21st century-format free trade agreement.

A brief word of warning with regard to TPP: by placing the ultimate priority on economic activity, there can be risks for human health and life. Under TPP, for example, there are serious concerns over the possible importing of genetically modified crops, and similar worries.

Considering such factors, the East Asian Community holds the greatest potential for optimising the roles and collaboration of Japan, China, the Republic of Korea and Asean, in spearheading further growth and progress throughout Asia.

Fostering mutual confidence

From the perception of the general public, I believe it can be said that genuine prosperity will never be realised without stable and working materialistic and psychological harmony. The same holds true for the ties between individual nations. As such, I find it self-evident that the road to true economic progress does not lie in excessive outlays for conflicts, deterrents and other behaviour rooted in lack of trust. Rather, by advancing the utmost efforts to foster mutual confidence and understanding, and forging win-win relationships, it will be possible to bear far greater economic fruits in the long run.

Such an enlightened stance is imperative when we consider that, much like the environmental crisis, we face issues clearly impossible for any one nation to resolve on its own. By their very nature, if not effectively addressed, such challenges threaten to produce massive economic losses on a global scale.

Today, we stand at the threshold of the road to a bright and progressive future. In my mind, the way to realise ideas often prone to be dismissed as vague utopian visions lies in one vital area – mobilising greater numbers of people who believe in and are willing to journey down such pathways. ■

FINANCIAL DEEPENING AND MARKET REFORM

China makes strong start on economic transition

The past year has been one of progress for China's structural reform plans. *Zhang Hongli,* IFF Academic Committee member and executive director and vice-president of Industrial and Commercial Bank of China, examines the forward momentum

Last year was a complicated and volatile one for the global economy. In China, economic headwinds helped forge consensus on the need to promote structural reforms, which are rebalancing the relationship between the government and the market. There is a need to deepen financial reforms and improve financial stability while boosting financial sector competitiveness. Some important progress was made in the past year.

Deposit insurance

On May 1, 2015, the State Council launched its Deposit Insurance Regulation, which guarantees deposits of up to 500,000 yuan, thus fully covering 99.63% of depositors, including enterprises. The deposit insurance scheme is an essential reinforcement of China's existing financial safety nets that will further stabilise the country's banking sector. It will boost the incentives for long-term saving and strengthen small- and medium-sized banks. The deposit insurance scheme lays the foundation for a competitive and sustainable financial system.

Renminbi reform

In August 2015, the People's Bank of China (PBoC) changed the way it determines the exchange rate of the renminbi, giving market forces greater influence over where it sets the daily midpoint rate – the rate it gives to the China Foreign Exchange Trade System before the opening of the interbank foreign exchange market on each working day. This marked a milestone in renminbi exchange rate reform during the past decade. However, in response to the market reaction that followed, the government adjusted the exchange rate, so that it can return to a reasonable and balanced level. This will allow it to serve as a reliable benchmark in future. The renminbi exchange rate formation mechanism (the midpoint rate determination mechanism) was overhauled and the International Monetary Fund's (IMF) Special Data Dissemination Standard was adopted.

In addition, several measures designed to further liberalise the renminbi have been announced. The foreign exchange and interbank bond markets are now open to foreign financial institutions, including central banks. The Ministry of Finance has been issuing three-month Treasury bills on a weekly basis since October, thereby strengthening the yield curve. And the first phase of the Cross-border Interbank Payments System (CIPS) was launched in

Zhang Hongli

October 2015. CIPS allows processing of cross-border renminbi transactions and supports the settlement of cross-border trades of commodities and services, cross-border direct investment, cross-border financing and cross-border remittance business for individuals. It simplifies settlement and safeguards renminbi internationalisation.

The measures mentioned paved the way for the renminbi's successful inclusion in the IMF's Special Drawing Rights (SDR) basket announced on November 30, 2015. The RMB is weighted 10.92% and the new basket will be launched on October 1. SDR inclusion is not only an important step towards renminbi internationalisation, but a testament to China's role at the centre of global economic and financial governance. There had been four currencies that made up the SDR basket for the past few decades, which represented the four most powerful economies in the world. The fact the renminbi joins as the fifth reserve currency represents the IMF's recognition of China's economic and financial system, and acknowledgement of the free use and internationalisation of the renminbi.

Interest rate liberalisation

To allow the market to play a decisive role in allocating financial resources, the PBoC, with the approval of the State Council, decided to remove the upper limit on deposit rates charged by

Pudong skyline, Shanghai

commercial banks and rural cooperative financial institutions on October 24, 2015. Thus, a key step was made towards interest rate liberalisation, manifesting China's determination to implement its reform agenda.

First, relaxing interest rate regulation helps optimise resource allocation, directing financial resources towards those sectors and enterprises truly in need of capital. It allows the market to play a vital role and should help to ensure healthy and sustainable economic development.

Second, relaxing control on interest rates instills fresh momentum in promoting the transformative development of financial institutions. With the upper limit on deposit rates removed, the traditional business model of financial institutions following the concept of 'scale is profit' is no longer sustainable. This helps financial institutions to adopt a business concept that is profit-centered, accelerate the transformation of their business models, improve the interest rate determination mechanism, enhance the capacity of independent pricing, implement differential pricing, satisfy increasingly diversified financial needs and truly enhance the quality of financial services.

> *"Relaxing interest rate regulation helps optimise resource allocation, directing financial resources towards those sectors and enterprises truly in need of capital"*
>
> *Zhang Hongli, IFF Academic Committee*

Third, relaxing control on interest rates creates favourable conditions for the transformation of the monetary policy framework, allowing authorities to gradually switch from quantity-based to price-based monetary policy regulation. Strengthening price control is inevitable to improve the efficiency of macro control, and easing control on interest rates is an important prerequisite to achieving such a transformation.

The PBoC has also released a paper on the roadmap for developing an interest rate corridor. According to the paper, the central bank could stabilise market interest rates through range management and expectations guidance. With the formation of market-based benchmark interest rates and improvement of the transmission mechanism, the PBoC's role in determining benchmark lending and deposit rates may be gradually reduced or even removed.

Policy-based finance

China has stepped up structural reform efforts and accelerated the implementation of innovation-driven strategies. Other major

Financial deepening and market reform

A ROLLER-COASTER RIDE FOR EQUITIES

The first seven months of 2015 witnessed major fluctuations in China's A-share market. The Shanghai Composite Index began its round of upward movement in February 2015 and soon gathered speedy momentum with the accelerated influx of off-market liquidity and leveraged funds. On June 12, 2015, the composite index hit it's a record recent high of 5,178.19 points. The ensuing stock market crash now appeared inevitable given the huge bubble created by large capital inflows, especially by leveraged funds. The fall was also exacerbated by market participants being able to short stocks.

The China Securities Regulatory Commission introduced corrective measures during the market swings last year and ultimately the authorities successfully prevented the situation from escalating into a systematic issue, creating a window of opportunity for the market to recover and develop. Such action conforms to the reform objective of "making the market play a decisive role in resource allocation and letting the government improve its role", which was announced at the Third Plenary Session of the 18th CPC Central Committee. Some temporary measures were withdrawn after the market began its self-recovery and development. One of the main causes to the stock market turbulence is the underdeveloped capital market in China, which is manifested in its flawed trading mechanism, imperfect market system, inexperienced traders and mismatched regulations.

As such, China will accelerate its reform and transform its governmental functions while comprehensively strengthening supervision to promote sustainable and sound development of the capital market. Persevering with 'marketlisation' and 'legalisation' represents the two foundations governing the development of China's capital market. Regulators, however, must still step in with action in the event of a complete or repeated market failure.

Broken circuits

China introduced circuit-breakers at the beginning of 2016 to prevent huge volatility in the stock market. Aimed at helping the market to 'cool down', circuit-breakers are intended to prevent or reduce hasty decision-making during turbulent market and dampen down programme trading. But they failed to yield the desired results when implemented on two occasions, instead causing a 'magnet effect', with some investors rushing to trade before halts occurred. This exacerbated the situation, forcing the CSRC to suspend the mechanism. The implementation of circuit-breakers will be explored gradually by regulators to have a fined tuned version of the mechanism ready as and when needed. But their use is less likely while China's stock market continues to be dominated by medium and small-sized investors.

IPO system

The creation of a registration-based IPO system is an important task in the State Council's top-level design for a sustainable and sound capital market, but it should not be implemented on its own. Improving the multi-layered capital market system, promoting reform toward a registration-based IPO system and facilitating equity financing through diverse channels should move forward hand-in-hand and reinforce one another.

strategies, such as achieving the Belt and Road initiative and the Beijing-Tianjin-Hebei regional development, need substantial investment. Development-oriented and policy-backed finance is crucial.

In April 2015, the State Council approved a reform plan laid out by China Development Bank, the Export-Import Bank of China and the Agricultural Development Bank of China. The plan specifies the core functions and roles of these three policy banks and requires them to establish and strengthen a capital restraint mechanism.

Specifically, the China Development Bank should adhere to its role as a development-oriented financial institution; the Export-Import Bank of China should strengthen its role as a policy-backed financial institution; and the Agricultural Development Bank of China should focus on policy-based mandates and transform itself into a sustainable agricultural policy bank. As $48 billion and $45 billion of foreign exchange reserves were injected into the China Development Bank and the Export-Import Bank of China respectively in July 2015, the work of capital replenishment required by the reform plans was successfully completed.

Meanwhile, reform plans on the scope of business, the improvement of governance structures and statute amendment of the three banks are in progress. Such reforms will improve the capital strengths and risk resistance capacity of the banks; strengthen their functions and the roles of policy-backed and development-oriented finance in supporting underdeveloped and key sectors; and help to ensure steady growth, make structural adjustments, bring benefits to people and promote a healthy and sustainable economic and social development.

Regulated internet finance sector

As China's development model is changing and technological advances are making themselves felt in finance, China's financial sector is undergoing a transformation. Regulators and supervisors must adapt. In July 2015, the PBoC – together with 10 ministries, departments and agencies of the Chinese govern-

Internet finance in China has entered a new period of regulation

THE DEVELOPMENT AND REGULATION OF INTERNET FINANCE

Yao Yudong examines how China can deliver on its promise to push toward mass entrepreneurship and innovation

With the rapid development of new information technologies such as cloud computing, Big Data, the Internet of Things and 'block chain' that make us ever more connected, human beings are gradually migrating from physical space to cyberspace.

This migration is driven by three overarching trends. First, we are witnessing an upsurge of 'makers' in mass entrepreneurship and innovation. The cost of starting an enterprise online is very low. Huge investments into fixed assets are no longer a prerequisite for success – just look at the explosion in e-commerce startups during the past few years. We may, as a result, in fact witness the decline of private equity firms and portfolio companies in the future.

Second, the potentially unlimited provision of goods in cyberspace is lowering marginal costs, which benefits consumers by driving down prices.

Third, new types of fintech businesses such as crowd funding and peer-to-peer lending are disrupting traditional models of intermediation, replacing them with direct and automatic matching.

At the Third Plenary Session of the 18th Communist Party of China Central Committee, the country called for a push toward mass entrepreneurship and innovation. How can China meet this objective? In short, through legal reforms.

According to Chinese law, a company can have at most 200 shareholders. That number should be expanded. The shareholder base of online platforms and tech companies typically numbers in the thousands. China needs to consider increasing the maximum number of shareholders from 200 to 1,000 – similar to US rules.

Commercial banking and securities laws should also be revised. Commercial banks in China are currently prohibited from investing in non-banking financial institutions or enterprises. This setup should be reviewed to ensure traditional lenders adapt to new ways of doing things – effectively enabling the proverbial 'elephants' to 'dance'.

In addition, revision of securities laws should aim to guarantee the quality of listed companies and discourage competition among the main board, second board and new third board markets. It should also ensure effective supervision of firms.

In 2015, the People's Bank of China (PBoC), together with 10 government ministries, departments, and agencies, issued the Guiding Opinions on Promoting the Healthy Development of Internet Finance, which is designed to strike a balance between financial innovation and risk. In addition, the 'One Bank and Three Commissions' group – comprised of the PBoC, the China Securities Regulatory Commission, the China Insurance Regulatory Commission and the China Banking Regulatory Commission – is drawing up rules on the administration of internet payment services and equity crowd funding.

In addition, capital pools should be banned to avoid risks of maturity mismatches and explicit, implicit guarantees should be prohibited since they are likely to incentivise excessive risk-taking and bad debts down the road. Guaranteeing highly risky crowd-funding projects underpinned by little or no capital is bound to lead to a variety of problems.

Yao Yudong is an IFF Academic Committee member and director general of the Research Institute of Finance and Banking, People's Bank of China

PROSPECTS FOR A GREEN FINANCIAL SYSTEM

Ma Jun explains the growing urgency for China to transition to a green financial system

Prospects for the environment in China are looking increasingly grim, so China's economic development needs to be transformed into a green and sustainable model, to underpin this transition. China needs to set up a green financial system as soon as possible to channel social capital into green projects that maximise social welfare. So far, although achievements have been made in directing green credit, efforts to build a green financial system are fragmented and many studies are still limited to concepts.

The so-called green financial system refers to a series of policies, institutional arrangements and relevant infrastructure projects that support social capital investment to green industries, including environmental protection, energy saving, clean energy and clean transportation, through financial services such as loans, private equity investment, bonds, stock issuance, insurance and emissions trading.

Building a green financial system in China can help to stabilise the economy in various ways. First, it nurtures new growth points and boosts economic growth potential. Second, it helps accelerate the green transformation of industry, energy and transportation structures and enhances the technological component of China's economy. Third, it alleviates government financial pressures caused by environmental problems. Fourth, it facilitates China's efforts to be recognised as a responsible powerhouse in the international arena.

At the current stage, China needs to channel more social capital into green industries. This can be done by increasing returns on investment in green projects, lowering returns on investment in pollution-intensive projects, enhancing enterprises' sense of social responsibility to boost green investment, and raising awareness of environmental protection and green consumption among consumers. If these policies can produce the same effects at the lowest price, they are optimal.

Based on China's current situation, one can propose some initial suggestions on building a green financial system in the country. In total, 14 suggestions are proposed and can be categorised into four types: institutional construction; policy support; financial infrastructure; and legal infrastructure. This classification helps to specify government agencies and market players' responsibilities for implementing each suggestion.

The first category, institutional construction, provides organisational support for green investments. It calls for the contribution of central and local government funds and relevant system reform, including building a green banking system and green industrial funds. Institutions that could offer this support include the Silk Road Fund, the Asian Infrastructure Investment Bank, the New Development Bank and other outbound investment and development institutions.

The second category concerns fiscal and financial policies, requiring assistance and impetus from bodies including the Ministry of Finance, the People's Bank of China (PBoC), the China Banking Regulatory Commission (CBRC) and the China Banking Securities Commission (CSRC) to create an efficient fiscal discounting mechanism for green loans. The National Development and Reform Commission, the PBoC, the CBRC, the CSRC and other departments issue guidelines on green bonds to permit and encourage banks and enterprises to issue green bonds. It is also necessary to promote the stock market's support for green enterprises.

The third category is financial infrastructure construction that supports green investment. This can be led by private financial institutions, encouraged and supported by the government and public sectors by accelerating the construction of an emissions trading market. One way is to build a green rating system, push forward the development and application of green stock indices, set up an environmental cost calculation system and databases under the leadership of the Ministry of Environmental Protection and financial societies (or associations), and construct a green investor network.

The fourth category relates to the construction of a legal system conducive to green finance. It calls for assistance and impetus from the legislative body, relevant ministries and commissions, and financial institutions. It includes exercising forced green insurance in more fields and specifying banks' legal obligations for the environment. In addition, the CSRC and stock exchanges should establish a mandatory environmental information disclosure mechanism for listed companies so as to provide a basis for environmental risk assessment and accurate valuation on listed companies.

Ma Jun is chief economist in the research bureau, People's Bank of China

ment – jointly published the Guiding Opinions on Promoting the Healthy Development of Internet Finance (the 'guiding opinions'), an important step that led the internet finance sector into a new stage of law-based regulated development.

Centering on five principles – "legal-based regulation, proportional regulation, classified regulation, coordinated regulation and innovative regulation" – the guiding opinions specify the regulatory responsibilities of different authorities in major types of internet finance businesses, including internet payment, online lending, equity crowdfunding, online sales of investment funds, internet insurance, internet trust funds and internet consumer finance. The guiding opinions represent a new starting point for developing internet finance in China, securing regulated development of this sector.

Regional financial reforms

In December, the State Council decided to pilot several financial reform and innovation projects in selected regions. The purpose is to allow for further accumulation of experience, with the aim to deepen financial reforms and improve the capacity to serve the real economy.

For instance, a rural finance pilot zone in the Jilin Province focuses on defusing risks associated with the scale operation in modern agriculture and exploring new ways of making good use of rural property rights. Meanwhile, the Guangdong free-trade zone facilitates investments and cooperation between the Guangdong Province and Hong Kong and Macau, and the Fujian free-trade zone focuses on the financial cooperation across the Taiwan Strait. The Tianjin free-trade zone, moreover, focuses on development of the financial leasing industry, providing support for the 'going out' strategy of the large equipment industry.

The PBoC is also piloting the expansion of cross-border use of the renminbi, as well as investment and financing activities.

Deposit reserves assessment

To further improve the deposit reserves system, provide more

Building a green financial system in China can help to stabilise the economy

flexibility to financial institutions in managing their liquidity and smooth money market volatility, the PBoC implemented a new method of calculating bank deposit reserve ratios in September 2015. Under the new average assessment method, financial institutions calculate the average value of their daily final balance of the deposit reserve over a reporting period and its ratio to the reserve assessment base, to ensure such ratio is not lower than the statutory deposit reserve ratio. To promote the stable operation of financial institutions, a daily lower bound is set in the deposit reserves assessment. At the end of each working day during the reporting period, financial institutions should calculate the quotient of the daily balance of the deposit reserves and the PBoC's assessment benchmark coefficient. The quotient should remain no more than 1% below the required reserve ratio.

Switching the method (from the 'time-point method' to the 'average method') of calculating bank deposit reserve ratios can lower the amount of required reserves financial institutions must hold to deal with emergency situations and can serve as an important buffer mechanism for financial institutions. During the assessment period, the deposit reserves of financial institutions can be lower than the statutorily required amount at some point of the time, providing the average amount during the period meets the statutory requirement. In this way, financial institutions will have more flexibility in managing liquidity, which mitigates money market volatility, improving the monetary policy transmission mechanism and creating favourable conditions for transforming the monetary policy framework.

"China made important progress in 2015, with reform measures being implemented at different levels of government and dividends constantly manifested"

Zhang Hongli, IFF Academic Committee

The year 2015 was the last of the Twelfth Five-Year Plan and was a key reform year for financial deepening. At the eighth meeting of the central leading group for deepening overall reform, President Xi Jinping, emphasised that improving the quality, rather than the pace, of reforms should be prioritised. President Xi also pointed out that the authorities should strengthen the momentum and synergy of reforms, reinforce the responsibilities of different departments and raise awareness of the general situation and urgency, so that the reforms of many key sectors can be driven by the reform of government itself.

With such guidance, China made important progress in 2015, with reform measures being implemented at different levels of government and dividends constantly manifested, helping to ensure the successful structural transition of the Chinese economy. ■

Eliminating Distortions and Promoting Structural Reform

Zhou Xiaochuan, Governor of the People's Bank of China analyzes the causes of overcapacity and offers six policy suggestions to ease overcapacity.

Based on economic models, when it comes to product and sectoral structures, structural problems and price issues are a pair of primal and dual problems. Therefore, structural reform and price reform are equivalent. Of course, the efficient market hypothesis is to be taken into consideration, and it is valid under most circumstances. Even in the cases where markets are not efficient, there are ways to repair the pricing mechanism. Experience from practice also shows that government-led pricing is not necessarily a better option, not even for some major product markets. The refined oil market is such an example. The same rule applies to other prices, including interest and exchange rates. Therefore, an important component of the supply-side structural reform is to eliminate price distortions.

Easing overcapacity while reallocating and reemploying employees with protection of their rights and interests remains a critical and complicated issue. The Chinese government has always paid close attention to this issue in formulating its economic policies, including structural reform.

This issue involves two aspects. First, what is the cause of overcapacity? How to prevent severe overcapacity from happening again and to reduce the pain caused by adjustment? Second, what are the policy issues that need to be studied and addressed in reducing overcapacity?

I. A priority of structural reform is to eliminate price distortion

According to economic theory, technological advancement, social changes and shifts in demand will bring about constant changes in capacity utilization ratio. Some capacity may be useful at the initial stage of investment, but as technology develops, such capacity might become technologically outdated and eventually excessive. Also, unlike before, an employee nowadays can hardly meet the demand of career development if staying with just one skill. He/she may need to be reallocated or retrained so as to keep up with rapid changes. This is particularly true during the past two or three decades when rapid social and technological changes have occurred. From this perspective, overcapacity comes as no surprise.

However, overcapacity is sometimes caused by policy and institutional reasons, or a lack of grasp of market forces. First, overcapacity can reflect to a large degree price distortions. If there is a rush to invest when a project is launched, this may be due to the distortion in pricing, which might be the indirect result of inappropriate tax policies. For example, overcapacity occurred in the textile industry in the late 1980s to the early 1990s, and had to be addressed through eliminating spindles. One of the causes for the overcapacity was the price distortion in the textile industry which left people with a false impression of high profitability and attracted lot of investment. As a result, a large number of township and village enterprises emerged in the textile industry. Economists later believed that the overcapacity in this industry was caused by distorted rates of effective tariffs: the tariff for fibre particles was very low while that for drawnwork products was excessively high. The domestic price of end products thus became artificially higher, as if their value added and profit margins are high as well. Allured by the false perception of huge profits, investment rushed into the textile industry. As China's trade policies adjusted and the tariff distortion eliminated, investors discovered that the textile industry did not have much profit space. To this day, similar price distortions still exist in the economy.

Zhou Xiaochuan

The second cause is environmental cost, which is actually a price distortion as well. Theoretically, pollution related costs (such as treatment of pollutants and carbon emissions) need to be factored into total production costs. Carbon quotas require emitters to purchase their quotas and reflect such environmental expenses in their total production costs and final prices. If environmental cost is not covered in cost accounting, pricing would be inappropriate, artificially boosting an industry's profitability. This would attract more investment than it should be, leading to overcapacity. Once environmental requirements are tightened and fines on pollution are increased, many enterprises will find themselves unable to meet the requirements and overcapacity would surface.

Third, trade policies can also cause overcapacity. Some industries' investment in their capacity is targeted at the export market.

Take the photovoltaic industry as an example, its products were not affordable for domestic consumers, and the industry relied on the export market. Once trade disputes occur, exports of these export-oriented industries would decline, leading to overcapacity. Therefore, an adequate assessment of international market conditions is required before investment. At the same time, global trade policies must emphasize the need to prevent protectionism and the abuse of trade support measures. Otherwise, they would have negative impacts on developing countries including China.

In addition, one complaint frequently heard from private investors is that they do not have free access to some of the industries that they want to invest in. The restrictions on some industries have already been removed on paper, but "glass doors" or "revolving doors" are still there. As a result, available industries are mainly limited to the manufacturing sector, which would result in the concentration of investments. Investors would rush into the industries all at once as soon as the window of opportunity opens up.

Furthermore, many commercial banks in the past had not done adequate industry analysis before making lending decisions, and had taken an indiscriminate approach. Banks usually offer loans to the industries that are promoted by the state, with the mentality such that if anything goes wrong with the loans, it would not be the banks' fault. At the same time, banks refuse to finance at all the industries banned by the state, for instance, energy-consuming, highly polluting and resource-dependent industries. Such industries in fact cover a wide range of enterprises, and some of them are rather competitive in segment markets. However, banned by the state, these segments are not able to get bank loans, nor issue bonds, nor go for an IPO. Overall, financial institutions have not been granular enough in considering the specificities of industries and enterprises, have not taken full responsibility, and have failed to cater to the diverse needs of industry development. As the economy goes through different stages of a business cycle, over-lending to industries with surplus capacity only surfaces at a later stage and it is usually too late by the time problems are identified. When these industries with overcapacity make adjustments, banks would be undermined by the large amount of NPLs.

Of course, overcapacity in certain industries is related to changes in demand. The ratio of China's investment to GDP was once overly high, resulting in huge demand for steel and cement. After the demand fell, overcapacity occurred. Such cyclical fluctuations are also found in many other countries, but it is particularly prominent in China.

In short, causes of overcapacity are a very complex issue that needs to be further studied in a comprehensive manner. Hopefully, regular studies and reviews will be conducted to learn from past experiences, minimize repeated mistakes, take measures to reduce price and tax distortions in particular, and better facilitate China's supply-side reform.

II. Taking comprehensive measures to accelerate structural reform

The financial sector attaches high importance to the research of this issue and has put forward various suggestions. First, the effectiveness of basic welfare for employees, the pension system and health care in particular, is very important. This affects employment flexibility, and reemployment of laid-off employees as we ease overcapacity. We have always believed that pension reform is critical. Some problems occurred in this area in the past. When pension reform is done properly, it will help ease the pain of adjustments. Looking back, there were deficiencies. For example, it was proposed more than 20 years ago to build "three pillars" for the pension system, namely social pooling, individual accounts and commercial insurance. But all these years the pay-as-you-go arrangement has played a dominant role in the pension system. The high contribution rate of the pay-as-you-go model does not necessarily mean inappropriate uses of the pension fund. It means the current generation of participants still bears the burden incurred by the pension for the last generation.

Moreover, individual pension accounts lack portability. This means that if someone takes a job in another city or province, his/her pension account is not flexible or portable enough. Our pension system reform is not to simply build a unified system with a universal standard, which does not match China's conditions either. Similar problems exist in the medical care system. If medical care could depend more on medical insurance and become more portable, this will make it easier for employees to seek reemployment. In cities that traditionally depend on resource producing industries, a transferable pension and health care system will be very helpful for those in need of job changes during the process of easing overcapacity.

Second, retraining for reemployment is important. Through retraining, employees can find and adapt to new jobs. It is unproductive to delay the needed adjustment of overcapacity. So we must respect the rule of market forces, and find a right path for adjustment. Meanwhile, public resources, particularly the public finance, should allocate fund to support retraining and reemployment, focusing more on the service sector which will create more jobs. In recent years, the service sector as a percentage of GDP has expanded. In 2011, the service sector only accounted for 43% of GDP. In 2015, it climbed to 50.5%, up by 7 percentage points within four years. This trend is continuing, suggesting that job opportunities will continue to abound in the sector. There are also different industries in the service sector, and some are relatively skill intensive. However, some industries in the service sector have encountered "glass doors", "revolving doors" and other administrative barriers in market access, limiting their capacity of creating employment.

Third, from the legal perspective, the enforcement of bankruptcy law and the efficiency of restructuring in bankruptcy proceeding is low in China. People tend to think of bankruptcy as forcing enterprises into liquidation and closure. In fact, bankruptcy is designed as a protection for those who are experiencing business failures or market changes, helping facilitate reallocation of resources. In addition, bankruptcy proceeding is a convenient and standard process of restructuring which helps adjust the relationship between creditors and shareholders and facilitates reorganizing of enterprises. Bankruptcy proceeding can dispose of existing debts. If an agreement is reached at the creditors' committee and a company in distress is believed to have an opportunity in restructuring and revival, any disputes can be easily solved through proceedings. In many other market economies, cases handled through bankruptcy proceedings are ten times or even hundreds times as many as that of China. This shows that reducing overcapacity and reorganizing businesses through standard legal procedures remains an arduous task for China.

Fourth, it is important to promote trade policy reform, including global policy coordination. In terms of international labour division, each country has its comparative advantages which may result in overcapacity. Such overcapacity can be reduced through exports as long as the products are really competitive. If the products are not competitive enough, however, the overcapacity has to be reduced domestically. Some countries or regions can foster competitiveness in certain industries, raising exports considerably while importing what they are short of. Therefore, global coordination of trade policies and reforms of individual countries' trade policies are very important. In other words, whether an industry's production capacity has exceeded domestic demand should not be simply taken as an indication for the appropriateness of capacity allocation.

Fifth, state-owned enterprises (SOEs) still have rigidity with their employment policy, incentive mechanism and reemployment. These enterprises should adapt to market changes and abolish outdated regulations. Just like what the State Council has done in streamlining administrative approvals, this should also be part of the overall reform of SOEs.

Sixth, for the financial sector, reducing overcapacity and deleveraging are interrelated. China has high leverage and overall debt ratios, reflected to a large degree by the excessive debt financing of enterprises. These enterprises rely more on bank loans and bond financing due to limited equity capital. High leverage would be difficult to adjust since it is harder to coordinate creditors and debtors. Thus, the development of direct financing and reduction of leverage will to some extent facilitate structural adjustments and restructuring of enterprises in the future. ■

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Reforming the Chinese banking system

China Banking Regulatory Commission chairman *Shang Fulin* explains how the banking system can evolve to safely support sound and sustainable development

The overall guideline for China's economic and social development throughout the Thirteenth Five-Year Plan period – as pointed out President Xi Jinping – is to understand, adapt to and generate a 'new normal' of economic development. Advancing supply-side structural reform is a prerequisite for adapting to this new normal. As a result, the banking sector needs to study and implement new concepts and strategies related to the goals of central government; analyse the development opportunities and challenges; and identify the direction, priorities and focus of our work – to understand and develop an action plan for the current situation.

Opportunities and challenges

The banking sector needs to fully recognise the historic opportunities brought about by the leadership's five development concepts of innovation, coordination, greenness, openness and sharing, while also being aware of possible 'growing pains' as China transforms its model. While the implementation of a stable macro policy, well-targeted industrial policy, flexible micro policy, practical reform policy and responsible social policy will greatly support sustainable development, the banking sector should also be fully aware of the impact that the implementation of these policies might have at an operational level.

Cutting overcapacity, destocking, deleveraging, reducing costs, shoring up weak spots and advancing supply-side reform will bring long-term benefits as well as short-term risks. In particular, banks need to deal with the closure of 'zombie companies', which will test their risk management, operating, profitability and capital replenishment capabilities.

Supporting the real economy

As President Xi has indicated, the real economy is the keystone of China's economy, so developing the real economy should be the ultimate goal of all policies, particularly financial policies. This requires reform of the banking sector to ensure it is focused on serving the real economy and facilitating the improvement of its quality and efficiency. There are three primary areas of focus:

First, to facilitate more efficient and direct flows of funds into the real economy. Banking institutions should allocate funds in a simple, transparent and efficient way within their capital constraints and risk tolerances. To ensure efficient and direct loan extensions, banks should cut embedded chains and conduits, optimise procedures and streamline processes while strictly following established

Shang Fulin

loan review and approval procedures – strengthening risk prevention and control without causing funding difficulties for firms.

Second, there is a need to lower social funding costs, especially for the real economy, and keep costs within a reasonable range. Banking institutions should provide different types of financial instruments in accordance with the varying scales and development phases of enterprises, and follow the principle of commercial sustainability to ensure a mutually reinforcing relationship between banks and enterprises. Banking institutions should also strengthen loan pricing management, enhance enterprise risk management and avoid hiking financing cost for enterprises beyond rational risk pricing and fee-charging.

Third, there is a need to expand the coverage of banking outlets and services to poorly served constituencies. Established banking institutions should adopt a scientific and practical approach to improve financial services to segments such as micro and small enterprises (MSEs), agro-related businesses, hi-tech and innovative enterprises, remote and poverty-stricken rural areas and vulnerable groups. Meanwhile, eligible private capital needs to be encouraged to enter the banking sector, in particular to set up private-owned banks offering consumer finance and leasing service, to take larger stakes in village and township banks, as well as to participate in the restructuring of high risk banking institutions. By optimising network distribution and services, the banking sector can also ensure equal and fair access to financial resources for the whole society.

Models for transformation

The *Report on the Work of the Government* (2016) states that financial structural reform should be deepened to ensure that finance can better serve the real economy. In the banking sector, the traditional business model was based on scale driven by national economic growth. As the economy gradually shifted from its previous high speed to a medium to high speed growth, banks' profit margins moderated and their non-performing loan ratios picked up. This showed that the 'obsession with speed' can no longer be sustained. Operational difficulties and increasing risks have put banks under increasing pressure to transform. During the Thirteenth Five-Year Plan period, the banking sector should defend the bottom line of no occurrence of systemic or regional financial risks and strive to build a multi-layered, widely covered and differentiated banking system by 2020. The current mission, therefore, is to accelerate the transformation and upgrading of the banking sector, rid it of dependency on external factors and an obsession with overall growth rates, and study and explore new development paths and models.

Banks need to explore business models that can promote sound and sustainable development. A near-century of banking development demonstrates that 'good banks' are not those that expand their businesses aggressively or inflate their assets rapidly at a certain point of time. Instead, they thrive in a stable yet sustainable way while being able to weather economic and financial cycles. History indicates banks should stop overemphasising scale expansion while ignoring risk-adjusted performance management. They need to accelerate improving cost management, capital allocation, pricing and risk resolution; strengthen countercyclical risk management; and gradually reduce their dependency on profit-making from the economic cycle, thereby guarding against uncontrollable or irresolvable risks that might occur during an economic downturn – effectively preventing a spillover of risks.

It is important to facilitate communication and coordination among the Party committee, board of directors, board of supervisors and senior management teams at banks. Banking institutions should follow the major principles of the socialist political economy with Chinese characteristics. Banking institutions also need to develop differentiated and distinctive business models in line with their target customer bases and competitive advantages.

The banking sector also needs to pay attention to indicators that reflect profitability and risk resistance capabilities. During the transformation process, stability and sustainability are important goals, and it is important to take a three- to five-year view.

Innovation and development

China's banking sector has introduced new products and business models for MSEs, agro-related businesses, green credit, internet finance and wealth management. However, these products and models are sometimes low end, structurally less diversified and homogeneous. Some are even used to circumvent regulation and mask risks. This is largely because the banking sector has failed to fully grasp the essence of financial innovation. Financial innovation should facilitate the efficiency of the real economy, reduce financial risks and protect the legitimate rights and interests of investors and creditors. As interest rate liberalisation is accelerating and funding channels are becoming more diversified, China's banking sector must grasp the essence of innovation and focus on the quality and efficiency of innovation so as to gain competitive edges. A few steps should be followed:

First, banks need to fully upgrade research and development (R&D). Financial innovation requires strong R&D and expertise that can unleash value from internet and financial technology. This is the key to shifting from low-end imitation to real financial innovation. Only in this way can banking institutions develop high-end financial products for their target customers.

Second, banking institutions should use appropriate risk pricing models for innovative products. These need to comprehensively assess potential risks, such as the underlying asset quality risk, counterparty credit risk and market risk. They should also be prepared to use risk management measures such as stress-testing and risk hedging, and bear in mind the trading limits, stop-loss points and other limits used to control risks.

Third, banks must fully protect the legitimate rights and interests of financial customers. Banking institutions are prohibited from inappropriately transferring, masking or increasing the duration of risks to customers. Financial innovation must be transparent, simple and well regulated. The banking sector must enhance information disclosure and investor education, improve complaint handling and strengthen measures to protect consumer rights.

Improving risk management

Currently, the manufacturing sector is cutting excess capacity, the real estate industry is reducing inventory and the real economy is deleveraging. These factors play a positive role in both the transformation and upgrading of the banking sector but also pose substantial credit risks. The banking sector should also not ignore the liquidity, market and cross-sectoral risks generated by social financing.

The overall situation poses challenges to the banking sector's risk management and control capabilities as well as those of banking supervisors. So a key task for the banking sector is to strengthen risk management and control, in particular to mitigate the risks associated with existing loans and strictly control the risks in incremental loans, to mitigate the danger of systemic or regional financial risks. Practival and effective guidelines need to be introduced to prevent and mitigate financial risks

This involves putting in place a comprehensive risk management framework covering all processes and procedures, business lines, products and links. There is also a need to proactively identify and mitigate risks abiding by the principle of 'substance over form' to strengthen the mechanisms for identifying, monitoring, measuring and controlling risks. Measures such as stress-testing, name-list management for high risk clients and ledger monitoring for risky projects, could be taken to strengthen ongoing monitoring, real-time control and dynamic management of risks. This would assist with the early identification, reporting, intervention and disposal of risks.

There is also a need to enhance risk-absorbing capacity. As the international regulatory organisations have required global systemically important banks to raise additional paid-in capital and increase total loss-absorbing capacity, China could learn from this practice to urge banking institutions to substantially enhance their loss-absorbing capacity. At present, with sufficient provisions in place, the banking sector could further utilise the provisioning coverage ratio as a countercyclical buffer to expand channels for capital replenishment, step up efforts to write off non-performing loans and enhance the market-based disposal of non-performing assets, thereby continuously enhancing risk resolution and risk-absorbing capacity. ■

Promoting China's financial liberalisation agenda

Increased risks are an inevitable upshot of greater innovation and disruption in the banking sector. But they can be mitigated through proper adjustment, writes *Zhang Liqing*, dean of the School of Finance, Central University of Finance and Economics

Since the convening of the Third Plenary Session of the Eighteenth Communist Party of China Central Committee, China has continued to reform and open up its banking and capital market sectors, as well as making additional progress in the areas of internet-based financial inclusion and openness. Meanwhile, with the deposit insurance system established and interest rate liberalisation completed, capital markets are poised to continue to develop and deepen at all levels. There are two highlights in this process:

First, after years of development the scale of the corporate bond market has grown to a significant level. The National Equities Exchange and Quotations market (the new third board market) is developing rapidly and innovative activities, such as margin trading and stock index futures, have also been launched. Meanwhile, independent innovation continues to drive development in the internet finance sector.

With regard to foreign-oriented finance, China has witnessed great progress with the initiation of the Shanghai-Hong Kong Stock Connect programme, overseas financial institutions allowed in the interbank bond market and the reform of the central parity interest rate. However, the development of financial innovation has also led to new risks. The stock market crash in the summer of 2015 was to some extent a reflection of breakneck speed financial innovation. It is clear that supervision has not kept pace and more experience is required to deal with relevant problems.

Second, risks emanating from reform and innovation are mainly restricted to the area of internet finance. And with the rapid development of peer-to-peer lending in recent years, risks are also building up. Insufficient supervision, the absence of sufficient market access thresholds and the lack of relevant credit checking have also caused concern among overseas investors. Still, there is no need for undue concern. While risks are an inevitable upshot of greater innovation and disruption, they can be mitigated through proper adjustment.

Financial deepening and market reform

Steady progress

Currently, China is proceeding steadily in the areas of inclusive finance, internet finance and financial openness. Regarding capital market reforms and financial openness, the proportion of direct financing in China is low, and indirect financing is still the major financing instrument. The overreliance on bank loans poses great structural risk and reflects the serious underdevelopment of the capital market.

Thus, further development of the capital market should be promoted. First, after dealing with the remaining problems of the stock market crash, capital market innovation should again take centre stage. Until recently, investors regarded going long as the only way to profit in China's stock market. A short-selling mechanism was later introduced but problems arose owing to immature regulation. Second, reform should be accelerated in the introduction of a registration system of stock issuance. Markets should play a larger role in distributing China's financial resources. The government should let the market decide the scale and price, instead of promoting a false bull market.

Returning to foreign-oriented finance, reforming the exchange rate system and opening up the capital market remain the most important issues. Further exchange rate reform is necessary. With the opening of China's economy, the capital account is also opening up. Without a flexible exchange rate, capital account opening will be highly risky and speculation inevitable.

During the Asian financial crisis, many countries, most famously Thailand, stuck to a fixed exchange rate system when opening up their capital accounts, prompting ample opportunities for speculation. China today faces similar problems. It is actively promoting capital account liberalisation, while dragging its feet on exchange rate reform. The adjustment of the middle-rate pricing mechanism and introduction of a genuine market mechanism in the exchange rate regime on August 11, 2015 – a meaningful, market-oriented reform – was immediately followed by exchange rate fluctuations. The People's Bank of China quickly intervened, consuming a great amount of foreign exchange reserves to stabilise the exchange rate. As the central bank knows, a substantial drop in the value of the renminbi may obstruct efforts to internationalise the currency.

Zhang Liqing

In the short term, China can manage exchange rate fluctuations and prevent devaluation by enhancing capital controls and macro-prudential regulations. However, renminbi internationalisation depends on more than the exchange rate. In the long term, it will be determined by economic growth prospects and the maturity of the financial market. Short-term exchange rate fluctuations should be put in perspective. It would be unwise to sacrifice exchange rate reform in the interest of renminbi internationalisation. Reform in other sectors cannot be held hostage by one overriding objective.

"Returning to foreign-oriented finance, reforming the exchange rate system and opening up the capital market remain the most important issues"

Zhang Liqing, Central University of Finance and Economics

Open for business

After more than a decade of development, China's capital account is now reasonably open. Of the 40 items described as cross-border capital transaction by the International Monetary Fund, only three are now inconvertible in China. The bond market is next in line for reform. Still, too rapid capital account liberalisation may cause turbulence in the exchange rate while capital market reforms are still ongoing. A lifting of restrictions or scrapping of QDII and QFII quotas or full launch of programmes like the Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect would have adverse consequences. China's financial opening must be flexible.

According to relevant research, the probability of financial crisis in China may vary based on the sequence of reforms. The probability of crisis will be 14% if China begins reform by promoting comprehensive and rapid opening of capital accounts. On the other hand, if domestic financial reform is conducted first, while the opening-up process of the capital accounts is slowed down, the risk of a financial crisis in China will drop to less than 5%. ■

Financial deepening and market reform

Accelerating capital market reform and cutting debt risks

Recent events have demonstrated that financing difficulties in the real economy persist and enterprises still need capital. *Chu Xiaoming*, chairman of Shenwan Hongyuan Securities, looks at how the government can tackle these risks

Two phenomena have recently occurred in China's capital market. First, despite five successive interest rate cuts between 2014 and 2015, funds have remained in capital markets, rather than moving to the real economy. This is despite a drastic fall in return on investment. Second, the new third board market, an over-the-counter equity exchange, has been extremely popular. As of November 6, 2015, 3,982 enterprises were listed on the platform. It is estimated this figure could rise to 10,000 as the market continues to develop.

These phenomena demonstrate two things: first, financing difficulties in the real economy persist; second, enterprises still need capital, not through debt financing but through equity financing instead.

Chu Xiaoming

Three reasons behind the two phenomena

First, enterprises are having difficulty financing themselves through direct channels, as financial institutions are proving inadequate in providing direct financing services. Direct financing accounted for merely 17.3% of all social financing in 2014 – excluding the inter-bank bond market where banks act as purchasers, the percentage falls to 13.1%. Though it was often stressed in the past that efforts should be made to increase the ratio of direct financing to indirect financing, we have seen little progress during the past few years in this aspect.

During the period from 2010 to 2014, China's equity financing reached 1.9 trillion yuan, only accounting for 2.52% of all social financing. Many enterprises were unable to obtain the equity financing they desired. That is why we are seeing an extended queue of companies now waiting to be listed on the main board market and the new third board market.

A second reason for the phenomena is the amount of debt held by enterprises, which totalled 94 trillion yuan at the end of 2014. The debt-to-GDP ratio was 160%. At the end of the third quarter of 2015, the debt-asset ratios of listed companies exceeded 0.6, while for many enterprises they surpassed 0.7-0.9. A ceiling should be set for such ratios; otherwise, both enterprises and banks will face substantial risks.

Third, enterprises are receiving low returns on investment. The return on equity (ROE) for non-financial listed companies in the third quarter of 2015 was 7.2%, while their average financing cost was 6.2%. With a one percentage point margin, the situation was not that bad. But even so, their profit margins were the lowest since 2007.

> "Enterprises are having difficulty financing themselves through direct channels, as financial institutions are proving inadequate in providing direct financing"
>
> *Chu Xiaoming, Shenwan Hongyuan Securities*

Meanwhile, listed companies with much lower ROEs than financing costs were pressured into a vicious cycle of paying off old debts with new debts, which poses a major risk to both enterprises and banks.

Lack of regulation for crowdfunding is an obstacle to mass innovation

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Addressing debt risks

In the next three to five years, China's economy may be at risk of a debt crisis on account of a relatively high national leverage level and even higher levels for enterprises. Should a debt crisis occur, the impact will be significant for the banking system and even the economy at large.

The government will likely need a comprehensive approach to address debt risks. One important measure is to accelerate the construction of a multi-level capital market. In doing so, China can rapidly lower the debt-asset ratios of enterprises and make them more resilient while defusing the risks in the banking system, where almost all risks of the financial sector are accumulated and concentrated.

To this end, a revision of the Securities Law should be made as soon as possible. After years of development, China has successfully established the framework for a multi-level capital market, while structural reforms that aim to adjust the ratio of direct financing to indirect financing are under way. But policy hurdles remain, and must be overcome through revising the Securities Law.

The authorities should also accelerate the development of multi-level and diverse equity financing. Regarding the main board market, the priority should be to simplify administrative authorisation procedures. Listed companies should also obtain more financing from the SME board market and the second board market. Moreover, a transferring system should be established in the new third board market and regional equity markets. This would enable enterprises listed in the new third board market to obtain financing in the SME board market and second board market, and enterprises in regional equity markets to obtain financing in the new third board market.

> "The government will need a comprehensive approach to address debt risks. One measure is to accelerate the construction of a multi-level capital market"
>
> *Chu Xiaoming, Shenwan Hongyuan Securities*

Further reforms

China should also build a healthy and sound crowdfunding system, in a timely manner, and affirm it is supportive of mass entrepreneurship. There is a need to establish a regulatory system for crowdfunding. On October 30, 2015, the US Securities and Exchange Commission approved a system for equity crowdfunding, with explicit access provisions on the investees and investors. China has no such provisions and rules, which stands as a colossal obstacle to mass innovation.

Another crucial reform concerns the regulatory system. At present, the China Banking Regulatory Commission, China Securities Regulatory Commission and China Insurance Regulatory Commission share responsibility for supervising and regulating Chinese financial markets. However, this approach has to be changed, because the fluctuations of the capital markets in July 2015 were mainly caused by over-the-counter financing, which was not subject to oversight by any of the three Commissions. ■

Financial deepening and market reform

The new normal and China's financial policy

Han Seung-soo, co-chair of the IFF and former prime minister of the Republic of Korea, offers a personal view on the impact of economic developments in China

The world economy is still recovering from the global financial crisis of 2008. But while there is still much work to be done, things could have been worse. The Chinese government played a key role in helping the global economy regain its footing following Lehman Brothers' collapse. The launch of its 4 trillion yuan fiscal stimulus programme in 2008-09 benefited not only China, but also trading partners dependent on Chinese imports and investments.

As China's economy slows, however, such anchoring effects are becoming less powerful, exacerbating structural weaknesses in both emerging markets and advanced economies. This ultimately leads to spillback effects in China, by depressing demand for Chinese exports in a sustained manner.

Time for a rethink

Thus, it is no surprise that a reassessment of global economic prospects is currently underway. Some leading economic thinkers, most prominently former US Treasury Secretary Larry Summers, have advanced the idea of 'secular stagnation', hypothesising that sluggish growth expectations lead to low private investment and excess savings, in turn making it difficult to achieve full employment. Massive interest rate cuts and large fiscal stimulus programmes are generally put forth as the solution that would allow the global economy to escape this trap.

Advanced economies, however, have used up a considerable amount of monetary and fiscal space already, with many pushing the envelope even further, employing unorthodox policies like quantitative easing. Alas, these measures have not jumpstarted private activity sufficiently enough to restore economic growth to pre-crisis levels. Rather, growth in advanced economies is anaemic and likely to remain so for the foreseeable future.

In emerging market economies, the secular stagnation hypothesis remains less relevant; there is still room for catch-up growth. Fiscal and monetary space has not been fully exhausted. Long-term trends, including the demographic outlook, remain relatively favourable compared with the advanced economies. With the right policy mix, these countries can still provide the appropriate incentives for firms to invest, create jobs and generate strong growth.

Emerging markets need to improve their infrastructure, reduce rigidities in labour and product markets and pursue financial market reforms to enable the efficient allocation of savings – while ensuring adequate risk management practices remain firmly in place.

China is an excellent example. Large infrastructure investments in the wake of the financial crisis enabled goods and people to travel faster, contributing to the near-doubling of the country's economy during the past seven years. With average real income in China still less than one quarter of US levels, there remains ample room for China to catch up.

New growth model

To realise economic convergence, however, China will need to shift its growth model away from depending on export-oriented manufacturing and heavy investment. Instead, it will need to focus more on services, innovation, and total factor productivity growth – in short, to combine resources and technology inputs more efficiently.

> *"By any standard, China's growth record during the past 30 years has been striking, with average annual GDP growth close to 10%"*
>
> *Han Seung-soo, former prime minister, Republic of Korea*

By any standard, China's growth record during the past 30 years has been striking, with average annual GDP growth close to 10%. As a result, China is now the world's second largest economy as well as its largest manufacturer and exporter.

Millions have been lifted out of poverty and economic opportunities have created a vibrant middle-class. It is worth noting that the United Nations' year 2000 Millennium Declaration goal to reduce world poverty by half during the next 15 years was achieved in 2010 thanks singlehandedly to Chinese growth.

Moreover, it is widely accepted that greater international integration, including the milestone accession to the World Trade Organization in 2001, has provided an impetus for Chinese leaders to speed up reforms and to open up the Chinese economy further.

Dmitri Umetsinsky / Shutterstock.com

Which way to turn?

China is at a crossroads once again. Continuing the process of liberalising its capital account and financial markets while striving towards full convertibility of its currency, the ambition of Chinese policymakers is to turn the renminbi into a potential international reserve currency in the near future. If achieved, this objective will likely be considered yet another milestone for the Chinese economy in the coming decades.

Financial sector reform will be instrumental in improving the overall efficiency of the Chinese economy and help China avoid falling into a middle income trap. It is also necessary to prevent asset price bubbles, seen most recently in the equity market and, potentially, the bond market.

Five specific areas of the financial sector merit attention:

First, completion of the move to a price-based monetary policy framework with interest rates as the main instrument. Getting the prices right is critical for the success of all market economies. This will help improve the pricing of financial assets and the efficiency of credit allocation, ensuring that savings get channelled to their most productive uses. The recent completion of interest rate liberalisation, and allowing banks to price deposits and loans as they see fit, are important elements of this process.

Second, strengthening of regulation and supervision. Dismantling the web of implicit guarantees on financial instruments and introducing an explicit bankruptcy resolution framework for failing financial institutions, as well as allowing investors to bear losses when defaults do take place, will encourage investors to differentiate between risky and risk-free assets and ensure the pricing of financial instruments reflects underlying risks. The recent introduction of a deposit insurance scheme is a major step in the right direction, enabling depositors to distinguish between insured bank deposits and other financial products when choosing where to place their savings.

Third, promoting capital market development to reduce reliance on bank funding. Deepening capital markets will help diversify the sources of funding available to firms and also provide insurance and pension funds with more long-term investment options.

Fourth, achieving greater exchange rate flexibility and reducing official intervention in order to manage exchange rate fluctuations.

Fifth, further capital account liberalisation. Plenty of progress has already been made on this front, particularly in the area of direct inward investment. Further easing of restrictions on the channels for cross-border portfolio investment will allow Chinese firms to access foreign savings to finance their expansion plans. It will also give Chinese households more options to diversify their portfolios and secure higher returns on their savings, as well as encouraging Chinese financial institutions to become more competitive and efficient in providing financial services.

Gradual transition

These reforms will need to be introduced gradually and carefully. Domestic financial liberalisation and exchange rate flexibility should precede full capital account liberalisation. Provided that they are implemented successfully, these reforms will further strengthen domestic macro-financial stability in China and enhance the international appeal of renminbi-denominated assets – in line with Chinese authorities' aim of turning the renminbi into an international reserve currency.

The reforms will also help achieve China's transition from a middle income economy to a high income economy. Nonetheless, downside risks persist. The transition could be bumpy, as suggested by events during the past year, and will need to be carefully managed. The turbulence in stock and foreign currency markets points to several immediate lessons. These include the need for a coordinating mechanism or financial stability committee to manage situations of financial stress and the imperative of communicating policies in one voice to ensure markets understand policy objectives. Moreover, an integrated, system-wide approach to financial sector regulation and better understanding of inter-linkages in the financial system remains crucial.

Transparency in information-sharing is another important factor that should not be ignored. Views about the state of the Chinese economy often differ substantially, partly due to a lack of reliable and high quality economic data. As financial markets have a tendency to assume the worst, Chinese policymakers would certainly benefit from disseminating information in a more transparent and timely manner. It would also allow them to maintain confidence in China's economy and financial system during the current structural growth transition.

Securing a stable and successful transition from a middle to high income economy is important not only for China but for the global economy as a whole.

Chinese authorities are well aware of this. Based on the country's impressive track record during the past three decades, China's government must make the right decisions to ensure a smooth transition to a stable and sustainable growth model and, eventually, high income status. In achieving that goal, authorities will at the same time ensure the rest of the world continues to benefit from China's rising prosperity. ■

Progress and prospects of pilot Free Trade Zones

Pei Changhong, director of the Institute of Economics, China Academy of Social Sciences, discusses the progress of reforms in China's pilot Free Trade Zones

How is financial reform of the China (Shanghai) Pilot Free Trade Zone (SHFTZ) progressing?

The journey of financial reforms in the SHFTZ can be divided into two phases: before and after the zone was expanded. The pre-expansion phase covers the period from October 2013 to December 2014, while the post-expansion phase began in 2015. Before the expansion, the number of newly established financial institutions grew rapidly. As of the end of 2014, 87 financial license holders and a batch of financial service providers had moved into the SHFTZ. In spite of the rapid settlement of financial institutions in the SHFTZ, the development of financial business in the zone fell short of expectations, with the growth rate of financial business obviously lagging behind that outside the zone. People from all walks of life focused on the convertibility of the capital account, market-based interest rates and a freeing up of the financial service sector in the SHFTZ. However, the progress of these reform items was slower than expected.

Expanding the territorial area of the zone is not the solution to everything. Various elements need to be put in place as preconditions for financial reform and opening up the SHFTZ. First, a mechanism should be built for interaction between the SHFTZ financial reforms and Shanghai's efforts to turn itself into an international financial centre. Second, more specific measures should be rolled out to encourage the opening-up of the capital account. Third, market-based reform of the interest rate should be further deepened. Fourth, more favorable policies should be introduced for financial development. Fifth, financial infrastructure construction should be stepped up by improving the international financial asset trading platform and building a convenient and efficient payment settlement system. Sixth, innovations should be made in the financial supervision system of the SHFTZ.

What about financial reforms in the Tianjin, Guangdong and Fujian Free Trade Zones?

The China (Tianjin) Pilot Free Trade Zone (TJFTZ)
Industry-finance cooperation and innovation will be a feature of the TJFTZ financial reforms. The reforms are expected to facilitate the combination of financial capital and industrial capital; the combination of financial innovation and emerging industries; and the combination of financial openness and introduction of emerging industries in the mode through which both industries and financial services will develop. New forms of integrated financing covering the entire industry chain will play a crucial role in the TJFTZ financial reform and development.

China (Guangdong) Pilot Free Trade Zone (GDFTZ)
To promote foreign trade development, transformation and upgrading is one of the major objectives of the GDFTZ financial reform. In other words, the aim is to support the sustained development of Guangdong's foreign trade, by using financial innovation. Guangdong-Hong Kong-Macau financial cooperation is supposed to be a feature of the GDFTZ financial reform. In particular, financial openness to Hong Kong and Macau will be the focus in the Qianhai and Hengqin areas of the GDFTZ. It is important to promote innovative cross-border renminbi business among Guangdong, Hong Kong and Macau, expand cross-border use of the renminbi and carry out two-way renminbi financing. Other important reforms include exploring ways to establish a mechanism enabling mutual recognition of financial product offerings; two-way capital circulation and market connectivity among Guangdong, Hong Kong and Macau; facilitating currency conversion for investment and financing in the three regions; making the financial services of non-banking institutions more accessible; and promoting the growth of consumer finance and e-payments. We should also explore the possibility of exercising a new model for home- and foreign-currency account management, and establish a new-typed factors trading platform targeted at Hong Kong, Macau and other parts of the international community.

China (Fujian) Pilot Free Trade Zone (FJFTZ)
Cross-Straits financial cooperation will become a feature of the FJFTZ financial reforms. China should allow banking institutions in the FJFTZ to roll out cross-border renminbi borrowing and other businesses with their Taiwan counterparts and encourage Taiwanese banks to extend cross-border renminbi loans to enterprises or projects located in the FJFTZ. It is also necessary to support the banking sectors on both sides of the Taiwan Straits to cooperate in equity investment in the zone and prepare the ground for Fujian equity exchanges to expand the scope of business with a view to providing comprehensive financial services for Taiwan enterprises. Finally, there is a need to strengthen cross-Straits cooperation in dispute mediation, arbitration and litigation, as well as the protection of financial consumers' rights and interests by introducing diverse dispute settlement means. ■

Pei Changhong is director of the Institute of Economics, China Academy of Social Sciences

INTERNATIONAL TRADE, INVESTMENT AND DEVELOPMENT CO-OPERATION

A strategy for growth: China's development initiatives

Wang Yan, deputy director, IFF Institute, examines the role China's One Belt One Road vision can play in providing a boost to global growth

The world economy needs a growth-lifting strategy, and infrastructure financing appears to hold the key. The vision of China's leaders for the Silk Road Economic Belt and 21st Century Maritime Silk Road (One Belt One Road) is winning the support of leaders throughout Asia and beyond. Two new development banks have been established focusing on infrastructure: the New Development Bank (NDB) and the Asian Infrastructure Investment Bank (AIIB). A Silk Road Fund was established in January 2015 and a China-Africa Industrial Capacity Cooperation Fund (CAICCF, $10 billion in size), designed to aid Africa's development, became operational in January 2016. However, what conceptual framework will they formulate? This section links infrastructure investment with special economic zones for industrial upgrading and structural transformation, which provides the foundation of the One Belt One Road vision.[1]

During the past eight years, the global economy has experienced its most tumultuous times since the Great Depression. Despite the coordinated policy response of the G20 nations and expansionary monetary policy, the global economy – especially the advanced countries – has not fully recovered. The US unemployment rate declined significantly but the economy grew only 2.4% in 2015. The eurozone and Japan face ongoing growth challenges, with their respective central banks embracing unprecedentedly loose monetary policy. The European Central Bank and the Bank of Japan are both pursuing negative interest rates in addition to quantitative easing. But monetary stimulus is insufficient to propel a seemingly leaderless global economy towards steady growth. There is a need for a grand investment scheme and a changed mindset.

Based on the intellectual foundation of the new structural economics[2], infrastructure investment looks to hold the key to long-term growth. Support for the One Belt One Road vision could motivate use of excess global savings to help development and improve employment, while also generating sound returns. It should also increase demand and jobs in advanced countries, giving them room to implement needed structural reforms. In particular, investment in bottleneck-releasing infrastructure would unleash particularly large spillover benefits.

1 This chapter draws on source materials from joint papers by Justin Yifu Lin and Wang Yan 2013, 2015. I am grateful to Justin Yifu Lin for advice and contribution, and to Chunxu Chen and Feng Zhang at George Washington University for research assistance. Do not cite without permission from the author.
2 Lin 2010, 2011, 2012

Wang Yan

Infrastructure provision may also have a disproportionate effect on the income and welfare of the poor by raising the value of the assets they hold (such as land or human capital), or by lowering transaction costs (such as transport and logistic costs) they incur to access the markets for their inputs and outputs. These effects may occur through a variety of mechanisms.[3]

Both the macroeconomic externality and income equality benefits point to the need for public investment in providing certain types of infrastructure, because they represent either non-rival public goods as in the case of rural roads, or a natural monopoly as in the case of electricity generation and distribution systems. Without government intervention or public investment, the critical infrastructure for development would be undersupplied.

But investing in infrastructure alone is not sufficient to propel growth and generate jobs unless it is combined with productive assets and human capital. One new idea is to combine infrastructural building with green urban development, eco-industrial parks and structural transformation to generate employment, revenue, growth and poverty reduction, making the environment more sustainable and the infrastructure financially viable.[4]

There is a huge infrastructural funding and capacity gap in developing countries, especially in the area of renewable energy and green technology. The One Belt One Road vision and associated funds (such as the Silk Road Fund) can help 'crowd in'

3 Estache, Foster and Wodon 2002, Estashe 2003, and Caldéron and Serven 2008
4 Lin and Wang 2013

SAUDI ARABIA'S SUPPORT FOR ONE BELT, ONE ROAD

HRH Prince Turki bin Abdullah bin Abdulaziz Al-Saud explains why his country is supporting China's ambitious initiative

We live in turbulent times. Political instability has resulted in significant problems in various parts of the world, leading in the worst cases to failed states, violent insurgency and civil warfare. This is the debit side of the balance sheet in global current affairs.

On the credit side there are optimistic and bold initiatives to improve social and economic order by enhancing dynamic exchange across national borders. This includes China's recently conceived One Belt, One Road revival of the overland and maritime silk roads.[1]

The naming of this major plan is a poetic echo of the Han Dynasty trading routes and is used by President Xi Jinping to describe his intention to export China's excess economic capacity with massive infrastructural investment in the surrounding region and beyond.[2] This is part of a strategy of outward direct investment, which recently for the first time exceeded foreign direct investment in China.[3]

The Silk Road Economic Belt and the 21st century Maritime Silk Road (One Belt, One Road) has justly been described in the *The Banker* as "the most ambitious example of international co-operation of modern times".[4] One Belt, One Road will cover territories with a cumulative population of 4.4 billion and 29% of global GDP.

To achieve its aims, China plans to invest an equivalent of $900 billion, with a further $300 billion of capital provided by dedicated funding entities. The estimated infrastructure funding gap for Asia alone, however, has been stated by the Asian Development Bank to be at least $8 trillion for the period 2010–2020.[5]

Finding huge sums in infrastructure finance is a major challenge. It is noticeable that early in 2015 the Asian Infrastructure Investment Bank entered into discussions with the Saudi-based Islamic Development Bank over the potential for Islamic finance to serve as a source of One Belt, One Road funding.[6] Here is an ideal opportunity for the stability and insurance features of Islamic banking and financial products to benefit a hugely worthwhile international project.

Islamic finance, while eminently suited to infrastructure finance, lacks standardised products and can give rise to 'manufactured' tax liabilities due to asset transfers, or indeed fail to meet local legal or fiscal rules. To level the playing field and draw on a huge pool of capital in many of the Silk Road Muslim majority economies, it will be necessary to systematically tackle the recognised problems. This will require central and local government goodwill, starting from China.

A standardised legal and tax code can be worked out and implemented by treaty with the Silk Road states, while the necessary work can be done by Islamic bankers to create standardised formats for infrastructure investment.

To move from ideas to action, I propose the formation of a working group to research what is needed to render Islamic finance a real and available option for One Belt, One Road project finance. It would strive to achieve practical solutions to identified problems and then move forward to seek Chinese government support to implement any necessary legal or administrative changes.

HRH Prince Turki bin Abdullah bin Abdulaziz Al-Saud is a former governor of Riyadh Province in Saudi Arabia

1 President Xi Jinping announced the first element of One Belt, One Road in Kazakhstan in September 2013, expressly mentioning the historical precedent of the Han Dynasty. The maritime element was added in a speech President Xi made in Jakata, Indonesia a month later in October 2013.
2 The details of this ambitious program were set out in the National Development & Reform Commission's March 2015 document: Vision and Actions on Jointly Building Silk Road Economic Belt and 21st Century Maritime Silk Road.
3 Ministry of Commerce, China; UNCTAD 2015.
4 *The Banker*, September 1, 2015.
5 *The Banker*, September 1, 2015.
6 Reuters, May 2015.

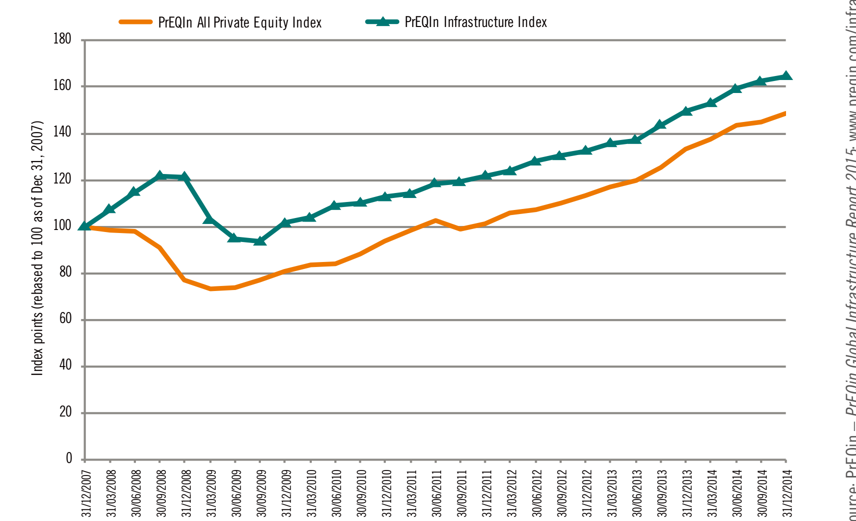
BOX 1: INFRASTRUCTURE FUNDS HAVE HIGHER RATES OF RETURNS

Historically, infrastructure has been favoured by long-term funds due to its long-term nature and relatively stable returns (in developed countries), as well as providing downside risk protection due to the asset class's inflation-hedging attributes.

The median net internal rates of return (IRR) for infrastructure funds across all vintages remains consistent at around 10%, only falling below for funds that were investing at the time of the financial crisis.

The PrEQIn Infrastructure Index currently stands at 164.6 points and has consistently outperformed the PrEQIn All Private Equity Index since its inception in 2007 (Fig. 1).

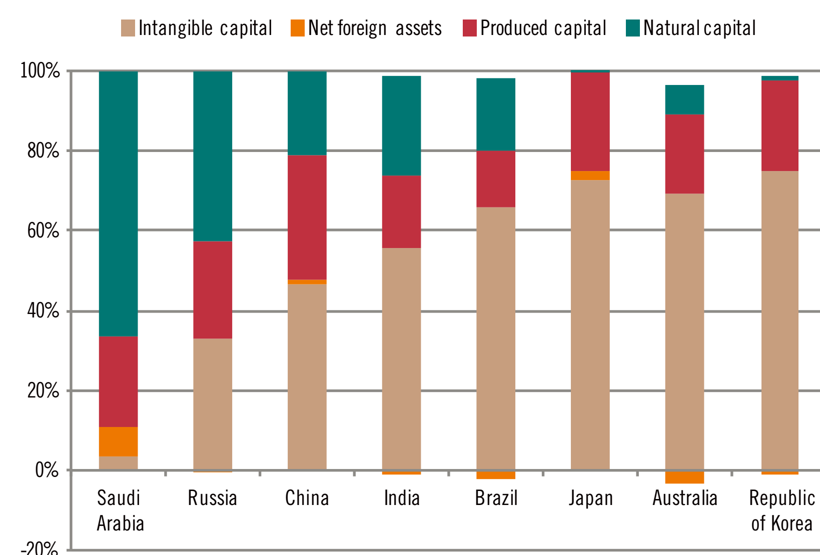
Fig 1: Private Infrastructure funds have higher rates of return than private equity funds since 2007



Source: PrEQIn – *PrEQIn Global Infrastructure Report 2015*; www.preqin.com/infrastructure

funding and increase utilisation of green technology by transforming existing cities into green cities, and building new clusters of eco-friendly industries. It will attract emerging market economies such as China and India as well as Arab countries to invest overseas and relocate some of their excess production capacity to low-income developing countries, where there is a demand. This will also help the rebalancing or structural upgrading in their domestic economies.

Fig 2: Transforming 'what the country has' to 'what the country can potentially do well': From natural endowment to productive assets



Source: Authors based on World Bank data from *Changing Wealth of Nations*, 2005. Intangible capital includes human and institutional capital.

Staggering shortfalls

Infrastructure shortfalls in the developing world are staggering. Roughly 1.4 billion people have no access to electricity, about 880 million people still live without safe drinking water and 2.6 billion without access to basic sanitation. Around 900 million rural dwellers worldwide are estimated to have no access to all-weather roads within two kilometers.[5] It is estimated that Asia alone will need about $8 trillion in national infrastructure and $290 billion in regional infrastructure development through 2020 and beyond.[6]

Estimates of the growth impact of infrastructure investment in developing countries support this notion. Caldéron and Servén[7] estimate that, on average, annual growth among developing countries increased by 1.6% in 2001-05 relative to 1991-95, as a result of infrastructure developments. This effect was particularly large in south Asia, reaching 2.7% per year. Caldéron and Servén[8] find that if low-income countries in Sub-Saharan African were to develop infrastructure at the same rate as Indonesia, the growth of west African low-income countries would rise by 1.7% per year. An increase in power generation in India to the levels of Israel and Hong Kong would enhance growth by 1.7%. Similarly, if Latin American countries can have the same level of infrastructure as east Asia's middle-income countries, their annual growth will increase 2%.[9]

As shown in Box 1, the median net IRR for infrastructure funds across all vintages remains consistent at around 10%. Investing in the infrastructure of developing countries is riskier, but it could have rates of returns ranging from 0% to more than 100% in the case of releasing bottlenecks.[10]

Closing the funding gap

The World Bank estimates that annual investments of more than $1 trillion – about 7% of developing country GDP – are required to meet basic infrastructure needs in the medium term. Countries that grew rapidly – such as China, Japan and the Republic of Korea – invested upwards of 9% of GDP every year for decades. Assuming that infrastructure financing in developing countries continues at historical trend levels, there remains an infrastructure financing gap of more than $500 billion per year over the medium term.

The One Belt One Road vision and associated funds could help to close this gap. However, investing in infrastructure alone is not sufficient to propel growth unless it is combined with productive assets and human capital. There is a need for infrastructure to be associated with special economic zones or urban development to ensure structural transformation becomes self-sustainable.

Comparative advantages

New structural economics postulates that each country at any specific time possesses given factor endowments consisting of land (natural resources), labour and capital (both human and physical), which represent the total available budget that the country can allocate to primary, secondary and tertiary industries to produce goods and services. The relative abundance of endowments in a country is given at any given specific time, but is changeable over time. In addition, infrastructure is a fourth endowment that is fixed at any given specific time and changeable over time.[11]

From the angle of land-based financing, investment in appropriate infrastructure and industrial assets would increase the value of land (a commonly accepted principle). Land-based financing offers powerful tools that can help pay for urban infrastructure investment.[12] And these options have been explored during China's experimentation with special economic zones and the infrastructure around these zones.[13]

5 MDG Working Group, June 2011
6 According to ADB estimates. Asian Development Bank and ADBI. 2009. *Infrastructure for a Seamless Asia*. ADB Manila, 2009
7 2010a
8 2010b
9 Guash 2010
10 Bai et al 2010, Canning and Bennathan 2000, and World Bank estimates

11 Lin 2012b, p.21

FINANCIAL INSTRUMENTS FOR THE BELT AND ROAD

Zhang Hongli discusses the role of financial instruments in the Belt and Road initiative

The Belt and Road initiative advocated by the Chinese government has injected new vitality into the surrounding countries and regions, pushing the world towards greater cooperation. In the first three quarters of 2015, direct investment made by Chinese enterprises in the 48 countries along the Belt and Road amounted to $12 billion, a year-on-year increase of 66.2%, which also accounted for 15.3% of the country's non-financial foreign direct investment in the same period.

Diversified financial instruments and flexible financial policies can be utilised to guide capital investment – with adherence to commercial norms – to propel economic development. Chinese financial institutions have accumulated significant experience in cooperation pursuant to local conditions in areas including investment, leasing and risk management that can be utilised in the step-by-step development path. Financial institutions can also play an important role in risk identification and use their 'soft' strengths to assist institutions regarding talent, information and security. 'Going global' enterprises are often not familiar with their new investment environment, investees and operations, so they can draw on the experiences of commercial banks as they implement the Belt and Road initiative.

Two sorts of mindset should be manifested. The first is the 'win-win' mindset. While establishing institutions, promoting projects and formulating rules, China should give full consideration to the interests of surrounding countries, carry out extensive cooperation by fully using different international organisations, actively seek a win-win situation and strive for strategic initiative. The second is the 'bottom-line' mindset: namely, ensuring there is no occurrence of regional and systematic crises while maximising interests.

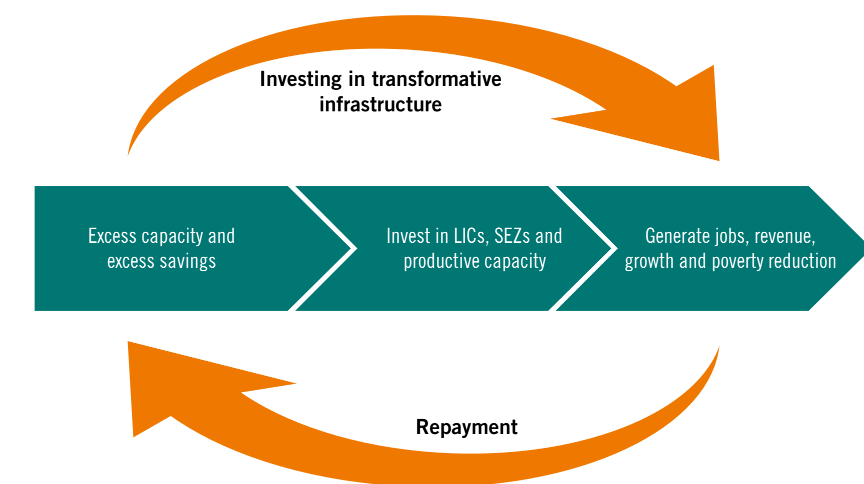
A number of aims should be met. First, Chinese financial institutions should not only be encouraged to go global, but also to introduce enterprises from countries along the Belt and Road to Chinese financial markets. Second, development should coincide with sound security. Third, strategic objectives should be coordinated with microcosmic interests. In this way, a solid foundation will be laid for the implementation of macroscopic strategies.

Zhang Hongli is vice-president of Industrial and Commercial Bank of China

Therefore, it can be proposed that: Other things being equal, a piece of land with the proper level of infrastructure is always more valuable than a piece of land without. Thus it can be well used as collateral for infrastructure development loans.

This proposition is supported by empirical evidence that infrastructure benefits the poor because it adds value to land or human capital and reduces inequality.[14] Since infrastructure is often sector-specific, the 'proper' level of infrastructure must be affordable to the population and be consistent with the country's existing or latent comparative advantage. Thus, market mechanisms should be relied upon to have the right relative prices and to determine which infrastructure is bottleneck-releasing. In addition, the government must provide information, identify the comparative advantages and the associated appropriate infrastructure, and facilitate this process by developing a self-discovery process by the private sector.

Fig 3: A framework: Investing in transformative infrastructure is financially sustainable



Source: Justin Yifu Lin and Wang Yan 2013

Therefore, it can also be proposed that: Transformative infrastructure helps link a country's endowment structure with its existing and latent comparative advantages, and translates them into competitive advantages in the global market. Thus, it can be made financially viable. In other words, combining infrastructural building with industrial upgrading, as well as real estate development, can help make both financially sustainable. Potentially this approach has high rates of returns.

Based on these two propositions, any low-income country can have the ability to pay for its appropriate infrastructure in the long term, as long as it can develop a strategy that is consistent with its comparative advantages. In other words, we should focus more on "what these countries have" rather than "what they do not have",

12 For legal and typical land-asset based infrastructure financing, see policy note by Peterson, George E. 2008. *Unlocking Land Values to Finance Urban Infrastructure: Land-based financing options for cities*. Trends and Policy Options Series. Washington DC. PPIAF.
13 Wang Yan 2011
14 Estache, Foster and Wodon 2002, Estashe 2003, and Caldéron and Serven 2008

IMPROVING SOFT INFRASTRUCTURE VIA EDUCATION

Wei Shangjin explains the importance of education to securing future growth in Asia

The economy can benefit from a redefined concept of infrastructure that encompasses 'soft' elements, such as human capital. As an investment in human capital, education is vital to economic growth in every country. Indeed, in addition to resources and capital, a large enough educated population is also indispensable for continued growth in Asia.

To improve education there is a need to look beyond quantity, to quality. This means one should focus more on whether the educated acquire all the necessary skills they will need in the workplace, including mathematics, science and communication skills. Education is not only about how many years students spend at school but also about what they actually learn. That is particularly important for countries facing a middle-income trap, which means their economies need to shift from a growth model based on cheap labour to one driven by highly educated talent.

Education poses a challenge to many Asian economies, including China, which must promote innovation while dealing with an ageing population. A shrinking labour force would threaten economic growth. If it dwindles by 0.4% every year, China will see a decline in productivity, and its GDP growth rate will drop by 0.2% every year; a 1% reduction in five years. So China's GDP growth is clearly threatened by a shrinking labour force.

China needs more investment in education, but that does not mean blindly pumping money into its education system. The country started to encourage university enrolment in the 1990s, so the number of Chinese college graduates has doubled since 2000. China has a large enough talent pool. The real problem comes from the high school education in rural areas.

Many rural teenagers of high school age choose to work instead of continuing their education. However, their professional skills cannot meet the requirements of the workplace. Others enrol in vocational schools but the quality of their education is less than satisfactory. A study by Stanford University shows vocational school students in remote areas not only fail to acquire necessary professional skills, but may even end up lacking the most fundamental cognitive and learning capabilities. That kind of sub-standard education is a barrier to sustained economic growth in China.

It is mentioned in a report by the Asian Development Bank that kindergarten education should be sufficient and accessible. Urban children who do not go to kindergarten can be home-schooled by adult family members. But their rural cousins may not receive a pre-school education of comparable quality from their possibly illiterate grandparents. The lost opportunity to acquire knowledge and skills in the pre-school stage could translate into an urban-rural gap in elementary school. Therefore, infrastructure investment should go beyond the tangible and extend to the intangible, including pre-school and vocational education. That could provide real momentum for China's future economic growth.

Wei Shangjin is a member of the IFF Academic Committee and chief economist of the Asian Development Bank

Table 1: China's overseas economic and trade cooperation zones

Continent	Country	Title
Asia	Pakistan	Pakistan Haier-Ruba Economic Zone
	Thailand	Thai-Chinese Rayong Industrial Zone
	Cambodia	Sihanoukville Special Economic Zone
	Vietnam	Long Jiang Industrial Park
	Vietnam	Vietnam China (Haiphong-Shenzhen) Economic and Trade Cooperation Zone
	Indonesia	Pt. Kawasan Industri Terpadu Indonesia China
	Republic of Korea	Republic of Korea-China Industrial Park
Africa	Zambia	Zambia-China Economic and Trade Cooperation Zone
	Egypt	China-Egypt Suez Economic and Trade Cooperation Zone
	Nigeria	Lekki Free Zone
	Nigeria	Nigeria Ogun-Guangdong Free Trade Zone
	Ethiopia	Eastern Industrial Zone
	Mauritius	Jinfei Economic and Trade Cooperation Zone
Europe	Russia	Ussuriysk Economic and Trade Cooperation Zone
	Russia	China-Russia Tomsk Timber Industry and Trade Cooperation Zone
S. America	Venezuela	Cua Industry and Trade Cooperation Zone

Source: UNDP-IPRCC study 2015, *Comparative Study on Special Economic Zones in Africa and China*, p 47

as suggested by Justin Yifu Lin in his farewell blog at the World Bank. See Figure 2.

What these countries need is a bridge fund in the medium to long term for 10-15 years or longer to build a productive and export base. One example shows how quickly the development results can be seen: Huajian Shoe Manufacturing Company established a large manufacturing facility in the Eastern Industrial Zone in Ethiopia, trained workers and started exporting, all within four months.[15]

China utilises its comparative advantage in construction

In the *IFF China Report 2015* (Section 3), we used empirical evidence to shown that China has been utilising its comparative advantage in construction and helping African countries tackle their bottlenecks. Between 2000 and 2010, 50% of China's commitment on infrastructure was allocated to electricity and its transmission in Africa – a key bottleneck. A recent study found that China has contributed, and is still contributing, to a total of 9.024 gigawatts of electricity-generating capacity, including completed, ongoing and committed power projects.[16] The impact of this investment is likely to be transformative when one considers that the entire installed capacity of the 47 Sub-Saharan Africa countries excluding South Africa is 28 gigawatts.

China has comparative advantages in constructing infrastructure. This was shown on page 65 of the *IFF China Report 2015*, where the graph shows that China's labour cost in construction (at about $10-15 per hour) is only 15% of those in the industrial countries such

15 See also Sheng 2013 on Chinese OFDI in Africa, and World Bank 2012 on China's FDI in Ethiopia

16 The Hoover Dam in Colorado, by comparison, is a two gigawatt facility, producing electricity for about 390,000 US homes, on average. See Chen (2013).

BOX 2: CHINA'S COMPARATIVE ADVANTAGE IN INFRASTRUCTURE: HIGH-SPEED RAILWAY CONSTRUCTION

China has the world's longest high-speed railway (HSR) system, with more than 16,000km of track in service as of December 2014.[1] China built this HSR network, remarkably, in less than 10 years at unit costs lower than for similar projects in other countries. The HSR network operates with high traffic volumes on its core routes and with good reliability. This has been accomplished at a cost which is at most two-thirds of that in the rest of the world, showing its comparative advantage.

According to Gerald Ollivier, World Bank senior transport specialist: "Besides the lower cost of labour in China, one possible reason for this is the large scale of the high speed railway network planned in China. This has allowed the standardisation of the design of various construction elements, the development of innovative and competitive capacity for manufacture of equipment and construction and the amortisation of the capital cost of construction equipment over a number of projects."

Based on experience with World Bank–supported projects, the Chinese cost of railway construction[2] is about 82% of the total project costs. China's HSR, with a maximum speed of 350km/h, has a typical infrastructure unit cost of about $17 million to $21 million (100 million to 125 million yuan) per km, with a high ratio of viaducts and tunnels. The cost of HSR construction in Europe, travelling at speeds of 300km/h or above, is estimated at $25 to $39 million per km. HSR construction costs in California (excluding land, rolling stock and interest during construction) is put as high as $52 million per km.

Source: Gerald Ollivier, Jitendra Sondhi, and Nanyan Zhou. 2014. *High-Speed Railways in China: A Look at Construction Costs*. World Bank, China Transport Topics No. 9, July 2014.

1 China defines HSR as any railway in China with commercial train service at the speed of 200 km/hour (124 mph) or higher. By this definition, China has the world's longest HSR network with over 16,000 km of track in service by December 2014.

2 Including civil works, track works, regular stations, yards, signaling, control and communication, power supply and other superstructure components; excluding the cost of planning, land, some of the mega stations, rolling stock and interest during construction

as the US or Europe. China's demonstrated comparative advantage is determined by the following factors: 1) existing domestic infrastructure such as highways, high speed railways, and hydropower; 2) low cost of labour including foremen and engineers; 3) ability to bring in financiers to these projects; 4) large number of infrastructure projects that have been implemented in Asia, Africa and the rest of the world. Now this argument is made stronger (see Box 2).

The benefits of special economic zones

China itself has had a favourable experience using special economic zones. The idea that industrial parks or zones can promote structural transformation as well as industrial upgrading is not new. Economists have emphasised that clusters take advantage of economies of scale and reduce transactions and search- and learning-costs.[17] Agglomeration helps firms to benefit from knowledge spillovers, create a market for specialised skills, and use backward and forward linkages (good access to large input suppliers, logistics, privileged network with customers and so on). These agglomeration benefits reduce the individual firm's transaction costs and increase the competitiveness of a nation's industry.[18]

17 Krugman 1991; Greenwald and Stiglitz 1986; Porter 1990, Lin and Monga 2011

18 Lin 2012, Zeng 2010

NEW BREAKTHROUGHS FROM THE BELT AND ROAD INITIATIVE

Wang Guogang examines the key role infrastructure can play in meeting China's economic challeges

Since the introduction of reforms, China has gained rapid economic growth, stunning the international community. However, to ensure its growth stays in the mid- and high-level range, China is facing a series of grim challenges.

First is the scarcity of natural resources. China's growth is bound to slip if it only relies on scant resources. Second, the contribution of foreign trade to economic growth is shrinking. The sluggish global economy in the wake of the 2008 US financial crisis has resulted in widespread weakness in demand. Moreover, the increasing competition in global trade and services aggravate deteriorating international trade conditions, posing new threats to China's sustainable economic growth.

Third, there is insufficient international investment globally. Though China is the country with the biggest foreign exchange reserves and the biggest creditor across the world, there is a big gap between China's overseas investment and that of the US or Japan. If this situation does not change, China's position and role in the international arena will be seriously challenged. Fourth, there is no effective mechanism for tackling the Triffin dilemma.

The implementation of the Belt and Road initiative can help solve these problems both theoretically and practically. Compared with traditional international trade, infrastructure construction initiated in the Belt and Road initiative is characterised by fixed asset investment. It plays a role in boosting foreign trade and international economic cooperation. It helps China tackle the Trans-Pacific Partnership and Transatlantic Trade and Investment Partnership enclosure dominated by the US, while expanding its contribution to the global economic recovery. Moreover, it helps form a new international economic development mechanism connecting investment and trade, and improves economic and social welfare in associated countries and regions.

Compared with the traditional export of production capital, infrastructure investment projects in the Belt and Road initiative are mostly projects that are overlooked by international investors but have strategic significance to the recipient country. Meanwhile, a multilateral mechanism in place of unilateral and bilateral mechanisms is more representative of international consensus and rules. This makes it easier to gain acceptance in recipient countries. Investment conditions are formed through rounds of negotiation and are thus more reflective of the consensus, interests and rights of all parties. As investment projects carried out under the Belt and Road initiative extend to countries and regions along the routes, the community will enlarge to include other countries and regions as well, creating a prospect for longstanding win-win cooperation.

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Around the world, and in particular in Africa, China has been supporting 15 or so special economic zones – or 'overseas economic and trade cooperation zones' – aimed to improve the investment climate and encourage direct investment into low income developing countries (see Table 1). According to detailed studies by Bräutigam and Tang (2012), in total China has jointly established six industrial zones in Africa. More than 80 companies

have signed agreements and settled in these industrial zones, creating tens of thousands of jobs for African workers.

During recent years, China's labour cost has been rising rapidly, from $150 per month in 2005, to $500 per month in 2012, and to more than $600 per month in coastal regions in 2013 (growing at the rate of 15% annually plus currency appreciation). China has an estimated 124 million workers in manufacturing, most of them in labour-intensive sectors (85 million), as compared to 9.7 million in Japan in 1960 and 2.3 million in the Republic of Korea in 1980. The reallocation of China's manufacturing to more sophisticated, higher value-added products and tasks will open great opportunities for lower income countries to produce the labour-intensive light-manufacturing goods that China leaves behind[19].

Future prospects for the Belt and Road

Economic and trade theory tell us that when countries trade with their respective comparative advantages determined by

19 Chandra, Lin and Wang. 2013

Table 2: Timetable of key reforms in trade, investment and development cooperation – 2015-16

Date	Reforms	Notes
March 28, 2015	Ministry of Commerce, National Development and Reform Commission, Ministry of Foreign Affairs jointly issued Vision and Actions on Jointly Building Silk Road Economic Belt and 21st-Century Maritime Silk Road.	Illuminated the strategy of the Belt and Road by pointing out its background, principle, framework, cooperation mechanisms, Chinese government's actions and different regions opening-up trend.
April 21 , 2015	Three free trade pilot sites – Guangdong, Tianjin and Fujian – were established	Marks the beginning of the 2.0 era of Chinese free trade areas.
June 1, 2015	Delegates of China and the Republic of Korea officially signed the China–Republic of Korea Free Trade Agreement	FTA was set to go into effect on December 20, 2015. More than 90% of the products of China and the Republic of Korea will be charged at zero tariff after the transition period.
June 17, 2015	Delegates of China and Australia officially signed the China – Australia Free Trade Agreement	FTA was set to go into effect on December 20, 2015. Within three years after its taking into effect, tariffs charged on Chinese export products will be cut by about 96.45%.
June 23 & 24, 2015	The Seventh China-U.S. Strategic and Economic Dialogue and the Sixth China-U.S. High-Level Consultation on People-to-People Exchange	Achieved 127 outcomes.
June 29, 2015	Signing ceremony of the Asian Infrastructure Investment Bank Agreement was held in Beijing.	China's amount of investment accounts for 30.34% of the total, and it has 26.06% of the right to vote, becoming the first majority shareholder and the country with the highest voting power in AIIB at the present stage.
August 11, 2015	People's Bank of China announced plan to improve the quoting mechanism for the central parity rate of the RMB against the USD.	Market makers should consult the closing quotation of foreign exchange market of the previous day before the opening quotation of the inter-bank foreign exchange market.
September 4, 2015	China formally accepted the World Trade Organization's trade facilitation agreement protocol.	China become the sixteenth member to accept the protocol
September 17, 2015	The Central Committee of the Communist Party of China under the state council released Several opinions about constructing new system of the open economy.	General requirement is to establish a new system of market resources allocation mechanisms, a new form of economic operation, and form a new pattern of all-round opening – new advantage of competitive international cooperation.
October 8, 2015	China International Payment System (first phase) was launched.	China International Payment System provides fund settlement and settlement services for domestic and overseas financial institutions' RMB cross-border and offshore business. It is an important financial infrastructure.
October 26, 2015	China officially applied to join the European Bank of Reconstruction and Development.	If the application is approved, China, as the world's second largest economy, will have an increasingly close relationship with European countries, which will help China to expand its influence throughout the world.
November 16, 2015	Xi Jinping announced that China will host the eleventh G20 leaders summit on September 4-5 , 2016, in Hangzhou.	The subject of the G20 leaders summit in 2016 is "constructing an innovative, dynamic, interactive and inclusive world economy".
November 30, 2015 (Beijing time December 1, 2015)	IMF officially announced that RMB will join the Special Drawing Rights (SDR) currency basket on October 1, 2016.	The weight of RMB is 10.92%, becoming the fifth currency in the SDR basket, after dollars, euros, sterling and yen.
December 25, 2015	China's Ministry of Finance announced that the Asian Infrastructure Investment Bank was formally established.	The world's first multilateral financial institution under the initiation of China.
January 16-18, 2016	Opening ceremony and board of directors funding conference of Asian Infrastructure Investment Bank was held in Beijing.	

their natural and factor endowments, both sides will gain naturally from this trade.

The future prospects for the One Belt One Road initiative are bright because it is based on sound economics and trade foundation, benefiting both sides, including utilising comparative advantages, although its implementation may take as long as 20-30 years.

China has used expansionary monetary and fiscal and investment policy to overcome the contractionary pressure during two crises – the 1998 Asian financial crisis, and the 2008-09 global financial crisis – and in the aftermath of the Great Recession. Now, after seven years of resistance, the idea of building infrastructure as a countercyclical measure in a low interest environment is well accepted (see Larry Summers 2014) and is recommended by the IMF.[20]

Fig 4: Belt and Road: one of many variance of routes

Source: Trans-EurAsia Railroad and Schengen Area
http://www.eastbysoutheast.com/wp-content/uploads/2015/02/chen-2-chian-map.jpg

In the post-2015 era, the emergence of new multilateral or regional development banks and funds such as the AIIB, the New Development Bank and the Silk Road Fund is encouraging, bringing positive energy and momentum to the world economic development arena. In a multipolar world, it seems inevitable to have different plurilateral and multilateral development banks, as well as various bilateral and plurilateral investment funds. We are cautiously optimistic that a common ground can be found for partners from the 'North' and the 'South' to work together on win-win solutions for sustainable development and world peace. ■

20 IMF 2014, chapter 3

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International trade, investment and co-operation

Financial institutions' role in infrastructure development

Jiang Jianqing, chairman of the Industrial and Commercial Bank of China, explains why financing modern, efficient infrastructure is the key to future prosperity

Investing in and developing infrastructure typically improves people's livelihoods by helping them to lead a high quality and convenient life. It also acts as an important engine to drive integrated regional development, as well as promoting global economic recovery and sustainable growth.

The need for more infrastructure

In recent years, the world economy has entered into a period of adjustment marked by slowing growth. Governments in all countries are faced with the daunting task of advancing economic development in a sustainable manner. Both economic theory and practice demonstrate that infrastructure is key to promoting growth, creating jobs and enhancing productivity. Investment in modern and highly efficient infrastructure is paramount to future prosperity.

Jiang Jianqing

Based on a study by the International Monetary Fund, an increase of one percentage point of GDP in investment spending raises the level of output by about 0.4% in the same year and by 1.5% four years after the increase. In 2015, China saw its infrastructure investment in the first three quarters chalk up year-on-year growth of 18.1%. It accounted for 29% of China's total investment, up by 7.1% compared with the same period the year before and played a critical role in stabilising the economy.

In such a context, increasing targeted investments and accelerating infrastructure development has become an important policy tool in many economies. Advanced nations are launching a series of large-scale development projects to upgrade existing infrastructure and stimulate economic recovery; while emerging and developing economies have earmarked more investment in infrastructure to supercharge their industrialisation and urbanisation processes.

Strengthening infrastructure investment is important in promoting closer economic ties and regional economic integration to ensure ongoing regional development. The ongoing expansion of trade, people-to-people exchange and capital flows among neighbouring countries and regions increasingly requires greater infrastructure capacity. Huge infrastructure investment deficits are hindering regional connectivity and integration. The ASEAN-China Free Trade Area has made enhancing connectivity a priority and brought attention to the cooperation between China and the Association of Southeast Asian Nations (ASEAN). According to professional services firm KPMG, by 2030, global demand for infrastructure investment and development will reach $50 trillion. The next boom is on its way.

Infrastructure investment synergies

Funding gaps and technical issues inhibit infrastructure investment from reaching its full potential, despite the huge market demands. Therefore, when trying to solve investment problems, countries need to draw on one another's strengths and create synergies by expanding international cooperation.

China sees infrastructure development as an important component of its outbound investment and cooperation. Over the years, it has actively supported and participated in infrastructure development on a global scale. The Belt and Road initiative has placed infrastructure connectivity at its core. It aims to bring European and Asian economies closer and drive regional economic and social development, ultimately creating an economic belt that connects policies, roads, trades, currencies and people.

China boasts the largest infrastructure development capacity in the world. It holds top technological prowess in some industries and enjoys a shiny track record in power generation, particularly hydroprojects, as well as in industrial production. China supports and encourages its companies to work with other countries and regions on infrastructure projects on a mutually beneficial basis and to share expertise and experiences. Meanwhile, by giving out project-specific concessional loans, establishing special funds and proposing the founding of new financial institutions, China is actively promoting a new platform to bridge the financing gaps of international infrastructure projects in a bid to clear funding bottlenecks. For example, the Chinese government spearheaded the establishment of Brics New Development Bank and Asian Infrastructure Investment Bank (AIIB), each with a starting capital of $100 billion. China also contributed $40 billion to set up the Silk Road Fund with the aim of financing infrastructure projects along the Belt and Road.

Taking part

There are three ways China can participate in international infrastructure development:

- By tapping into its advantages in capital, technology and equipment, China could enter into bilateral cooperation with economies that are significantly short of funding for urgently needed infrastructure projects. China may provide technological assistance, capital and manpower to less-developed nations after in-depth research and careful local surveys. Take the China-Pakistan Economic Corridor as an example. The collaboration between the two countries focuses on the development of Gwadar Port, the energy sector, transportation infrastructure and industrial parks with highways, railways, oil and gas pathways and optical cables to be built along the economic corridor (see page 62).
- China could form complementary and powerful cooperation with technologically and financially well-off economies to co-develop third-party markets. Countries and regions with advanced infrastructure can act as financing centers, R&D centers, trade hubs and technology suppliers and work together with China.
- China welcomes established companies from around the world to provide funding and technical support for its infrastructure development and upgrading. The pace of infrastructure development in different parts of China is uneven. Eastern China, which benefits from a much earlier infrastructure development known for its quality and speed, has to upgrade part of its existing facilities to sustain future economic development and meet people's daily needs. In central and western China, there is still a vast amount of land with great development potential that will fuel high infrastructure growth rate in years to come. At the same time, the Chinese government has always attached great importance to agriculture and less-developed rural areas. As such, companies around the world with capital, technology and proven track records will always find infrastructure investment opportunities in China.

Financial institutions can play a leading role

The early involvement of financial institutions is the first step towards infrastructure investment. Commercial financial institutions can play a leading role by making use of their advantages as partners in cross-border services.

- Financial institutions should lead by providing credit funds and comprehensive financial solutions for international infrastructure investment. For example, as a major Chinese bank, the Industrial and Commercial Bank of China (ICBC) has more than 400 overseas branches in 42 countries and regions. As of mid-2015, ICBC provided $200 billion of funding for equipment and international cooperation in production capacity, plus another $110 billion of financing to support Chinese companies 'going abroad'. The bank now operates in more than 30 countries in Asia, Africa and Europe and serves industries ranging from power, transportation, oil and gas and mining, to telecommunications, machinery, industrial park construction and agriculture.
- Financial institutions should lead in information-sharing by utilising their overseas networks. Chinese multinational banks have gathered substantial amounts of management, client, government and market-related information through daily operations, and are able to resolve the issue of information asymmetry in international infrastructure investment and cooperation by bridging communication between upstream and downstream sectors as well as parties home and abroad. On the one hand, financial institutions can help companies identify market opportunities in international infrastructure investment and cooperation, evaluate risks, allocate resources and support companies in their decision makings. On the other hand, they can provide feasible financing solutions and consultation services to host countries in their infrastructure planning and development. By acting as effective information intermediaries, financial institutions help companies and host countries avoid unnecessary mistakes.
- Financial institutions should lead in cooperation with an open mindset for collaboration, innovation and communication. A diversified financing mechanism is necessary when resolving funding issues in infrastructure development. It requires extensive cooperation among commercial financial institutions, equity funds and multilateral international organisations so that information and resources can be exchanged, and earnings and risks can be shared.

Commercial financial institutions may collaborate with the AIIB and other multilateral development organisations in the following ways:

Guidance funds: Commercial financial institutions can work with multilateral development organisations to set up investment and financing funds, as well as industrial financing platforms. Both parties can contribute guidance funds to be used as funds-of-funds to attract international investment for infrastructure project development.

Financing method: Both parties can jointly support infrastructure development of a particular market using a combination of debt and equity financing. In this regard, the successful investment in a Pakistan power project by the Silk Road Fund set an example. In this project, the Silk Road Fund and World Bank's International Finance Corp (IFC) invested in China Three Gorges South Asia Investment under China Three Gorges Corporation to provide capital for the project. In addition, China Development Bank and IFC issued a project loan as a bank consortium under the coordination of Export-Import Bank of China.

Source of finance: Multilateral development organisations finance projects through bond issues, with commercial financial institutions able to purchase such bonds or underwrite bond issues to effectively reduce these organisations' financing costs.

Financing standards: Major Chinese multinational banks are increasingly internationalised. Over the years, they have accumulated concrete experience of overseas expansion and formulated financing standards, regulations, processes and methods for infrastructure projects, such as policies on environmental assessment, purchasing, credit rating and extension as well as borrower country sustainability evaluation and green loans. The AIIB and other multilateral development organisations may take this information as a reference and use it for their own purposes. Such bodies can implement high investment and financing standards by tapping into these resources.

Global infrastructure investment is embracing a new round of opportunities. Only by strengthening cooperation in all aspects can one effectively resolve the investment issues faced by many countries, significantly improve infrastructure quality, promote regional connectivity and integrated development, and spur economic growth. As China deepens its cooperation with other countries in infrastructure investment and construction, it will contribute to overall infrastructure development in the world. Chinese financial institutions including ICBC are willing to make full use of their advantages and actively participate in international infrastructure cooperation, to achieve common development and win-win results for all parties. ■

International trade, investment and co-operation

Sustainable infrastructure investment and financing

Infrastucture investment is key to enhancing economic growth and achieving long-term stability, writes *Zheng Zhijie*, president of China Development Bank

The world economy is still undergoing a period of heavy adjustment, characterised by much instability and uncertainty. Nonetheless, a global consensus has emerged on the significance of infrastructure development, social investment, enhancing economic growth momentum and achieving long-term sustainable development.

China's economy is faced with substantial downward pressure. Annual GDP growth dropped below 7% in the third quarter of 2015, while fixed asset investment growth dropped to 10.3%, its lowest point since 2000. Fixed asset investment has been responsible for approximately half of GDP growth for a long time. The drastic decline in investment growth is having a substantial impact on China's economy. From another point of view, however, China's economic downturn is a manifestation of the longstanding conflicts of its economic transition. This, however, provides an opportunity for structural adjustments and civil welfare improvement.

Infrastructure remains inadequate in rural areas. A great deal of work remains to be done to push forward urban-rural integration and achieve infrastructure connectivity and equity of public services. Even in cities, the capital stock for infrastructure per capita in China only amounts to approximately one third of that in European countries. There is a $10 trillion investment gap to fill before attaining European Union standards. According to an estimate from the Ministry of Housing and Urban-Rural Development, China will be paving 7,000km of underground pipeline in the next three years. With the investment for every kilometer estimated at 120 million yuan, this project alone will bring about one trillion yuan's worth of infrastructure investment.

Diversified and sustainable investment

Infrastructure development is characterised by high levels of investment, long cycles, many uncertainties and relatively low returns, making its implementation a challenge worldwide. Developing countries are especially constrained by funding limitations, while developed countries also face issues such as ageing infrastructure. The key to driving reform and establishing a diversified and sustainable infrastructure investment and financing system lies in exploiting the synergies between government and market action.

Not only can infrastructure development drive investment, but it has the potential to significantly improve the environment for wider economic development. Thus, infrastructure must be prioritised as a government investment target. Rising government debt is a common issue faced by many countries and investment should be made more efficient through capitalising on the government's credit enhancement and leveraging capabilities, in addition to direct funding. This could include setting up funds and offering investment guarantees.

Zheng Zhijie

Taking advantage of development finance is also critical. It is market-based, has a slim but guaranteed profit margin, can raise substantial amounts of low cost and medium-to-long-term funds, and can effectively manage the medium-to-long-term risk. Practice has proven that development finance institutions play a decisive role in infrastructure development, no matter if they are multilateral development banks, such as the World Bank and Asian Development Bank, or national-level development banking organisations, such as the China Development Bank (CDB).

The participation of cooperative capital is of considerable significance in expanding sources of funds for infrastructure development, reducing the fiscal burden and improving the operating efficiency of infrastructure. Monopolies and all forms of entry barriers should be broken down and relevant statutory rules and investment protection systems should be perfected to create the necessary conditions for cooperative capitals' equal participation. Exploring options to attract medium-to-long-term funds and foreign funds through models such as public-private partnerships or funding; issuing basic infrastructure development bonds to both domestic and international markets; and facilitating the conversion of household savings to the medium-to-long-term development funds, are also important.

CDB's role in infrastructure

The CDB has extensive experience in advancing infrastructure development both home and abroad. Since its establishment in 1994, the CDB has supported the construction of 1.4 million kilometers of highway, 90,000km of railway, 695,000km of power grid, 4,000km of urban rail transit – all of which have contributed extensively to China's economic and social development. Among the CDB's 8.6 trillion yuan-worth of total loans, 4.2 trillion yuan were applied to infrastructure.

The CDB will strive to play a larger part in infrastructure development, both domestically and globally. First, the CDB will commit to stabilising growth, staunchly supporting squatter settlement rebuilding and railway construction, and coordinating with the National Development and Reform Commission's major project packages and increase input into infrastructure development. The CDB will also strengthen innovation in financing models. It will continue to step up inter-industry associations and explore effective models for public products and services provision, including social capital investment into infrastructure. Third, the CDB will fully support the Belt and Road initiative. It will give top priority to the development of high speed rail, road and pipeline networks, nuclear power, and industrial and trade zones. ■

> *"The capital stock for infrastructure per capita in China only amounts to approximately one third of that in European countries"*
>
> *Zheng Zhijie, China Development Bank*

Construction works on the Guangzhou–Shenzhen–Hong Kong Express Rail Link

Driving China's overseas investment activities

Li Keping, vice-chairman of China Investment Corporation, explains why working together to achieve shared goals must play a key role in China's overseas investment strategy

China's overseas investment strategy is not just a vision imposed by the government on the country's enterprises. Rather, it is rooted in their development needs and the necessity of upgrading China's economic structure. It is informed by the global economic environment and complementarity of countries around the world. Such strategic planning is inductive and supportive, aiming to follow the demands and needs of stakeholders at home and abroad.

As such, China's internationalisation strategy does not serve as a 'train' with room in the carriages for free riders. It is more akin to an organised camel team. While it is provided with guidance, support and services, the team still relies on the effort from every single enterprise to reach the final destination. This entails more than simply committing resources to the journey.

Li Keping

While making investments overseas, some Chinese enterprises automatically borrow from their domestic experiences and business models. Very often, they make their investment decisions from a macro perspective. Moreover, many experts and scholars discuss the investment strategy of a particular industry based on the basic macro-economic data. Investment environments vary from country to country, however, limiting the usefulness of this data. When pouring capital into a project, enterprises should, as a matter of priority, pay attention to the local laws and regulations, as well as rules and requirements on land use and environment. They must be ready to adjust their mindset and way of decision-making when they face problems.

During the past few decades, the Chinese government has played a major, sometimes dominant, role in economic development and reform. However, this may not be the case in other countries. The aspiration and vision of the politicians of two countries does not necessarily translate into smooth and successful business cooperation between them. It is important that stakeholders from both countries are able to establish a long-term and mutually beneficial cooperation mechanism. Therefore, Chinese enterprises should not be overoptimistic about – or even rely on – intergovernmental agreements and willingness to cooperate; otherwise, they may lose the initiative in investment decision-making and suffer losses.

The long game

Overseas investment is not a one-off event, but a process of long-term integration and value creation. The reason why so many enterprises have failed in the past is because they focused too much on the initial investment and overlooked the importance of subsequent operations, management and value creation. They missed the real purpose of making that investment and producing returns in an appropriate way. Investment is like marriage: pouring resources and energy into the wedding does not necessarily guarantee a subsequent happy family life.

> *"It is important stakeholders from both countries are able to establish a long-term and mutually beneficial cooperation mechanism"*
>
> *Li Keping, China Investment Corporation*

Moreover, while it has large amounts of capital to invest in absolute terms, China is still a developing country with a per capita GDP of $7,000. Therefore, it is important to invest wisely.

The Chinese government has taken the initiative to build a multilateral financing mechanism for infrastructure investment in emerging markets by establishing the BRICS Development Bank

> *"Chinese enterprises ought to set clear goals and strategies to achieve internationalisation. They should continuously discover, utilise and improve their comparative advantages"*
>
> *Li Keping, China Investment Corporation*

and the Asian Infrastructure Investment Bank. These institutions can not only bring about large amounts of capital, they can also serve as an innovative way to solve problems through multilateral coordination and cooperation.

Investment strategies

Now, Chinese enterprises need to strengthen their role in overseas investment activities. Enterprises ought to set clear goals and strategies to achieve internationalisation. They should continuously discover, utilise and improve their comparative advantages, without which enterprises will not be able to achieve sustainable international development.

Enterprises should set up clear business goals, conduct follow-up research and carry out full due diligence on investment projects, utilise legal contracts as safeguards, and have specific post-investment management and operational plans to increase corporate value.

Enterprises should also find ways to create 'win-win' situations and ensure there are mutual benefits. This is more than just a concept and slogan. Specific and favourable arrangements should be made so Chinese enterprises are able to achieve sustainable development in host countries, with a particular emphasis placed on localisation efforts.

Diversification benefits

In terms of regional strategies, while China should continue to focus on investment in emerging economies, it should also diversify its investment destinations, so the systemic risk in some regions can be reduced and the resource allocation balanced more evenly around the world. Furthermore, investment sectors should not be considered only on the traditional complementary portfolio of the energy and resources, but also be taken into account on the need to upgrade industrial structures and embrace innovative technologies. Though 'going out' is becoming more and more popular, 'bringing in' is also necessary.

In carrying out its internationalisation strategy, the Chinese government has the responsibility of providing guidance, service and support to domestic enterprises. It also needs to strengthen bilateral and multilateral coordination in the international community, so that it can better protect the legal rights and interests of Chinese investors when conflict of interest occurs, and also create a more open, transparent, and predictable investment environment. ■

Meeting global infrastructure needs with MDB backing

KV Kamath, president of New Development Bank, discusses the pivotal role that multilateral development banks can play in meeting the infrastructure investment requirements of developing countries

Emerging markets have spearheaded the global recovery following the financial crisis, contributing 75% of the increase in world GDP in purchasing power parity terms since 2009. This is symbolic of the changing times we live in, characterised by a shift in geo-economic power to the global 'South'. I believe South-South cooperation is poised to supplement North-South flows of both finance and knowledge. It is a partnership among equals.

In absolute terms, China and India now contribute more to global growth than the eurozone and US put together. There is talk of a slowdown, but this does not mean the same in emerging markets as in the developed world. A slowdown in China means growth falling from 10% to 7%, but for many developed economies it implies a full-blown recession. Even with unprecedented liquidity, the developed world is still struggling to cope with the legacy of high debt and high unemployment. There is uncertainty as to what the next steps of quantitative tightening would do: both for the developed world and the developing world.

KV Kamath

Maintain the momentum

It is imperative that the nations of the South keep reinventing themselves, continue with their development efforts and ramp up their public investments in infrastructure.

Recent reports suggest developing countries will require additional spending of close to $1 trillion a year for the next two decades, to meet their infrastructure requirements. No single set of institutions can meet these requirements. Some countries may lack the sufficient structural and institutional capacity to absorb funding. Capacity-building should be at the forefront of policy efforts – leading and not lagging our infrastructure needs. In this regard, we can learn from China's development model.

Four key elements can be identified in the model: investment in agriculture, animal husbandry, fisheries, water and flood management; development of massive infrastructure; development of manufacturing and industry; development of the services sector, climate and environment.

Keeping an eye on capacity requirements for the future, China is pursuing the One Belt, One Road initiative. This plan will channel investment into the country's underdeveloped inland western provinces on the back of trans-national networks and interconnectivity with Europe and the Middle East. It will boost intra-regional commercial and financial linkages and develop infrastructure capacity along the route. This infrastructure spend will promote internationalisation, foster trade and, most importantly, spur economic growth.

Current financing and investment patterns are inadequate in meeting investment needs. Private international capital flows are not only volatile, but insufficient in volume and maturity to fund sustainable development, which typically requires long-term investment. Multilateral development banks (MDBs) can play a pivotal role in meeting these requirements.

> *"Reports suggest developing countries will require additional spending of close to $1 trillion a year for the next two decades, to meet their infrastructure requirements"*
>
> *KV Kamath, New Development Bank*

While the annual resource commitment from MDBs has risen from $45 billion to more than $100 billion over a 10-year period, it is still not enough to meet the demand for infrastructure. MDBs must reinvent themselves and embrace guarantee structures, asset securitsation and derivative arrangements to hedge risk, while promoting reinsurance among financial participants. They must also partner with central banks to create a platform for currency swap arrangements between developing countries. Most of their external debt is denominated in hard currencies, with their balance sheets vulnerable to currency volatility.

To be successful, MDBs need to lead the structural reform agenda and go where others do not. It is imperative they demonstrate greater risk appetite. We are living in times with record low interest rates and ample global liquidity. MDBs should seize this opportunity and consider how to increase their funding base. For example, they could contemplate operating with one notch lower credit ratings, which could help raise substantial resources at a very low incremental cost, without in any way impairing their financial health. MDBs can play an important role in sharing the vast pool of knowledge they have collected over the years.

New Development Bank (NDB) needs to listen, learn, collaborate and innovate. A significant step would be for the NDB to establish global, regional and local partnerships with new as well as established MDBs and with market participants, so that we can leverage knowledge, capacity and financial resources. ■

PROMOTING FINANCIAL INCLUSION

Substantial technological shifts are taking place in finance. From an era of branch banking to mobile banking to contact-less banking, technology shifts have changed the paradigm of the banking business.

Technological advancements have been widespread and comprehensive, extending reach, while lowering cost. We should recognise these shifts, understand that the future lies with these technologies and align our processes to leverage these advancements. These shifts provide for a completely different approach to inclusive banking.

Take the example of Aadhar – a unique identification card for citizens of India, which is based on their biometric identification. Aadhar will supplement financial inclusion, subsidy reduction efforts by the government and significantly reduce leakages in subsidy transfers. With the implementation of Aadhar, 190 million bank accounts have been opened, banking the unbanked, within a short span of one year. The government plans to offer access to funding, pension, insurance and medical benefits through Aadhar.

This is a scalable, replicable example of how technology advancements can lead to widespread financial inclusion while eliminating leakages. Financial inclusion needs to be supplemented by social inclusion, health, education and skilling.

KV Kamath

Case study: The China-Pakistan Economic Corridor

The Karakoram Highway links China with Pakistan via the Kunjerab pass

Countries such as Pakistan stand to benefit enormously from Chinese infrastructure investment as part of the One Belt, One Road policy, according to *Nauman K Dar*, president and chief executive officer of Habib Bank

The role of infrastructure development and financing has traditionally been state owned or sponsored, but this is changing. As the largest financial institution in Pakistan, we believe Habib Bank has a responsibility to participate in infrastructure development and we are keen to work alongside other domestic and international institutions in ensuring projects meet local needs.

The creation of new development financial institutions like the Asian Infrastructure Investment Bank (AIIB), New Development Bank (Brics Bank) and Silk Road Fund heralds the advent of a new era. We expect these institutions to play a key role in boosting development and hence, sustainable growth, in emerging and low income countries. With their formation, there will be more collective funding available from new and old Bretton Woods institutions. There may be more competition for financing infrastructure, which could create an opportunity for the borrowers to access relatively low cost capital for longer tenures.

President Xi Jinping's One Belt, One Road policy should be tailored to the different environments it involves, making it more inclusive. This will help achieve diversity and economic wellbeing at the grassroots level, which is necessary to curb extremism and promote harmony and peace.

Nauman K Dar

China-Pakistan Economic Corridor

One initiative is the China-Pakistan Economic Corridor (CPEC), announced in mid-2013 during prime minister Li Keqiang's visit to Pakistan, which had gained significant momentum by the time president Xi visited in 2015. This is a $46 billion infrastructure plan, based on the requirements of the Pakistan economy.

The CPEC covers the immediate need for building power-generation plants and transmission lines, constructing highways and subways, and improving railway infrastructure. It also addresses the medium-term needs of the economy, by developing port city infrastructure, constructing hydropower plants and investing in social infrastructure by building schools, universities and medical facilities.

Since 2010, Pakistan's annual GDP growth has dropped to an average of 2–3%, from 6% in the preceding five years. This appears to be a result of multiple factors, including the impact of the financial crisis and slowdown in the global economy on Pakistan's major exports of textile products. However, on closer scrutiny, a question arises: why were some developing counties able to attain higher growth, while Pakistan lagged? The answer is simple: it did not invest in infrastructure. From 2004 onwards, investment in energy and energy-related infrastructure fell, leading to shortages, with consequences for household consumption. The direct and indirect costs for growth were estimated by some experts to be in the range of 2–3% a year.

What would the country require to break this vicious circle? Additional power generation of 5,000 megawatt in three years and another 8,000 megawatt in eight years; infrastructure to transmit power; dedicated areas like industrial parks; and the provision of natural gas, to name a few things.

The CPEC is designed to provide this infrastructure, in support of the current and future economic needs of Pakistan. Chinese knowledge, expertise, technology and experience are being utilised, while the massive investment will be financed by Chinese financial institutions – both commercial and developmental, new and old – alongside both international and Pakistani financial institutions.

Connecting investors

Habib Bank is working very closely with two leading Chinese banks, ICBC and CDB, on various aspects of projects such as providing financial advisory services, arranging debt and equity from China and Pakistan, and connecting investors. For example, CDB, ICBC and Habib Bank are working on the execution of the first coal mine and power plant in Pakistan, which is being set up at the cost of $2 billion. We will also work together on the financing of a 900km transmission line – a project we are jointly advising on.

Separately, Habib Bank is taking a leading role in providing and arranging the the domestic portion of the financing, and other projects that do not have a Chinese element. Nonetheless, the scale and size of the CPEC initiative is beyond the capacity of the Pakistani banking sector. The Silk Road Fund has committed investment in two projects in Pakistan, and is reportedly considering others. The AIIB will hopefully also play a key role in project financing in Pakistan.

Energy mix

International institutions can also play a critical role in helping Pakistan balance its energy mix. Pakistan is an economy with GDP in excess of $280 billion, a population of 180 million people and a minimum power shortage of 5,000 megawatt. At the same time, it is the only economy in the world of this size with no power generation from coal. Yet the Bretton Woods institutions shy away from coal projects while promoting financing of renewables like wind and solar. This is despite the fact good practices and technology can be deployed to reduce carbon content to acceptable levels.

> *"Chinese knowledge, expertise, technology and experience are being utilised and it will be financed by Chinese, international and Pakistani financial institutions"*
>
> *Nauman K Dar, Habib Bank*

Meanwhile, the cost of producing power from alternate energy sources is much more than coal. The Chinese banks and Silk Road Fund are adopting a practical and pragmatic approach to financing projects, which considers the development needs of the recipient country. This will be one of the defining themes of how the new international institutions will contribute and challenge the established norms of the old.

Finally, we hope lower risk weights for infrastructure financing can be included in Basel III, enabling commercial banks to play their role without excessively drying up capital. ■

China's role in globalisation post-financial crisis

Huang Mengfu, honorary chairman of the All-China Federation of Industry and Commerce, examines what China's role will be in an increasingly interconnected world

It has been seven years since the financial crisis in 2008 but the world economy is still in a post-crisis era. Developed economies are facing various difficulties such as depressed investment activities, high debt ratios and weak economic growth, while emerging economies are under great pressure to restructure and deal with falling commodity prices, capital outflows, weak domestic demand and economic slowdowns.

As the largest developing country, China is not exceptional in facing a daunting economic restructure. At the same time, global trade growth is slowing, with annual growth rates of less than 3% during the past four years, much lower than the average rate of 5% during the previous 20 years.

Since the Doha round of world trade negotiations stalled, the world has been witnessing the boom of regional trade liberalisation and the formation of bilateral and multilateral free-trade zones, which have brought new economic development opportunities to the participating countries and regions. However, if booming regional trade does not accelerate the progress of globalisation, and only provides exclusive benefits to the participating countries, such regional trade development is not favourable overall to the long-term development of international trade and investment.

Nowadays, world economies are intertwined, so no country can achieve economic growth on its own. As the interconnectivity of world economies is strengthening, the development of any particular country will bring benefits to others. On the other hand, any economic disaster of one country may cause spillover effects and spread to others. Thus, it would be a wise choice for all of us to focus regional trade liberalisation on the ultimate goal of achieving economic globalisation. If regional trade liberalisation is narrow-minded and exclusive, it will further enlarge the gap among different regions, and will damage global trade and investment in the long term.

Huang Mengfu

A wiser path to globalisation

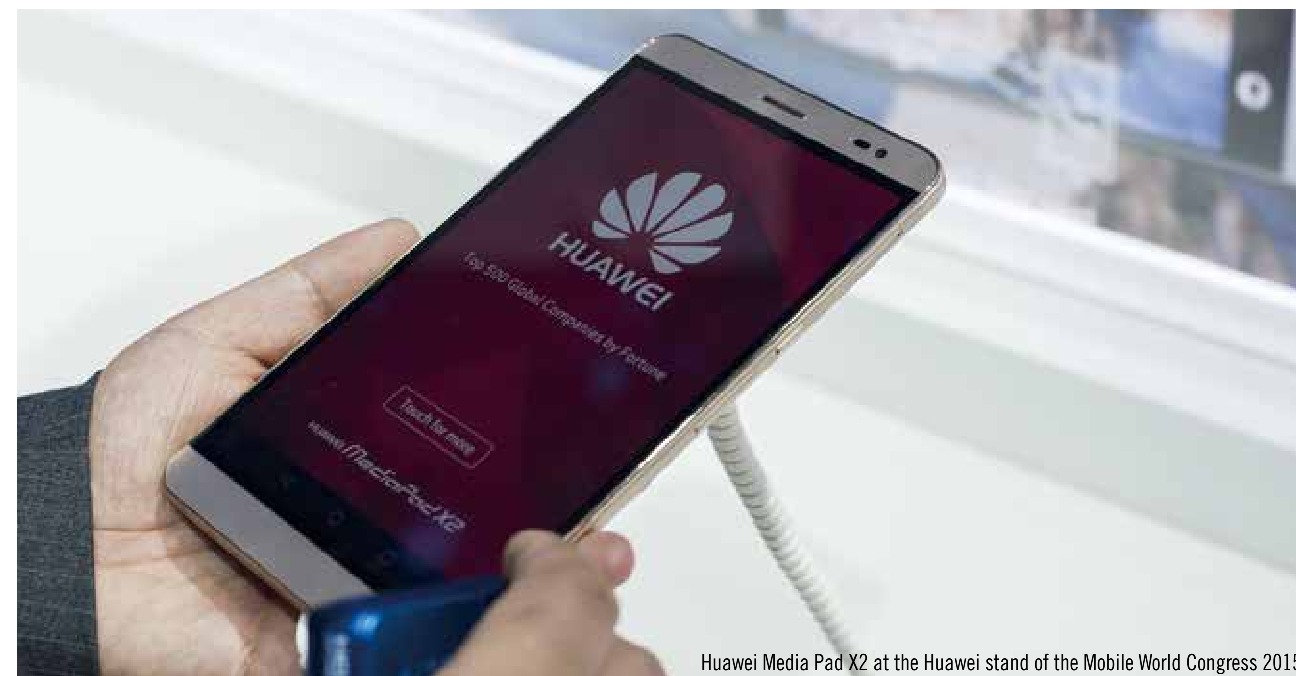
Following the trend of globalisation in the post-crisis era, China has proposed the strategic vision of the One Belt and One Road initiative, which should be a wiser path to realising economic globalisation in the context of regional trade liberalisation. The Silk Road Economic Belt and the Maritime Silk Road were established to develop economic and trade exchanges between the East and the West thousands of years ago, and still display their importance today. Asia remains the global economic powerhouse and the communications and exchanges between Asia and the West (Europe and America) still rely on the Belt and the Road, which link the economic activities of countries along the way and bring profits to countries that engage in infrastructure development under the Belt and Road initiative.

In contrast to existing regional economic communities, the Belt and Road initiative will not be the ultimate form but should be a very good transition to achieving economic globalisation. Under the initiative, investment drives infrastructure development, which further drives industrialisation and the facilitation of trade and investment. The initiative is characterised as open, diverse and inclusive and both developing and developed countries can join it, with each of them making the most of their comparative advantages to make profits. Furthermore, regional economic cooperation is necessary but should involve as many countries as possible.

China's future role

What role will China play in the world economy in a post-crisis era? As China accounts for 12-13% of global trade in goods and contributes to nearly 30% of world GDP growth, China's future economy will have a significant impact on the world economy.

China has made a qualitative change in economic restructuring. Although China's economy has been driven by industrialisation for many years, more recently its tertiary sector has grown faster than its secondary sector. It now contributes more than 50% to the country's GDP. The fact the service industry has replaced manufacturing as the main driver of the Chinese economy will have a significant impact on the global economy. And the growth of the service sector foreshadows the growth of consumption.



Huawei Media Pad X2 at the Huawei stand of the Mobile World Congress 2015

Ivan Garcia / Shutterstock.com

China's economic restructuring will affect global trade and investment, notably the Chinese economy will no longer be driven by exports. In the future, China's exports will grow at an annual rate of 3-5%, which is the mean growth rate of global trade. This is important for many countries because they will have the opportunity to consume domestic products that have comparative advantages, rather than import products from China. Meanwhile, China can increase the added value of exports.

The country is also becoming a big exporter of capital. In the past, China was a big importer of foreign capital and attracted foreign investment worth several hundred billion dollars every year. Now the situation has started to change. Official statistics suggest the amount of foreign capital that China attracts is now equal to the amount of China's overseas investment. However, some sources say the overseas investment made by many Chinese enterprises, especially private enterprises, has not been incorporated into the statistics, implying the actual amount of China's overseas investment may far exceed what is indicated by current statistics. My personal observations suggest China has indeed become a net exporter of capital, with a surprisingly fast growth rate.

Having a sufficient amount of capital is a prerequisite for the One Belt and One Road initiative. Directly selling Chinese products to foreign countries, as China did in the past, may have a negative impact on local economic development and employment; however, investing in those countries' local industries, setting up factories, producing and selling the products to the world is an approach that is highly welcomed by many countries.

Growing middle-class

Chinese citizens also are gradually getting richer and China's middle-class is expanding. According to the Ministry of Commerce, in 2015, there were 100 million Chinese outbound tourists that spent in excess of 1 trillion yuan while overseas. According to the *Global Wealth Report*, China has the biggest middle-class; and according to statistics from domestic research institutes, the Chinese middle-class now totals around 300 million people.

> *"The fact the service industry has replaced manufacturing as the main driver of the Chinese economy will have a significant impact on the global economy"*
>
> *Huang Mengfu, All-China Federation of Industry and Commerce*

The number of enterprises per thousand people in China is about 15, compared to approximately 50 in developed countries. Therefore, China has great potential to improve its domestic consumption level, as more and more Chinese citizens become middle-class. As we know, consumption in the US was a major driver of world economic growth before the financial crisis. With its large population base, China may be home to 500 to 600 million middle-class residents in the future, so the country is likely to surpass the US and become the largest nation of consumers in the world. ■

The role of infrastructure in spurring growth

Wendy Dobson, IFF Academic Committee member and former Canadian associate deputy minister of finance, highlights three lessons that can be applied to the Silk Road initiative

Not all infrastructure investment has the same impact on growth. When making decisions about where to channel funds, there are important lessons to be learned from past experience, in particular for the Silk Road initiative and the Asian Infrastructure Investment Bank (AIIB).

The economics of infrastructure investment are straight forward, albeit with some qualifications. In a severe cyclical downturn, such as in 2008-09, coordinated expansionary monetary policy can help offset the recessionary impacts of lower demand. In that instance, deficit financing helped to maintain consumption and stimulated growth through investment spending on real assets, which increased aggregate demand, aggregate supply, productivity and generated future economic returns.

Note that fiscal expansion of this kind was most effective when part of a cooperative strategy among countries rather than in isolation by one government. Moreover, such spending was more likely to have the desired impact if applied to pre-approved projects that are likely to expand aggregate demand quickly.

Wendy Dobson

Not all forms of infrastructure have the same growth impacts, however – energy, communications and transportation investments facilitate greater economic activity, while maintaining and renewing infrastructure stock often provides higher returns compared with new investment. Location also matters, since investments in one place can spill over to others, especially in urban areas.

It is possible to overinvest in infrastructure. Public finance decisions should be subjected to a test of their strategic importance – including whether a project generates returns. It has been shown that efficient public investment can double the growth impact. Investment should go far beyond short-term stimulus to enhance both productivity and growth prospects over time.

Efficient public investment can serve as a catalyst for growth by supporting or enabling the delivery of key public services and connecting firms and citizens to economic opportunities.

With public investment increasing in emerging markets, more so than in advanced economies, there are major funding requirements. Some worry a rush into infrastructure investment could have negative financial, environmental and social impacts. An International Monetary Fund study points to the importance of institutions – ones that improve public investment management, especially at the planning phase – in the allocation of capital and implementation of projects.

Rigorous and transparent arrangements for the appraisal, selection and approval of projects are required; stronger institutions are needed to carry out funding and management and monitor project implementation. Strict oversight of public-private partnerships is required, alongside better integration between national strategic planning and capital budgeting.

Key lessons

I would like to highlight three significant lessons, which can be applied to the Silk Road initiative and performance of the AIIB. Firstly, the overriding objective of greater growth requires structural changes, not just more lending. Secondly, now China has assumed the presidency of the G20, it has the opportunity to stress its 'responsible' initiatives: those in which the AIIB makes high quality and inclusive lending decisions.

Finally, inclusion is especially important in maintaining Chinese legitimacy, especially in the early days of AIIB-funded projects, when precedents are created. There may be a temptation to achieve a 'multiplier' effect by relying on other Chinese financing sources such as the China Investment Corporation and China Development Bank, or private sources, instead of turning to ADB or World Bank.

Such a strategy could have significant negative consequences. It could create the perception of China hijacking projects. Instead of expanding China's international influence, it could create a backlash against a 'Chinese embrace' as smaller countries hedge by seeking closer relationships with other large countries. This can also happen if the perception develops, rightly or wrongly, of differences in quality controls in AIIB projects.

The Silk Road initiative is a long-term vision, one that will bear fruit only if the investments are in projects of value to people in the region, as well as providing payoffs to Chinese and other foreign investors. ■

THE RENMINBI AND THE INTERNATIONAL MONETARY SYSTEM

Internationalisation of the renminbi

The renminbi and the international monetary system

Zhou Yueqiu, IFF Academic Committee member and director of the Urban Finance Research Institute of the Industrial and Commercial Bank of China, offers some perspectives on the future role for the renminbi post-SDR inclusion

On October 1, 2016, the International Monetary Fund (IMF) will make the renminbi the fifth currency in its Special Drawing Rights (SDR) basket. It will have the third largest weighting, behind the US dollar and euro, ahead of the Japanese yen and British pound. Since the pilot projects of cross-border renminbi business were launched in 2009, the internationalisation of the renminbi has achieved notable successes. The RMB's inclusion into the SDR basket, announced in late 2015, indicates one of the most influential international organisations recognises the reform and opening of China's financial sector.

New opportunities are often associated with new risks. The increasing volatility of the renminbi exchange rate in the past year has helped people to recognise this reality. Nonetheless, the internationalisation of the renminbi continues. By the end of 2015, the People's Bank of China (PBoC) had signed swap agreements with 33 foreign central banks and monetary authorities, with a total amount of 3.3 trillion yuan, and established RMB clearing arrangements in 20 countries and regions. As reform efforts continue, the implementation of the Belt and Road initiative and other national strategies will stimulate more market demand. The convertibility of the RMB capital account will be orderly promoted and the scope and scale of the international use of the RMB will be steadily expanded.

New epoch for the renminbi

Due to its controversial distribution mechanism and limited scale of use, the SDR has played a limited role in the international currency reserves system. Nonetheless, the decision to include the renminbi in the SDR basket represents the most significant progress the IMF has made with reform of the international monetary system in recent years. It serves as a solid foundation for the organisation's attempt to diversify its reserve currencies, win the support of emerging economies such as China, further expand the use and volume of the SDR, and boost the influence of the SDR in the international monetary system (see Figure 1).

Inclusion helps pave the way for the renminbi to become an investment and reserve currency, in addition to being an increasingly popular trade currency. As it progresses along this path, the RMB's international use will likely expand in both breadth and depth.

Zhou Yueqiu

Based on the volume of the British pound and the Japanese yen, which have a similar weighting to the RMB in the SDR basket, the volume of the RMB held as official foreign exchange reserve assets could be expected to increase by $149.3 billion to 190.4 billion in the longer term. The volume of international bonds and notes denominated in the RMB is also expected to increase – potentially by much larger amounts in a range from $303.8 billion to 1,889.5 billion.

There is also likely to be more RMB product innovation and broader RMB investment channels. Rapid growth with increasingly diversified investment vehicles could prompt a large amount of surplus capital to flow into China's interbank bond market and the renminbi's inclusion into the SDR basket will significantly boost its acceptance in the mortgage market and help RMB funds to take root in the offshore markets. Various international stock exchanges and financial institutions may accelerate their offerings of offshore securities and derivatives denominated in renminbi, while the offshore renminbi bond market may also take off.

Moreover, as the Belt and Road initiative will further strengthen the economic ties between China and the countries along the routes, the renminbi will become more influential in local markets and is likely to gradually become a settlement currency for trade and investment among non-Chinese residents in the region. This would lay a solid foundation for the multilateral use of the renminbi in the future.

Exchange rate formation is maturing

To enhance the marketisation level of the midpoint exchange rate of the RMB to the US dollar and strengthen its role as a benchmark rate, the PBoC decided to further improve the midpoint rate determination mechanism, which takes as main references the closing rate of the interbank exchange market of the previous day, the demand and supply of the foreign exchange market as well as the exchange rates of the world's major currencies. Starting from August 2015, market makers will report this midpoint rate to the China Foreign Exchange Trade System.

After the implementation of this reform, the foreign exchange reserve market experienced great volatility. The PBoC responded by strengthening communication, trying to manage expectations, providing liquidity, adopting macro-prudential measures, discouraging speculative trades, and attempting to prevent procyclical behaviours and 'herding' effects.

Since the People's Bank of China implemented the reform of the midpoint exchange rate on August 11, 2015, expectations for a depreciation of the RMB abruptly picked up. Consequently, the RMB midpoint exchange rate and the spot rate decreased by 4.4% and 3% respectively. Soon afterwards, the authorities intervened in the market and narrowed the depreciation range of the renminbi to some extent. The major measures included moderately interfering in the foreign exchange market; increasing the liquidity of foreign currency in the market; including foreign currency liquidity and cross-border cash flows in the scope of macro-prudential management and adopting macro-prudential regulatory measurements into the future foreign exchange settlement of banks; and guiding market expectation through enhanced communication.

Since the beginning of 2016, the renminbi midpoint rate and spot rate against the US dollar have been divergent in their variation trend. On January 6, the offshore renminbi traded in Hong Kong (CNH) closed at 6.6959, marking a record low after the '8.11' exchange rate reform. In the following month, the spread between the spot rate and the midpoint consistently was more than 100 basis points, reflecting that the People's Bank of China was guiding the trend of the exchange rate via the midpoint exchange rate again. This initiative was in the background of a weak US dollar against other major currencies. From January 5 to February 5, the US dollar index has declined by 2.4%. After lowering the midpoint exchange rate with reference to the trend of a basket of currencies, the offshore renminbi quickly went up and the spread between

Fig 1: Latest IMF SDR weightings

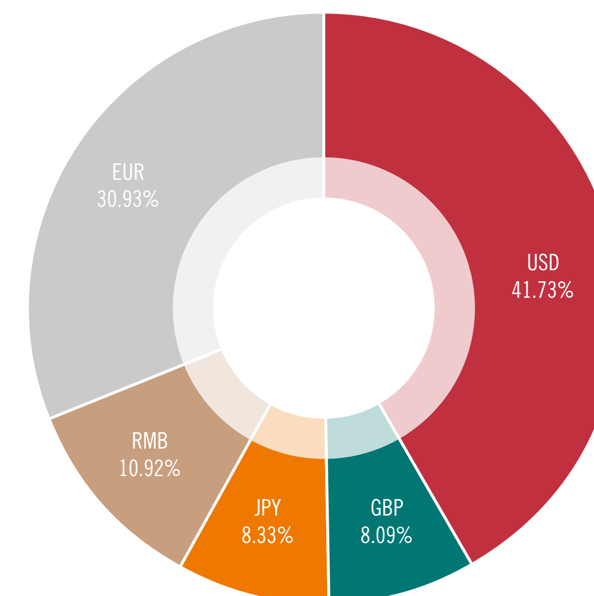
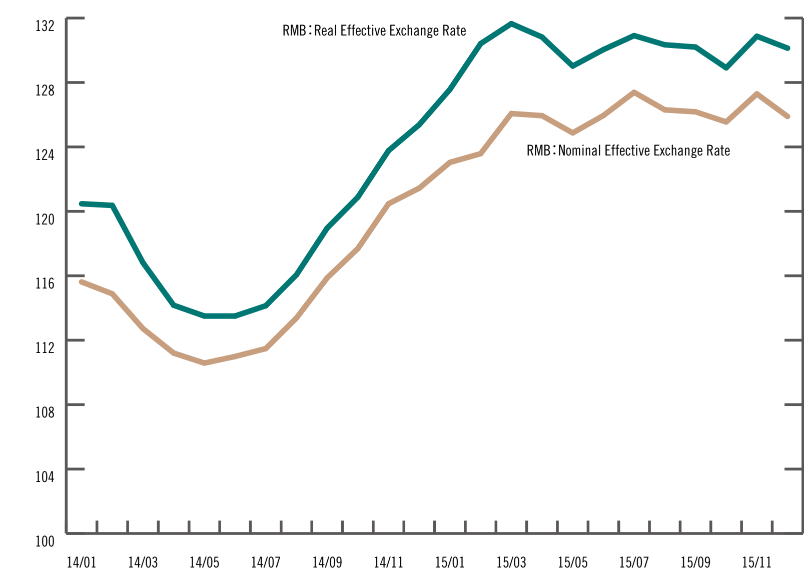


Fig 2: RMB nominal vs real effective exchange rate



THE INTERNATIONALISATION OF THE RENMINBI

Wendy Dobson examines the implications of increased international use of the renminbi

Chinese officials are encouraging greater international use of the renminbi. This has provided the narrative for the reform and modernisation of the financial system – necessary for full capital account convertibility and the eventual use of the renminbi as a global reserve currency.

It has been a pragmatic process. Relaxation of capital controls has brought greater use of the renminbi in cross-border settlements, the issuance of renminbi bonds in Hong Kong, and currency swaps with other central banks. In October 2015, the renminbi became the world's fourth-most-used payments currency. The liberalisation of commercial banks' deposit and lending rates was another significant step.

But some difficult questions, and decisions, remain. First, if interest and exchange rates are to be market-determined, what does this mean for a central bank that operates under political direction?

Moreover, how much moral hazard is still in the system? Are state-owned and -directed commercial banks still used as instruments of industrial and development policy? How robust are the risk evaluation and risk management capabilities of commercial banks, which have enjoyed years of riskless spreads?

The authorities also need to strengthen and modernise capital market institutions. This includes the creation of a sound and credible enterprise bond market and transparent equity markets. Foreign investors and commercial banks must be able to invest in China's bond market. Exit channels are required for financial institutions that fail, and more sophisticated instruments are needed to mitigate the risks of potentially large and volatile financial flows. All are essential if China's financial system is to produce globally competitive products and thrive in an environment of capital account convertibility. Regulators should also ensure the financial system supports growth in the real economy.

How Chinese authorities meet these challenges will determine the path of economic development as well as the renminbi's international role.

The renminbi will be included in the International Monetary Fund's special drawing rights (SDR) basket from 1 October 2016. I admit to being a sceptic about the importance of SDRs, since barely no one uses them and their existence is mainly symbolic. Of greater significance is the use by foreign investors and central banks of the renminbi as a store of value in their investments and reserves. Their confidence will depend heavily on market-determination of the renminbi, free of political influence.

I am also a bit of a sceptic about the relative costs and benefits to China of the renminbi becoming a global reserve currency – beyond the undeniable prestige. Yes, there are advantages to greater seigniorage, reduced transactions costs, the ability to issue cheaper debt and conduct more invoicing in the domestic currency.

But there are also large and irreversible costs, not least the responsibility to be a global lender of last resort in times of crisis. It also complicates the conduct of monetary policy beyond the pursuit of price stability objectives. These can be onerous responsibilities, especially when there are significant and possibly conflicting domestic priorities.

Wendy Dobson is an IFF Academic Committee member and former Canadian associate deputy minister of finance

the spot rate and the midpoint exchange rate was also significantly narrowed accordingly.

Overall, the renminbi remained generally stable against a basket of currencies during 2015. The real effective exchange rate increased by 2.73 points, to 130.31; only half the growth of 2014. Based on the Bank for International Settlements currency basket, the RMB exchange rate index was 101.71, a 1.71% appreciation compared with the end of 2014.

It depreciated more sharply against the US dollar, drawing media attention and market participants to question the future of the renminbi exchange rate. There is, however, fundamental evidence to suggest it will remain largely stable moving forwards (see Figure 2).

First, China's economy is generally developing steadily at medium-high speed. It is being increasingly reformed and liberalised. Second, China's productivity is growing faster than that of other major economies, which provides strong support for exports and should enable it to maintain a trade surplus. Third, the external environment has calmed, after markets were spooked by the US Federal Reserve's raising of its interest rates. Finally, the economic fundamentals will continue to provide long-term support to the RMB exchange rate.

Although the US dollar serves as an important reference in measuring the exchange rate of any currency, it is not the only standard. Pegging the RMB to the US dollar to maintain a stable exchange rate may accumulate distortions and imbalances, exacerbate the imbalance of international payments, cause more arbitrage activities and reduce the economy's flexibility in dealing with external impacts. It is understood the RMB exchange rate formation mechanism will, in future, focus more on a basket of currencies as a major reference.

The RMB exchange rate index of CFETS has been released with reference to the 13 kinds of forex currencies listed on the CFETS. And the weightings of these 13 currencies were calculated according to their respective weighting of trade with China. Thus currencies with the top four weightings were the US dollar, euro, yen and Hong Kong dollar, and their weightings were 26.4%, 21.39%, 14.68% and 6.55% respectively. The sample monetary price was in reference to the midpoint and trading price of the renminbi exchange rate on that day. The index is anchored to prices on December 31, 2014, which are represented by a value of 100. The renminbi exchange rate index released by the CFETS provided a quantitative indicator for observing the trend of the renminbi exchange rate, which can comprehensively and accurately reflect the market changes. Moreover, this index can guide the market to divert the focus on the bilateral exchange rate against the US dollar in the past to a new frame of reference pegged to a basket of currencies. All these were instrumental for stabilising the RMB exchange rate at equilibrium within a reasonable range.

Capital account opening and offshore developments

Last year, Yi Gang, deputy governor of the PBoC and then director of the State Administration of Foreign Exchange, stressed: "China has its own schedule of achieving the convertibility of the RMB capital account and neither volatility nor external situations will disrupt

the plans." As such, he said, the authorities would "steadily and orderly achieve our targets according to our own schedule".

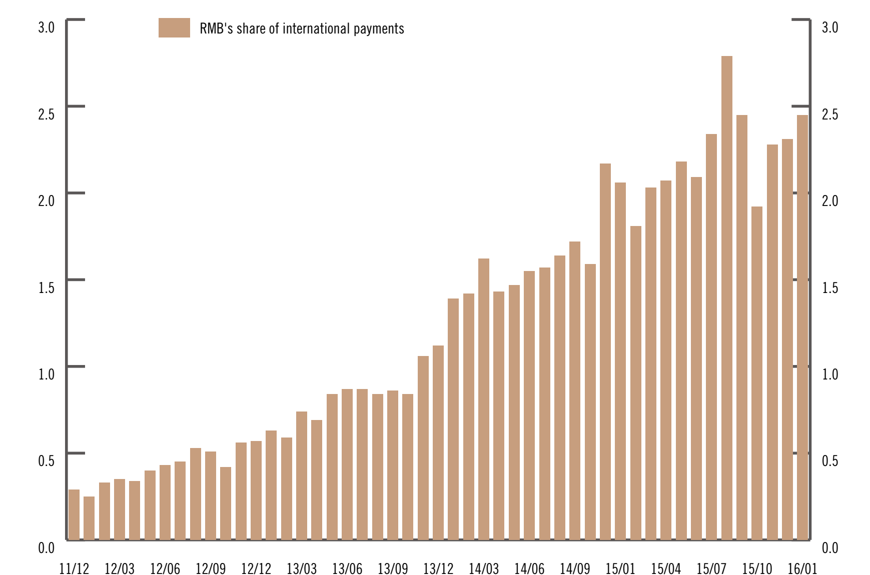
Indeed, the Chinese government has adopted a series of measures with a view to opening the capital account during the past year. Those measures aim at facilitating investments both at home and abroad. They address elements including the operation and management of the foreign-exchange funds of multinational companies, personal foreign exchange management, foreign cash management of domestic institutions, management of cross-border fund sales in mainland China and Hong Kong, specific types of futures trading within Chinese borders by foreign traders and brokerage institutions, online personal currency exchange service by licensed institutions, and foreign exchange account management by foreign central banks investing in China's interbank markets.

According to the IMF's classification of the capital and financial account, 37 out of 40 items in China have become convertible to various degrees. The three missing items involve elements of the domestic primary capital market, such as money market instruments, derivatives and stock issuance by non-residents within China. One of the most recent announcements on capital controls, in February, saw the State Administration of Foreign Exchange set out relaxed qualified foreign institutional investor quotas, which will further open up China's domestic capital markets.

As the capital account opens, Chinese authorities are stepping up their regulation of cross-border flows. From January 1, a 100,000 yuan limit was placed on the amount of cash that can be withdrawn overseas using renminbi UnionPay cards. This measure will effectively reduce large withdrawals from banks overseas and inhibit the illegal transfer of assets. China has also tightened the authenticity verification for the purchasing and payment of foreign exchange, in an effort to curb abnormal flows of foreign exchange capital. The authorities have also launched special regulatory programmes on key sectors and channels, including special investigation programmes on exporting companies that avoid receiving foreign exchange in exporting businesses, and also on foreign cash held by individuals.

The RMB has become the second most-used currency in trade finance, the fourth most-used currency for global payments, and the sixth most-used currency in foreign exchange trade. Offshore renminbi transactions have experienced explosive growth and, according to the *RMB Internationalization Report*, published by the PBoC in June 2015, the daily trading volume of RMB foreign exchange in major offshore markets such as Hong Kong, Singapore and London exceeded $230 billion in 2014 (the latest data available) – more than four times the daily trading volume of domestic markets.

Fig 3: RMB's share of international payments



Share of international payments

The offshore RMB foreign exchange futures market has been developing rapidly in recent years, with daily trading volume of about $830 million. And the participants in the RMB offshore markets are more diversified, including financial institutions, enterprises and individuals, which has provided liquidity for the market. The trading mechanism of the RMB offshore market, which does not set the midpoint exchange rate of the RMB and has no price limits, is more liberal with less intervention by the monetary authorities. Generally speaking, the RMB offshore market is becoming an important carrier of RMB's internationalisation and serves as an important step in promoting that process.

Meanwhile, the prospect for 'panda' bonds and 'dim sum' bonds is quite bright. It is very likely that after a period of rapid expansion and along with the internationalisation of RMB, these bonds will enter into a stage of stable development. In most cases, financial markets are complementary to each other, but there are also cases of competition and replacement. From this perspective, along with the internationalisation of China's economy and the RMB, bonds markets are also due for more development. ■

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A year of progress but there is much still to do

Pan Gongsheng, deputy governor of the People's Bank of China, writes about China's growth prospects, RMB exchange rate reform and the past years' stock market fluctuations

China's economy continues to grow at a reasonable pace, despite recent headwinds. Maintaining a 7% growth rate is difficult under any circumstances, and especially so for a country with a $10 trillion GDP. From a global perspective, China's growth rate is remarkable. Employment remains stable, household income is growing steadily and progress in the transformation of economic structure continues. Nevertheless, China must remain highly alert to any downside risks. To understand our current situation, we must first look backwards.

Global growth has been slower than expected. Growth remains below target in the eurozone and Japan. Emerging markets are also experiencing difficulties. Global financial markets, meanwhile, remain turbulent.

In China, the traditional growth model is losing steam. After many years of investment-driven growth, the economy is suffering from industrial overcapacity and high levels of debt. Government, corporate and household debt currently exceeds 200% of GDP. Leverage is a particular issue in the corporate sector, with corporate debt at 120% of GDP. Debt deleveraging and capacity lowering will likely result in a drag on growth in the short term.

The Chinese government sees slower growth as necessary in facilitating the country's economic transition. The traditional growth model, while highly successful, also caused some problems. Increasingly, the focus in China will be on the quality and sustainability of economic growth. This is positive both for China and the rest of the world.

The record growth rates in China and other emerging markets during the past three decades came at a price. Depletion of natural resources, environmental damage and growing income inequality are some notable side effects, as are the global economic imbalances that helped fuel the global financial crisis.

In recent years, China has contributed to global economic stability by mitigating financial balances both home and abroad. The country's current account surplus fell from 10% in 2007 to 2.1% in 2014. Net exports fell from 7.5% of GDP to 3.7% in the same period. Moreover, in the first three quarters of 2015, services accounted for 51.4% of GDP growth – 2.3 percentage points higher than in the previous year and 10.8 percentage points higher than manufacturing. These achievements contribute directly to improving global financial imbalances.

What about China's future growth trajectory? Despite recent downward pressure, there are a number of positive near-term developments. Home sales are bouncing back. A 3.2 trillion yuan

Pan Gongsheng

government debt swap programme has reduced the funding costs of local infrastructure projects as well as the risk of large-scale maturity mismatches. Finally, since the beginning of 2015 fiscal policy has been loosened and the People's Bank of China has cut benchmark interest rates several times. The effects of fiscal and monetary easing will likely become visible in the coming quarters – our estimates indicate a five- to nine-month time lag.

Over the medium term, China's growth potential in services, agriculture, advanced manufacturing and information technology is substantial. A rapidly growing middle-class, meanwhile, will drive greater demand for consumer products. We can also expect healthcare, tourism, entertainment and e-commerce to significantly outperform the overall economy. The huge disparity across regions also means there is still a vast potential for investment linked to urbanisation. Most importantly, the market-oriented reform will likely boost the vitality of the economy, particularly in the service and technology sectors.

The main challenge facing China today is how to strike a balance between maintaining reasonable growth on one hand and promoting structural adjustment while controlling risks on the other. Launching a major stimulus program would boost GDP in the short term but only at the cost of more debt, heightened financial risks and a slower reform tempo. If we allow a sharp slowdown in growth, on the other hand, it will spur unemployment, financial

People's Bank of China headquarters, Beijing

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stress, and make it more difficult to implement structural reforms. Managing this balancing act will require a steady hand. I am confident it can be achieved.

Renminbi exchange rate reform

Last August, the Chinese government reformed the daily fixing of the renminbi against the US dollar, allowing market forces to play a greater role in determining the exchange rate. This was ultimately in line with reforms first formulated in 2005 and the currency's trading band has widened gradually since then, from 0.3% to 2.2% today.

What does the future hold for the renmibi? Since the August decision, the currency has depreciated modestly. This follows continued appreciation against most leading currencies in the preceding years. Since the current government took office in 2012, the real effective RMB exchange rate has gone up 17%. Moreover, the US Federal Reserve's expected tightening cycle is intensifying international capital flows.

> *"In light of domestic and international economic and financial conditions, there is no reason to expect further depreciation of the renminbi"*
>
> *Pan Gongsheng, People's Bank of China*

The market is expecting a correction in the value of the renminbi as a result of market forces and the currency's return to its long-term equilibrium level.

In light of domestic and international economic and financial conditions, there is no reason to expect further depreciation of the renminbi. China's economy continues to grow at a reasonable rate and the country still has a current account surplus. The trade surplus also remains strong – a fundamental factor in determining supply and demand for foreign exchange. Finally, China maintains abundant foreign exchange reserve.

According to Swift, the renminbi now ranks as the world's fifth most used currency and the second most used for trade financing. It has also been accepted for inclusion in the IMF's special drawing rights basket. The US Treasury issued a report in 2015 stating that the renminbi remains below an appropriate medium-term evaluation. China's government will continue to pursue reforms aimed at expanding and deepening the market's role in determining the exchange rate.

China's stock market fluctuation

Unlike the mature financial markets in developed countries, which have developed over centuries, China's stock market is still very young, only 25 years old. Its investment structure and regulatory regime are still evolving. Several factors contributed to turmoil in the market during the past year. Investors resorted to high leverage margin trading, often using informal, unregulated margin facilities, stoking a bubble. The subsequent correction prompted large losses and triggered a downward spiral, raising the spectre of systemic risk. The Chinese government responded with a series of robust policy measures.

While such dangers were fended off successfully, there are lessons from this episode. We could have done better. Nonetheless, market risk has decreased since the worst turbulence. Valuations of blue-chip stocks have reached reasonable levels and leverage ratios have come down dramatically, even if the valuation of smaller stocks remains high. There are also concerns that market reforms in China may slow down as a result of this episode.

China is committed to the reform agenda, including the opening up of financial markets. In the short term, we need to strengthen investor confidence in the stock market. In the medium and long term, we must enhance the effectiveness of regulation and supervision, implement macro-prudential policy and further promote the opening up of China's capital market. We also need to reform IPO registration and grow the institutional investor base. There is still a lot to do. ■

Coordinating domestic and international efforts

As China becomes an ever-more significant player on the international stage, it can no longer be insular in its policies, writes *Yi Gang*, deputy director of the Office of the Central Leading Group on Financial and Economic Affairs, and former director of the State Administration of Foreign Exchange

With the rise of its economy, China has come to play an increasingly important role in the international community. As a participant and leader of global economic governance, China must also contribute to a more equal and fairer system that will ensure the continued prosperity of the world economy. With much to gain from greater international cooperation, China should coordinate both domestic and international efforts with a view towards creating a more harmonious and favorable international environment for economic development.

Maintaining a high growth rate

China is likely to maintain a growth rate of approximately 7% during the next three to five years, or even longer. Two important driving forces are underpinning confidence in economic growth. One is the new model of urbanisation. Permanent urban residents currently account for about 55% of China's population. If the ratio grows at 1% annually, they will make up 70% in about 10 years, an increase that is likely to spur considerable economic growth.

The other driving force arises from Beijing's efforts to delegate administrative powers to regional and municipal governments, as well as to society at large. Such reform will help boost total factor and labour productivity, which will further increase growth.

As China's economy enters the 'new normal' era – representing a transition from high to medium-high economic growth internationally – the country's growth model will change. First, domestic consumption will take precedence, replacing investment as the top contributor to economic development, and services will replace manufacturing as the leading sector. Second, China will attach greater importance to environmental protection and energy conservation, which will provide major growth opportunities in the future. As the largest developing country in the world, China will make great efforts in tackling climate change, protecting the environment, saving energy, reducing emissions, and lowering energy use per unit of GDP.

Third, China will put greater emphasis on social security. The country's social safety net will be developed to cover pensions, healthcare, subsistence allowances and care for the disabled. Fourth, and most importantly, China's economic growth will be driven by innovation, relying increasingly on human resources and less on investment and resource consumption.

Yi Gang

No slowdown to reforms

The International Monetary Fund's decision on December 1, 2015, to include the renminbi in its Special Drawing Rights (SDR) basket, was a mutually beneficial milestone that promises to provide long-term benefits for China and the world. It is testament to the international community's recognition that China has come a long way in reforming and opening up its economy and – importantly – its currency.

While the renminbi's inclusion in the SDR basket was of great importance, much remains to be done. Upcoming reforms will make China's monetary policy framework more consistent with international practices in terms of transparency, communication and the management of expectations. A stable interest rate corridor will be developed that continues the focus on prices, while also placing greater emphasis on quantitative instruments. A huge gap between China and more mature markets still exists and China should continue reforms to ensure the renminbi reaches its potential as a widely used international reserve currency.

Active role in global governance

As globalisation deepens, economies are growing more intertwined, creating new challenges that require global solutions. Currently the world's second largest economy and expected to grow at a medium-high rate during the coming years, China's economic influence is constantly expanding, while global financial markets simultaneously are affecting the country to a higher extent. Therefore, it is important to facilitate international macroeconomic policy coordination and make use of bilateral and multi-lateral platforms to engage in constructive dialogues. This will promote economic growth in China, as well as international stability. China should work actively to strengthen global economic governance and make efforts to continuously improve the underlying framework.

A stable global financial system is vital to economic growth and social stability. China must be fully engaged in the core decision-making processes of international bodies like the Bank for International Settlements, Financial Stability Board and Basel Committee on Banking Supervision.

> *"A stable global financial system is vital to economic growth and social stability. China must be fully engaged in the core decision-making processes"*
>
> *Yi Gang, Central Leading Group on Financial and Economic Affairs*

The government must articulate its position and ensure that all reform proposals and international standards conform to China's national interests, thereby contributing to the improvement and consolidation of the global financial system.

China should step up efforts to monitor and promote orderly capital flows. It should also introduce and implement, in a timely manner, new international standards aimed at strengthening cross-border supervisory cooperation and preventing the occurrence of systemic financial risks. China should raise the world's awareness of inclusive finance and financial infrastructure construction, share successful experiences with others and promote development of the financial system in a manner that will benefit low-income countries and stakeholders.

Finally, China will actively promote and lead negotiations on the Regional Comprehensive Economic Partnership and the establishment of the Free Trade Area of the Asia-Pacific, as well as accelerate the establishment of free-trade zones with surrounding countries.

Meanwhile, China should adhere to the concept of 'open regionalism', promote cross-regional collaboration, undertake to establish a network of free-trade zones that is open to the world and of high standard, and realise 'win-win' results and mutual benefits with related countries. ■

Internationalisation of the renminbi

Lin Jianhai: The state of the global economy

Secretary general of the IMF *Lin Jianhai* offers his views on global challenges and China's economic transition

Lin Jianhai

What were the main conclusions from the IMF and World Bank annual meetings in Lima last year?

The ongoing global recovery remains moderate and uneven, and there remains a lot to do if we are to achieve higher and sustainable growth. There are three key forces driving the current global economic outlook, starting with China's transition to slower but safer and more sustainable growth. Significantly lower global commodity prices are also important. Since the middle of 2014, global oil prices have declined more than 50%, while metal prices have fallen almost 30%, reflecting both demand and supply factors. Diverging monetary policies across the major central banks, and especially the normalisation of US interest rates, are also key. This divergence has had a strong impact on exchange rate movements, notably in Brazil, Japan, India and the eurozone.

Legacy problems associated with the crisis and longer-term factors, including persistently high unemployment and public debt in a large part of the world, and lower medium-term potential growth, also matter. Policy options and upgrades are needed to lift today's growth and tomorrow's potential.

What is your view of China's transition?

China's transition to safer and higher quality growth is challenging but needed. It is both healthy and necessary in the longer term, though in the near term there are important implications both for China and its trading partners. We have seen some positive progress in the process, with the service sector surpassing manufacturing and becoming the largest sector in China's economy. Consumption, meanwhile, is playing a more important role in driving growth. The country was the centre of all policy discussions during the IMF annual meetings.

Is the legacy of the crisis behind us?

It is still with us. Unemployment and public debt remain persistently high in a large part of the world. Youth unemployment in some advanced economies is particularly serious, at about 50%. Government debt is another challenge. In 2007, the debt-to-GDP ratio in major advanced countries was largely below 60% of GDP. Today, many countries are suffering their highest levels of government debt since the Second World War.

For many emerging economies, rising corporate debt warrants urgent and careful attention. As a share of GDP, corporate debt in emerging economies has increased from 78% in 2009 to about 110% in 2015. More worrisome is that, of this debt, the proportion in foreign currencies is large and still increasing. Companies that borrow externally face the risk of tighter global financial conditions, meaning higher interest rates and borrowing costs.

Additionally, much of the external borrowing is subject to the risk of further US dollar appreciation. In the eurozone, while signs of recovery are encouraging, the high level of non-performing loans is a serious issue that needs to be addressed. In nominal terms, the stock of non-performing loans was estimated at about €900 billion at end-2014, which is very large by any standard.

Setting the crisis legacy aside, what long-term factors are at play?

Most importantly, the estimated potential growth — that is, the pace at which an economy will or can grow in the future — has declined in both advanced and emerging economies. This change is important because it affects tomorrow's growth, thus also affecting today's investment and consumption decisions.

The reasons behind this slowdown are not entirely clear. It seems slowing total factor productivity growth, which measures technological change and efficiency gains, is a major contributor. So is weak capital investment. Some analysis shows total factor productivity growth had already declined in advanced economies before the crisis, but the crisis has made it worse. The change in total factor productivity growth is also poorly understood. But likely reasons include slower human capital accumulation, a shift of GDP toward services and — at least in the US — a gradual decline in the positive effect of the IT revolution.

What can policymakers do to address these challenges?

There is no easy answer. We need a combination of strong efforts to maximise growth while minimising risks. We need to use all available tools to strike the right balance between supporting short-term demand and implementing structural reforms to lift potential growth. In short, we need to secure faster growth while safeguarding financial stability.

A lot has been said about structural reforms. This is a very important area but also a difficult one to understand and act on. What are the right structural reforms for a particular country or region? How should these be designed and implemented? How should the potential gains be measured?

IMF analysis shows there are different payoffs across the many different possible reforms, dependant on country circumstances. For low-income countries, lowering trade tariffs and barriers and promoting agriculture are likely to be the most productivity-enhancing measures. For emerging economies, competition policies and labour market reforms would be particularly important and necessary; and for advanced economies, innovation is key. For all countries, an efficient financial and banking sector, along with infrastructure investment, will be most critical. ■

Lin Jianhai is secretary general of the IMF

Han Seung-soo: financial opening and the renminbi

Han Seung-soo explains why the time is right for a rethink on the current international financial system, and offers his views on China's role in a proposed new system

What does China's financial opening and the internationalisation of its currency mean for the Bretton Woods order?

I have a very strong view on the governance of international financial institutions. The Bretton Woods system born 70 years ago no longer reflects the global economic balance of power and, moreover, has become increasingly outdated as a result of recent financial innovation. I therefore think it is time to drastically overhaul the existing international financial architecture. This process will have to take into account China's financial opening and the internationalisation of the renminbi.

What is the significance of the renminbi's special drawing rights (SDR) inclusion?

It is very big news. At the third plenum of the Fourteenth CPC Central Committee in 1993, China set the goal of gradually making the renminbi a convertible currency. In 1996, China achieved current account convertibility and it will seek to achieve capital account convertibility. China has come a long way from that time. It is the second largest economy in the world as well as the largest exporter and manufacturer. So it is natural to expect the renminbi would be used for international trade, finance and investment and serve as a reserve currency.

What does renminbi internationalisation mean for China domestically?

Domestically, renminbi internationalisation has been a catalyst for necessary financial reforms. A sound, well-functioning financial infrastructure is a prerequisite for currency to be used internationally for various purposes. As renminbi internationalisation inevitably involves opening of the capital account, it is very important to safeguard the financial system through the right sequencing of reforms to avoid potential risks during the internationalisation process. Domestic financial sector reform should proceed first. Appropriate regulatory and supervisory frameworks should be put in place. Then the exchange rate should be allowed to move freely, with monetary policy used to achieve domestic policy goals. Finally, the capital account should be entirely opened as a last step to allow the free flow of capital across borders.

What does it mean for other countries?

Renminbi internationalisation will contribute to improving the international monetary and financial architecture. We saw some

Han Seung-soo

side effects of the US dollar-dominant currency system during the global financial crisis. If the renminbi can serve as a supplementary international currency, backed by China's economic and financial stability, it will help stabilise international monetary and financial architecture and improve the global financial safety net, especially for emerging and low income markets.

Where have you seen the biggest impact of renminbi internationalisation?

The use of renminbi in cross-border payments and its status as an actively traded currency in global financial markets have grown rapidly in recent years. About 20% of Chinese trade and 25% of other current account transactions, such as services income and dividend payments, are now settled in renminbi. Moreover, as of 2014, about 30% and 16% of inward and outward foreign direct investment transactions were settled in renminbi, up from 13% and 4% in 2012. Also, as part of broader reforms aimed at moving China onto a sustainable growth path and building the international market for renminbi securities, Chinese authorities have gradually opened the capital account while introducing measures to strengthen the domestic financial system and expand cross-border payment infrastructure. Offshore deposits, meanwhile, now amount to about 2.5 trillion yuan.

What is the next step?

Since 2009, renminbi internationalisation has primarily been focused on trade settlement and investment but gradual opening of the capital market is a very important part of the process. Capital

account transactions in China are generally subject to restrictions, preapprovals and quotas. However, as a part of a broader financial reform agenda, the authorities have been gradually easing restrictions, widening China's access and increasing quotas to capital flows over time. There are several underlined policy measures promoting renminbi internationalisation in China. One is the gradual opening of the capital market. Capital account transactions in China are generally subject to restrictions, preapprovals and quotas. However, as a part of a broader financial reform agenda, the authorities have been gradually easing restrictions, widening China's access and increasing quotas to capital flows over time. Second is improving cross-border transactions through introducing cost-associated regulatory approval, where regulations have already shifted from pre-approval to registration and export monitoring investment transactions in capital account. It is expected that capital account liberalisation will proceed along a path of managing the convertibility going forward. Third, foreign central banks, international financial institutions and sovereign wealth funds are now allowed to trade foreign exchange products directly including spots, forwards, swaps and options in China's inter-bank market without any quota restrictions. In addition, non-resident interest in the renminbi as a funding and investment currency has been helped by specific steps to allow renminbi funds to flow onshore.

> *"The use of renminbi in cross-border payments and its status as an actively traded currency in global financial markets have grown rapidly in recent years"*
>
> *Han Seung-soo, former prime minister, Republic of Korea*

How important are domestic reforms in driving internationalisation?

As part of a broader structural reform agenda pushing China towards a safe and sustainable growth path, the authorities have initiated financial reforms aimed at achieving more market-based pricing, better alignment of risks with returns and greater efficiency of allocation. During the past decade, the People's Bank of China has gradually liberalised interest rates. Lending rates were completely liberalised in 2013 and the central bank eliminated the final administrative interest rate in October 2015. A nationwide deposit insurance programme was introduced in May 2015, covering 99.6% of depositors and more than 40% of total deposits. During the past two or three years, authorities have taken steps to rein in shadow banking through tightened regulation and supervision of securities and trust companies, activity in the inter-bank market and insurance of high yield wealth management products. These are the kind of measures taken by Chinese authorities that contributed, for instance, to the willingness of the International Monetary Fund to include the renminbi in its basket of SDR currencies in 2015. ■

Han Seung-soo is co-chair of the IFF and former prime minister of the Republic of Korea

Internationalisation of the renminbi

Reform facilitated by RMB's inclusion in SDR basket

Ba Shusong, IFF Academic Committee member and chief China economist of The Stock Exchange of Hong Kong examines the significance of the renminbi's SDR inclusion

The initial draft of the Thirteenth Five-Year Plan offered some advice on the development of the financial sector. For instance, China needs to integrate and consolidate its regulatory frameworks, realise convertibility of renminbi capital accounts, and promote the free and wide use of the renminbi. It also sought to ensure the renminbi joined the International Monetary Fund's Special Drawing Rights (SDR) basket.

Background of SDR creation

The SDR was created in 1969 as a supplementary international reserve asset, as official reserves in the post-Second World War Bretton Woods system – gold and the US dollar – were inadequate. The SDR is not a currency but rather a basket of currencies, and its quota allocation is reviewed and adjusted every five years under the IMF framework. Later, as major currencies shifted to floating exchange rate regimes, the SDR became less important since various countries and markets had easy access to financing. From then on, the SDR received much less attention, largely only being mentioned in finance textbooks until the global financial crisis occurred in 2008. In 2009, the SDR was reconsidered an important tool that could help to maintain global financial stability at a time when the international community sought international financial stability frameworks.

Impact of the renminbi's inclusion

When the renminbi was being reviewed to join the SDR (it was confirmed in 2015 and will officially comprise part of the SDR later this year), two aspects required particular attention: First, the issuing country (or region) of the currency must play a major role in global economic and trading activities – something China been doing for a long time. Second, the currency must be measured as a "freely usable currency" – a term that can be interpreted in a somewhat subjective manner.

For China, the inclusion of the renminbi in the SDR was an important recognition of a series of efforts made by the Chinese government in promoting renminbi internationalisation, in accordance with market demand. The inclusion itself is actually less important than the series of Chinese economic and financial system reforms resulting from the efforts made by the Chinese government to facilitate the renminbi's membership of the basket, which have positive implications.

The authorities in China have carried out a series of financial reform measures – not just aimed at meeting the IMF's 'freely usable' criterion – but also to open the economy. This has resulted in a more market-based exchange rate mechanism, interest rate liberalisation, the opening the domestic bond markets to foreign buyers including foreign central banks, the launch of an international payments and clearing system, and the adoption of IMF's Special Data Dissemination Standards to improve transparency. Therefore, the vote to include the renminbi in the SDR basket last November was, effectively, recognition of China's financial reforms.

IMF headquarters, Washington DC

Meanwhile, from the perspective of global investors and the markets, major institutional investors still hold a relatively small amount of renminbi-denominated assets. The fact the renminbi is joining the SDR basket may prove to be an important factor considered by investment funds' committees when deciding to increase the amount of renminbi-denominated assets in their portfolios, encouraging them to invest more. With more assets denominated in renminbi, overseas financing costs should be lowered for Chinese enterprises, financial institutions and government bodies. This should reap incremental benefits over the longer term.

Ba Shusong

During the period from 1969 to 2009, the SDR became less important for the IMF; and even since 2009 when its importance was reconsidered, the SDR has been only used in official settlements and very rarely by the private sector. In addition, the previous SDR currencies' issuing countries (the US, the UK, Japan and the eurozone) all have shrinking percentages of the world's GDP. Therefore, the inclusion of the renminbi into the SDR basket will significantly boost the percentage of world GDP that the SDR basket represents. This should also help to enhance the attractiveness of the SDR in international financial markets and extend its use from official settlements to the private sector.

Boosting reform and development

Currently, the weight of the RMB in the SDR basket is 10.92%, which will probably increase to 19-20% by 2020 if China maintains an annual growth rate of 6.5% and continues its economic restructuring. This means the renminbi is likely to become the third major currency after the US dollar and euro, with a much larger weight than that of the Japanese yen and British pound. However, the currency is still in an initial stage in terms of its weight in the international financial markets and in achieving major reserve currency status. The gap between the renminbi's weight in the SDR basket and its weight in international financial markets needs to be narrowed down by taking further supporting measures that facilitate financial and economic reforms. This will be another example of how China "draws on further opening up to boost reform and development" – a characteristic repeated since its reform and opening up 30 years ago.

Achieving reserve currency status requires a very long and complicated process, as one can see from the evolution of the world's major reserve currencies such as the British pound, yen, euro and the US dollar. The factors that facilitate such evolution include rising economic aggregates, financial markets development and adjustment of the global political and economic landscape. With the renminbi joining the SDR, more focus should be placed on how to accelerate economic and financial reform and the two-way opening-up of financial markets, so the renminbi will achieve similar weights in both the international monetary system and financial markets as its weight in the SDR basket as the world's third major currency. As China proceeds with its reform efforts, it should actively develop financial markets, promote a positive interaction between onshore and offshore financial systems and develop financial products and investment instruments – for instance, supporting the international usage of renminbi in global infrastructure development.

Through strenuous efforts in the lead-up to 2016, more than 40 central banks have decided to hold renminbi as part of their reserves. With the renminbi joining the SDR basket, more than 180 central banks may incorporate renminbi into their portfolios. According to research by many financial institutions, central banks around the world may not increase their holdings of renminbi-denominated assets immediately. Accessible financial infrastructure is essential for clearing and investing in renminbi. And central banks and other investors require adequate financial disclosures to be able to assess the pros and cons of financial products denominated in renminbi, which also includes information about the overall operation of the economy and financial system.

Positive offshore/onshore interaction

The renminbi market experienced great volatility in the recent stock disaster. The market gyrations would likely have been greater still if the Chinese stock market was more open to foreign investors. Therefore, establishing a positive interaction mechanism between the offshore and onshore markets has become meaningful for the internationalisation of the renminbi and further opening up of the Chinese markets. Pilot projects can be carried out in the offshore markets where there is no foreign exchange control on the currency so that the price signals, interest rates and exchange rates formed could serve as benchmarks for future practice. Once the results of these test cases are proven to be positive, the Chinese authorities may then feel more comfortable gradually opening up the onshore markets. And the interaction between the offshore and onshore markets should be achieved through building interconnectivity between them.

Results of the Shanghai-Hong Kong Connect

The Shanghai-Hong Kong Stock Connect has achieved the goal of opening up domestic markets to the outside world and building a bridge between the Chinese markets and offshore international markets without making many changes in each other's existed regulatory frameworks. For instance, Japanese or Australian investors are able to trade Shanghai stocks through the Hong Kong stock market or other offshore markets, operating directly from their own stock account. Therefore, China should promote the orderly opening up of the renminbi by establishing the interconnectivity between onshore and offshore markets, as well as providing more diversified assets denominated in renminbi to foreign investors by gradually opening up its stock market in Shenzhen, bond market, commodity market and derivatives market. However, when calculating overseas use of the renminbi, the IMF excludes the offshore markets in Hong Kong, Macau and Taiwan and thus underestimates the actual overseas use of the currency, since Hong Kong is the primary offshore centre. This needs to change otherwise a misleading picture of onshore and offshore renminbi use will develop. ■

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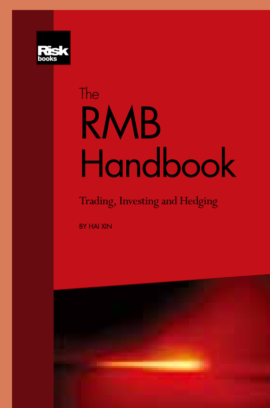

Price: £145
Format: Paperback
ISBN: 978 1 906348 81 6

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