THE IFF CHINA REPORT 2015

Insight and opinion
from China's top
policy-makers

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

In asscociation with:

CENTRAL BANKING

About IFF

Given the ongoing changes in global economic and financial conditions in the 21st century, the world has a pressing need for a more extensive mechanism for dialogue and cooperation, in order to join global wisdom and strength, and to regularly discuss and seek solutions for significant issues such as the current financial crisis. The International Finance Forum (IFF) was founded on October 28th 2003, when 78 representatives from over 20 countries, regions and international organizations such as China, the U.S., the EU and the U.N. gathered in Beijing and witnessed its birth.

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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.

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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

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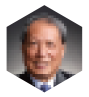
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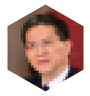
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Welcoming remarks

The *IFF China Report 2015* was conceived at a crucial turning point for China's society and economy, which started in November 2013, when the Chinese leadership under president Xi Jinping and premier Li Keqiang unveiled a bold market-orientated reform blueprint.

During the period from 2013 to 2015, China's economy and its evolving growth model experienced a profound transformation, creating mixed results, greater uncertainties and diverging predictions by China watchers.

Outside observers are divided on the condition of the country's economy and its reform process. Views range from the very pessimistic "The coming Chinese crackup", as published in *The Wall Street Journal*, to the reasonably positive "Made in China: New, improved and stronger than ever" by *The Economist*.

This report – the first by the International Finance Forum (IFF), and published in collaboration with Incisive Media's *Central Banking* – provides readers with the IFF's unique access to many insiders in China, as well as to its network of experts with long and rich experiences studying China on the ground.

The *IFF China Report 2015* is divided into four sections. They comprise: the transformation of China's growth model; financial deepening and capital markets development; international trade, investment and development co-operation; and the internationalisation of the renminbi and its impact on the international monetary system.

Each section contains a series of analytical articles reviewing the scope of the relevant topic, as well as interviews and contributions by leading thinkers and decision-makers on more specific aspects.

We are delighted that so many senior policy-makers and industry officials have agreed to support the publication of this report, offering readers a genuine understanding of the real challenges China faces as it embarks on the next phase of its economic transformation.

We hope that the report gives you some interesting insights and thank you for reading!


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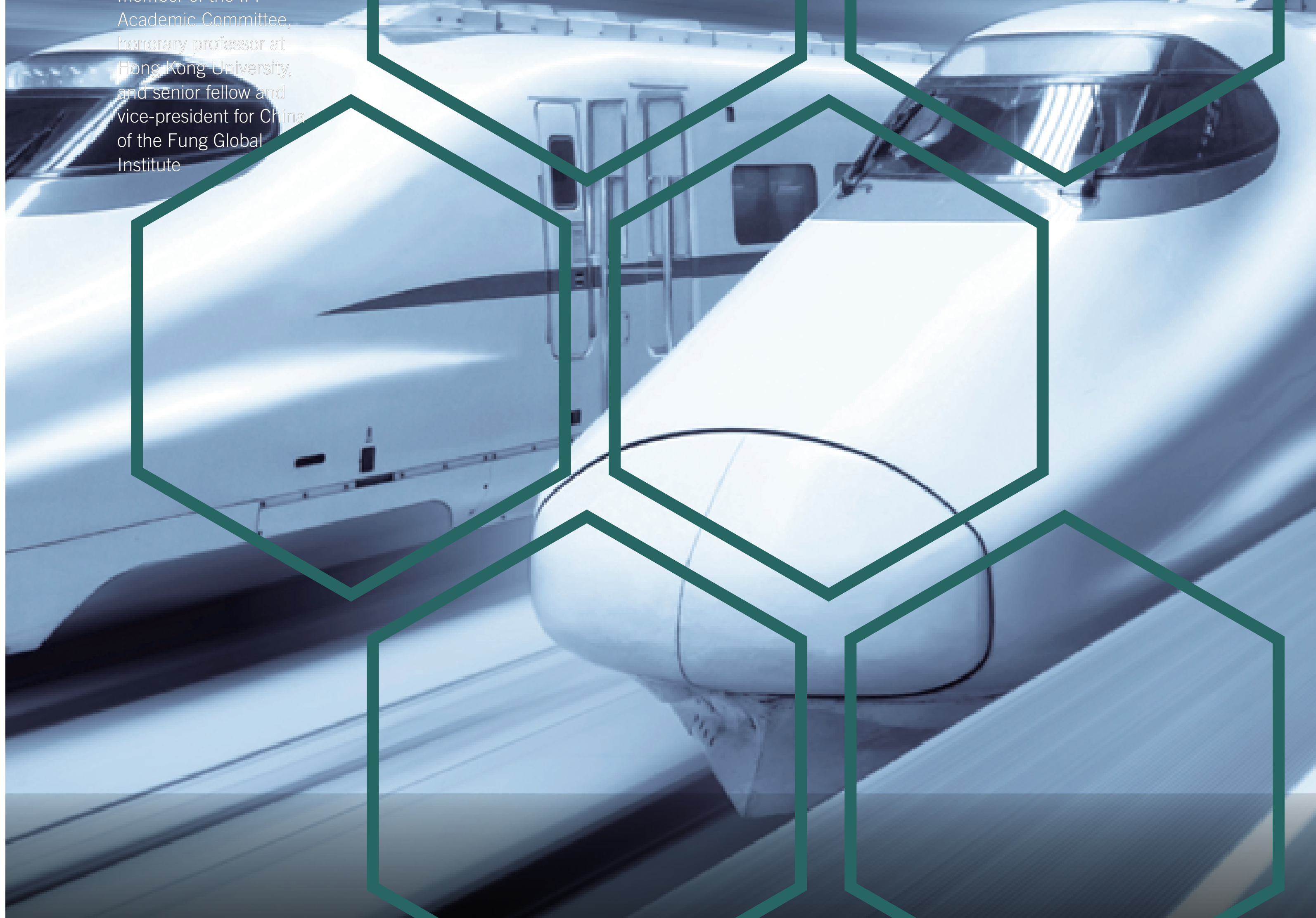

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The transformation of the Chinese economy

Accelerated and deeper structural reforms to the economy were keywords in the Chinese premier's report to the National People's Congress, with an emphasis on increasing stability and sustainability. This section looks at how the market could be given space to help transform the economy, moving away from old Chinese growth models

At the National People's Congress (NPC) in March 2015, Chinese premier Li Keqiang articulated the government's work plan for the year with a much stronger focus on stabilising growth, while accelerating structural reforms towards an inclusive, sustainable, innovative and open growth.

With the country's slowing economy and declining inflation rates, Li lowered the GDP growth target from 7.5% for 2014 to around 7% for 2015, stressing that the authorities have ample macroeconomic policy space to support growth if necessary.

He also pointed out that China's structural transformation has been dramatic over the past few decades, and is still continuing in at a healthy pace, where the tertiary sector has grown to surpass the secondary sector in GDP, reaching 48.2% in 2014 (see figures 1 and 2). Additionally, household consumption has also risen strongly.

Throughout his report to the NPC as well as the policy statements from key macro authorities such as the National Development and Reform Commission (NDRC), the Ministry of Finance (MOF) and the People's Bank of China (PBOC), the emphasis has been on the implementation of accelerated and deeper structural reforms. This is particularly the case in repositioning the government's role from controlling the economy towards enabling and supporting the market while downplaying the role of short-term cyclical macro stimulus.

Although the MOF raised the central government's fiscal deficit from the actual level of 1.8% in 2014 to a target as high as 2.7% in 2015 in light of slowing growth, the key policy measures focus on improving the transparency and discipline of local budgets. This includes the announcement of a 1 trillion yuan programme – possibly the first batch of similar measures – for replacing about half of the local government loans that are due in 2015 with new long-term local government bonds that will have much lower interest rates and much longer payback periods. This would mean that the cost and term structure of the bonds would be much more consistent with the nature of local infrastructure projects being financed than the *ad-hoc* short-term banking and shadow-banking loans at high interest rates.

Similarly, although the PBOC has relaxed the monetary conditions through a gradual lowering of interest rates and reserve requirement ratios, the target for the growth of money supply (M2) in 2015 is set at 12.2% – lower than the target of 13% and slightly higher than the actual growth of 12% in 2014. The inflation target for 2015 is set at 3%, lower than the 3.5% target in 2014, but higher than the actual inflation rate of 2% in 2014.

The PBOC also highlighted that the exchange rate for 2015 is likely to be stable, given healthy two-way cross-border capital flows so far. The PBOC reiterated its intention to further relax its control on interest rates by implementing deposit insurance reform in 2015 as well as to gradually further open China's capital account.

Clearly, even with slowing growth as well as rising challenges in inequality, pollution, corruption, and the global economic, political and security environment, China's policy-makers are determined to deepen structural reform and are confident they could maintain a balance between stable growth and effective change.

In the past two years, China's macro authorities appear to have put more effort into micro and structural problems – such as controlling overcapacity, property bubbles and local government debts – than into preventing deflation and providing an accommodative macro environment for positive risk-taking by innovative and productive companies.

This regulatory risk aversion reflects challenges in structural reforms as well as a lack of effective tools for implementing structural changes, such as deposit insurance and a bankruptcy mechanism. As a result, more targeted measures are being employed

Fig 1: Composition of GDP by sector, 1978–2014 (%)

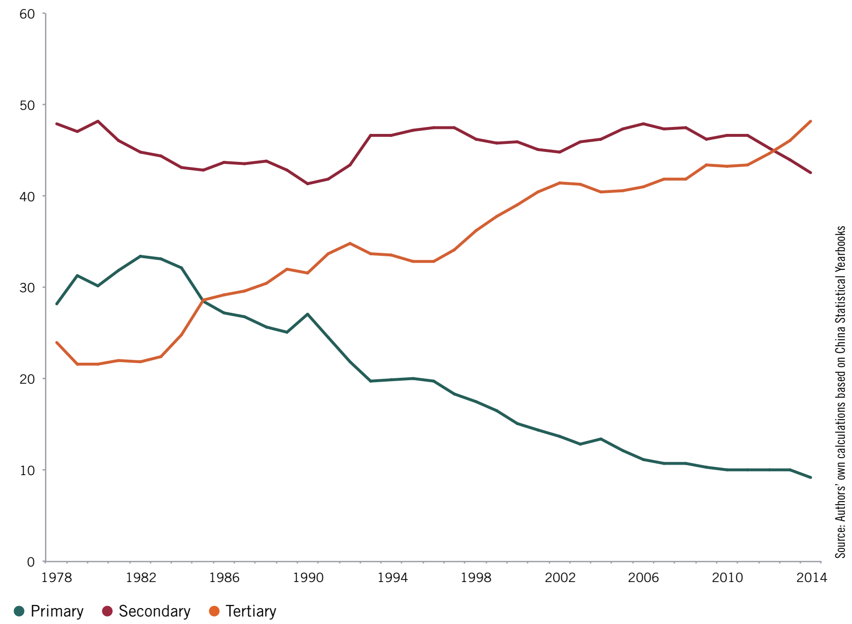
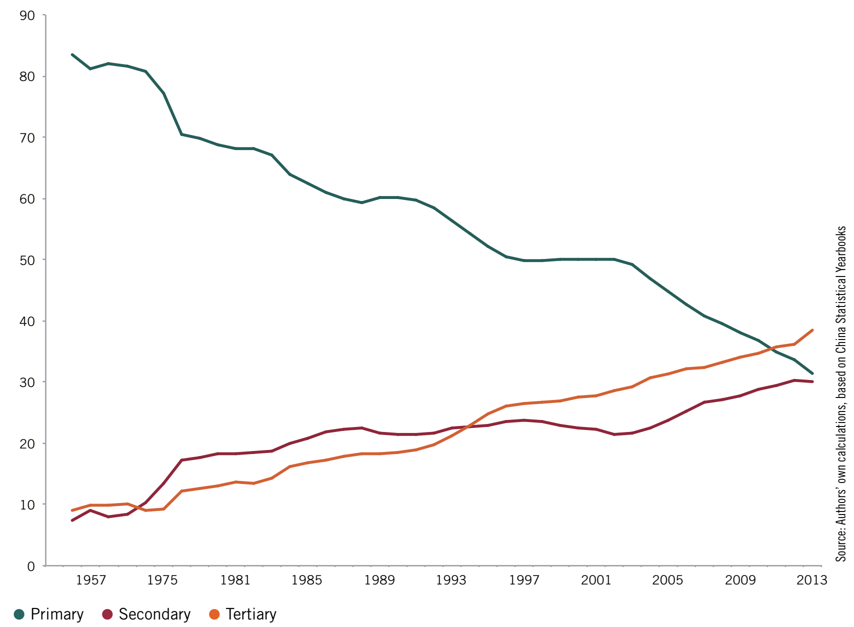


Fig 2: Composition of employment by sector, 1952–2013 (%)



to deal with structural problems, such as supporting small and medium-sized enterprises (SMEs) and housing for low-income people through the targeted release of central bank funds.

Moving away from a regulatory mentality

China's bureaucracy is still struggling to get rid of the central planning mentality, where regulators such as the NDRC and the PBOC are tasked to support priority sectors, institutions and projects. There is an implicit assumption that regulators know better than the market about which sectors, companies and projects are sound, and deserve access to credit, when the fact is that even markets are unable to predict winners and losers from within its own ranks.

It is therefore important for macro regulators and policy-makers to intervene less on structural problems and to tolerate more market-orientated failures, as they are symbiotic with success in the ecology of market competition. In other words, ghost towns and large cities, overcapacity and bottlenecks, excessive debts and excessive savings are all normal in a dynamic and fast-growing market economy – and China needs to find a sustainable way to live with that reality.

As China's market matures, the good parts will expand at the expense of the bad parts. What governments need to do is provide the correct platforms for facilitating structural changes, such as deposit insurance, a bankruptcy mechanism and negative lists, which are micro-tools for dealing with specific cases.

Quality, not speed

Global development experiences, including those from China, confirm that it is the quality of growth – with its emphasis on inclusivity, poverty reduction, equity, environmental sustainability, and innovation – not the pace of growth that improves people's wellbeing.

Among developing countries that were studied by the Growth Commission, only 13 economies were able to sustain an average growth rate of 7% for over a decade and nine out of the 13 were from east Asia. Among them, China was the only country that has made three historical transformations: from a centralised planning system to a market-orientated economy; from a closed economy to an open and export-orientated one; and from an agrarian economy to the manufacturing centre of the world.

During these transformations, China achieved the fastest poverty reduction in the world: more than 660 million people have been lifted above the World Bank poverty line of $1.25 per person per day.[1]

However, China's old growth model, which emphasised more export, GDP and investment, is inadequate for equity, environmental sustainability and innovation.[2] The accumulation of capital in urban industry widened the productivity differences with rural areas, leading to large income inequalities. With an estimated Gini coefficient of more than 0.47, China is now less equal than the US and Russia.


Great Hall of the People, Tiananmen Square, Beijing

tcly / Shutterstock

Although China has improved the use of natural resources and energy in some respects, environmental constraints on growth now loom large. As the world largest producer of carbon emissions, China has 16 of the 20 cities with the most polluted air. A recent World Bank study found that the health costs of air and water pollution in China amount to about 4.3% of its annual GDP. Adding the non-health impacts of pollution, estimated at about 1.5% of its GDP, brings the total cost of air and water pollution to about 5.8% of GDP.[3]

Can China raise the efficiency and the quality of its growth through reforms and structural change? To answer this question, we need to closely examine its evolving growth model. n

1 Ravallion, M and SH Chen (2004), *China's (Uneven) Progress Against Poverty*, World Bank Policy Research Working Paper no. WPS 3408, World Bank, Washington, DC. And World Bank, 2012, *China 2030: Building a modern, harmonious, and creative society*, *http://documents.worldbank.org/curated/en/2013/03/17494829/china-2030-building-modern-harmonious-creative-society*

2 Thomas, V, RE López and Yan Wang (2008), *Fiscal Policies for the Quality of Growth*, IEG Briefing 9, World Bank.

3 World Bank (2007), *Cost of Pollution in China: Economic Estimates of Physical Damages*, *http://siteresources.worldbank.org/INTEAPREGTOPENVIRONMENT/Resources/China_Cost_of_Pollution.pdf*

The dual-economy challenge

The growth experiences of a large number of countries – particularly China – during the past few decades highlight that both the pace and pattern of growth are critical for achieving desirable development outcomes. While fast economic growth is essential to lifting people out of poverty, some growth patterns are more effective than others in reducing poverty, improving wellbeing, promoting equity and stimulating innovation.[4]

The quality growth framework developed by Thomas et al emphasises three key points for starting and maintaining growth momentum: poverty reduction, equality and environmental sustainability.[5]

Broadly speaking, countries are endowed with at least three types of assets that matter for growth and welfare: human and social capital; natural and environmental capital; and physical and financial capital. Technological progress, the institutional environment and good governance that affect the use of these assets also influence growth and welfare. In traditional neoclassical growth theory, much attention has been given to the accumulation of physical and financial capital. In the endogenous growth models, more attention has been given to ideas, knowledge and institutions, while physical capital has been put on the back burner. For poverty reduction, human (and social) capital as well as natural (and environmental) capital, such as land and water, are particularly important, as these are the primary assets possessed by the poor.

The role of the government is crucial in enabling the accumulation of human capital and the conservation of natural capital. In many countries, including China, there are market failures that lead to an underinvestment of human capital and overexploitation of natural capital. For example, the social returns from primary education and preventative health care are much higher than the private returns, and the levels of investment in these public services would be suboptimal if the government failed to provide them. There are also market failures in the form of undersupplying certain types of physical capital and public infrastructure, such as clean water, rural roads, irrigation systems or agricultural technology and innovation with some characteristics of public or semi-public goods, while overproducing pollution and greenhouse gas emissions that have negative externalities.

China's past success in achieving high GDP growth is based on a growth model where regions, companies and households have been gradually but steadily allowed by the central authorities to compete on attracting and using the human, natural, physical and financial capital for generating employment, profits and GDP, with central guidance on planning, market regulation, appointment and discipline of officials, and other national strategic objectives.

China's unique central-local governance system has facilitated many institutional innovations that have motivated local governments, state-owned enterprises (SOEs), private companies and households to pursue growth through a 'trial-and-error' strategy. As a result, the 35 years of high growth have created a dual economy, with both successful and failing parts. The structural imbalance of the dual economy in China can be summarised as structural, financial, institutional and systemic.

Structural challenge

The structural divergence of the Chinese economy is particularly forceful now. The profits from SOEs are dropping much faster than from privately owned enterprises (POEs), even though the former continue to enjoy better access to credit. But more importantly, while the first- and second-tier cities are seeing signs of recovery – both in prices and transaction volumes of real estate – the third- and fourth-tier cities are experiencing a further fall in housing prices. Even though the absolute levels of housing prices in the former are much higher than in the latter, the former actually has more affordable housing than the latter. To buy a 100 square meter residential flat, it would cost about 11 years of the city's per-capita GDP throughout 2010–2013 for 35 selected first- and second-tier cities, which is much lower than the national average of more than 14 years. In other words, the problems of overcapacity and local debt have roots in SOEs and the third- and fourth-tier cities, which comprise the lower productivity and less competitive track of the dual-track Chinese economy.

> *"35 years of high growth have created a dual economy, with both successful and failing parts of the economy"*

The better-performing track includes the private sector and the first- and second-tier cities, which not only have attracted a higher inflow of people, companies, projects and money, but also enjoyed better local governance and management as well as closer links with the global economy.

The central authorities have long recognised the gap and divergence in the dual-track economy, and attempted to deal with them by spending more money and providing more preferential policies to the lagging section, which ironically then created overcapacity and unsustainable local debts, particularly when the people and projects decided to move to the better-performing section of the economy, leaving ghost towns behind.

The dilemma and challenge for policy-makers is how to deal with the sunk costs of past local planning decisions while also avoiding

4 See, for example: Ravallion and Chen 2004; Christiaensen, Demery and Kuhl 2006; and Loayza and Raddatz 2005; World Bank 2005, and the *Annual Review of Development Effectiveness* (IEG 2007a) and the Development Results in Middle Income Countries Report (IEG 2007b).

5 Thomas, V, M Dailami, A Dhareshwar, RE López, D Kaufmann, N Kishor and Yan Wang (2000), *The Quality of Growth*, New York: Oxford University Press.

future planning mistakes. It should be emphasised that overcapacity and local debts are typical sunk costs, which in a market economy should be managed by the process of bankruptcy, as the key is to allocate losses among the stakeholders and release the tied-up resources so that all parties can move on to more productive activities.

This is the most difficult part of the structural reform, as it has to be locally executed project by project, and could not be substituted by any top-down macro policies. China actually had a very rich and successful experience of dealing with bankruptcies of state-owned enterprises and banks before and after the Asian financial crisis, including the use of the four asset management companies to manage the non-performing loans (NPLs) of the four biggest state banks so that the good assets of the banks could be listed and utilised at much higher efficiency levels.

Macro and financial challenge

Macroeconomic management is particularly hard because of the dual-track nature of the Chinese economy.

For the well-performing track, there is a huge revaluation of increasingly productive assets such as land and human capital and demand for rapid growth of credit with rising prices, currency appreciation and high real interest rates to maintain high and productive growth.

But for the poor-performing track, the challenge is to manage the 'balance sheet recession', which demands huge credit being tied up pending bankruptcy, currency depreciation to regain competitiveness and low real interest rates to avoid a debt crisis. Both tracks have their legitimate and logically reasonable demands on the macro authorities but their demands are contradictory, except with regard to the demand for more credit.

To deal with the differential requirements from the dual-track economy, the PBOC has attempted to deploy structurally orientated monetary instruments, such as differential reserve requirement ratios by sector or by type of financial institutions.

"The dilemma and challenge for policy-makers is how to deal with the sunk costs of past local planning decisions while also avoiding future planning mistakes"

The results have not been ideal. For example, when the PBOC lowered the interest rate in November 2014 with the objective of helping lower the costs of financing for enterprises, it instead triggered a speculative boom on the stock markets.

On disappointing January 2015 macro data, the PBOC again made an across-the-board cut in the reserve requirement ratio of 50 bps and an additional 50 bps and 400 bps for SME-focused banks and the Agricultural Development Bank of China respectively. This stimulus, however, was less than some in the market would like to see, as both the poor- and well-performing tracks of the economy need more credit, one for buying time for restructuring and the other for productive growth.

Institutional reform challenge

2014 marked the beginning of serious institutional reform under the leadership of president Xi Jinping, with the clear objective of making the market the dominant force in allocating resources, managing companies, innovating while refocusing the government on strategic planning, regulation, social services and environmental protection. This is the core element in terms of repairing China's growth engine, particularly with regard to anti-corruption and rule-of-law initiatives.

However, in the short term, these reforms are consuming large amounts of government bodies' time and effort, as well as freezing massive amounts of fiscal and financial resources, as the people in charge of decision-making at all levels are currently re-evaluating their spending plans to ensure they are consistent with the 'new normal' in terms of governance and growth model.

In 2014, the government budget deficit actually fell to 1.8% of GDP from 2% in 2013, even when the leadership called for active fiscal policy to support unprecedented reforms.

In other words, institutional reform related to anti-corruption, cutting overcapacity and dealing with unsustainable local debt is in the short term clearly an austerity programme, which may generate reform dividends and sustainable stimulus in the medium and long term.

This means that short-term offsetting stimuli, such as tax cuts and higher fiscal deficits, may be necessary to reduce disruption to the normal growth momentum.

Systemic risk challenge

The challenges need to be viewed in the right context. A good part of the Chinese economy continues to expand – and it is still expected to grow much faster than most other economies in the world. Because of the substantive ongoing reform initiatives, the country's economy as a whole is much healthier today, and is in better shape to support more sustainable growth in the medium and long run than it was previously.

Its consolidated balance sheet still shows a net holding of foreign assets as large as $1.7 trillion, or 17.6% of its GDP, according to the latest International Monetary Fund data.

As China's central government has no solvency problem, the restructuring of local debts is basically a domestic problem. Some cities will suffer more than others during the process of restructuring, but the overall productivity of people, companies and capital could actually improve after the painful restructuring.

Using the analogy of dealing with cancer, the procedure of removing tumours is absolutely necessary and needs to be done as soon as possible before they spread to other parts of the body. But patients need life support, such as oxygen, blood and nutrition, so they can survive, recover and live healthily again.

This is why China needs to keep relatively stable and high growth levels as well as maintain positive market sentiment and confidence through both reform actions and relatively relaxed monetary and fiscal policies to offset the austerity effects of intensive ongoing institutional and structural reforms. n

Learning by doing

China's first two decades of growth (1980–2000) were marked by the transformation from an agriculture-based economy to one dominated by the industrial and service sectors, and by rapid growth associated with poverty reduction. Learning through an experimental approach played an important role in the rapid productivity growth without the severe disruption that happened in the eastern European transition economies that adopted 'shock therapy'.

Innovative approaches – such as the township and village enterprises, special economic zones (SEZs) and dual-price system – made it possible for rural migrants to participate in the rapid expansion of the industrial and service sectors and the process of urbanisation. Through 'learning by doing' via openness to trade and FDI, China was able to explore its comparative advantages in low-cost labour, achieving economies of scale, and improving efficiency and productivity. The inclusive pattern of growth in the 1980s and 1990s was instrumental in expanding employment opportunities for the majority of the Chinese population and lifting over 500 million people out of extreme poverty.

Between 2000 and 2010, however, China's economic growth was driven largely by an over-reliance on exports, excessive capital accumulation and growth in energy-intensive industries, such as automobile, steel and cement production. This growth pattern was associated with structural imbalances and unprecedented growth in fixed-asset investment, while domestic consumption failed to keep up with the pace of GDP growth. The national income distribution skewed towards enterprises in the form of profits and to the government in the form of tax income, while the share of household income in the national economy eroded to an exceedingly low level by international standards. The sectoral imbalances were more striking, with a dominant industrial sector and a significantly underdeveloped service sector, compared with countries of similar income levels.

Despite progress in poverty reduction, inequality in China has risen sharply since the beginning of the 1978 economic reform. This rising trend of income inequality is confirmed using various measures and data sources. The Gini index increased sharply from the mid-1980s until 1985, when rural income growth started to slow down as a result of the shifting focus of development policies to the urban industrial sector and coastal regions. Compared with other large developing economies and Organisation for Economic Co-operation and Development (OECD) countries, China experienced the largest increase in inequality between the 1990s and 2000s.

The overall inequality in China was manifested in the regional disparity and rural-urban divide. The coastal-to-inland GDP per-capita ratio rose from 1.7 in the late 1980s to 2.4 in 2004,[6] reaching the highest level in a half-century. In 2004, urban inequality accounted for about 36% of overall inequality, rising from 20% in 1989. Evidence based on targeted surveys showed that the average income of migrant workers was much lower than that of urban residents. And income inequality among migrants was much higher, with the Gini coefficient of hourly income at


Shenzhen Special Economic Zone

Sorbis / Shutterstock

6 Huang, Yukon and Xubei Luo, "Reshaping Economic Geography in China" in *Reshaping Economic Geography in East Asia*, Yukon Huang and Alessandro Magnoli Bocchi (eds), Washington, DC, World Bank, 2009.

INTERVIEW: ZHU GUANGYAO, VICE-MINISTER OF FINANCE

What should we infer from the leadership statement that "the Chinese economy has entered into a state of new normal"?

From my perspective, the 'new normal' proposed by president Xi Jinping has three implications. First, the gear of China's economic growth is shifting from high speed to medium-to-high speed. This speed is still very high by world standards and also helps maintain the sustainability of our economy. What president Xi has in mind is how to achieve long-term sustainable economic development of China in the coming decade or so.

Second, to fit into the 'new normal', a thorough implementation of economic structural reform is needed. Sustainable economic development is led and driven by structural economic reform. During the reform period, economic policies are required to secure a more sustainable growth. Therefore, we should continue to take an approach that achieves economic, social, cultural and ecological progress. Great importance should be placed on environmental issues, and Chinese people should be able to enjoy a higher living standard.

Meanwhile, innovation should replace traditional factors as the new driving force of economic growth. This is a fundamental transition of the growth model. Investment is key to the traditional factor-driven economic growth model. To replace traditional factors with innovation as the new stimulus requires a new spirit of reform. We should combine innovation and reform together and enhance investment quality.

What are the major aspects of improving investment quality?

Improving investment quality concerns three aspects. First, the adjustment of investment quality should be combined with economic structural adjustments, which include mixed ownership reform and public private partnership reform. We should promote the increasing role of private enterprises and small businesses in economic development, and promote private sector participation in infrastructural construction by encouraging financing models such as co-operation between the government and private capital.

Second, improving investment quality involves addressing the relationship between poverty reduction and investment. President Xi has said the realisation of a well-off society lies in the contribution of village residents. Therefore, enhancing investment quality requires us to comprehensively combine economic structural adjustments and poverty reduction strategies to continue to increase investment in remote poor areas and make infrastructure investment play more of a leading role in reducing poverty. Poverty reduction is the key indicator to realising a well-off society.

Third, improving investment quality involves addressing the relationship between investment and environmental protection. We should promote green credit and give more emphasis to the impact of investment projects on the environment and society.


Zhu Guangyao

How do you assess the external economic environment faced by China?

The global economy this year faces the most complicated and challenging environment since the outbreak of the financial crisis.

First, currency policies of developed countries are changing. For instance, the Federal Reserve is expected to initiate the normalisation of interest rates. Second, the crude oil price may continue to drop. Third, unstable factors still exist in the eurozone. Fourth, geopolitical risks are resulting in uncertainty; and fifth, the ups and downs of emerging market economies will continue to exert influence on the world.

Will external environment changes greatly affect the Chinese economy?

The influence of the uncertain external environment is definitely increasing and the current environment is complex. But the best approach to stabilising our economic development is to deepen structural reform. The tone of fiscal and monetary policies has been settled. We should now ensure that proactive fiscal policy is actually proactive, and adjust – retune and fine-tune – prudent monetary policy in response to the complicated environment. The People's Bank of China has already taken related measures, including reducing the deposit and loan rate twice and lowering the deposit reserves requirement ratio. All these measures are taken in response to the complicated internal and external environment.

What is your take on this year's proactive fiscal policy?

Last year, the Central Economic Work Conference made clear arrangements in this aspect. In 2015, we will continue to implement proactive fiscal policy and sound monetary policy, on which this year's *Report on the Work of the Government* has made a comprehensive plan. Implementing proactive fiscal policy faces both domestic and overseas challenges, but fiscal policy should play a more important role in promoting economic structural adjustment.

The effect of proactive fiscal policy can already be displayed in two aspects. First, there has already been progress in structural trade reductions, especially the tax reduction for micro and small businesses. Second, tax reductions will be widely and comprehensively applied, and fees will be removed.

In addition, as premier Li Keqiang has mentioned, the two engines that drive growth – economic structural adjustments and more investment in public goods provision – are the essence of a proactive fiscal policy. Indeed, the current external and domestic situation makes issues such as local government debt more complicated. But no matter how difficult it is, we must address the problems left from the previous large-scale economic stimulus plan, including local government debt.

Therefore, we should implement the new budget law that has already taken effect, which makes issuing government bonds the only legal channel of raising capital for local government. And issuing bonds should be regulated strictly by the law and promoted in accordance with existing policies.

We should maintain stability during the transition, prevent any regional or systematic risk and ultimately solve the problem of local government debt.

0.42 for migrants, compared with 0.38 for their urban counterparts.[7] This suggests that urban inequality is likely to be much higher when taking into account migrant populations.

Sources of rising income inequality

As China deepened its economic and structural transformation, rising income inequality was inevitable. A more important question concerns what is driving the country's rapidly increasing income inequality.

First, the geographic income disparity in China, particularly between the coastal and inland regions, is a top contributor to the overall inequality. The coastal provinces enjoyed geographic advantages because of their proximity to seaports and the closer links with newly industrialised economies such as Hong Kong, Singapore, South Korea and Taiwan. In addition, the labour force in coastal regions has a relatively better level of education.

> *"China's tax structure and collection system are still developing, with many loopholes for tax evasion and limited capacity for redistribution"*

Second, the government's preferential industrial policies also contributed to the income disparity between coastal and inland regions. In 1989, as the first step of its large-scale open-door policies, the government introduced SEZs, aimed at opening up coastal regions to international trade and attracting foreign direct investment (FDI). The openness to international trade and massive inflow of FDI no doubt played an important role in raising incomes in coastal regions at a much faster rate than in the rest of China.

Third, the significant increase in return to education is another major factor underlying rising inequality in China. The increasing dominance of the private sector in China's economy, together with the restructuring of state-owned enterprises (SOEs), intensifies competition among firms. To maintain competitiveness, firms strive to continuously improve efficiency, upgrade production through new investment and compete for more educated and skilled workers.

Fourth, a taxation structure that did not focus on redistribution of income has contributed to income inequality. Since 1995, China has started to modernise its tax system. However, China's taxation structure is quite different from those in developed economies, where income redistribution is more prominent than extraction of tax revenues from GDP production. Currently, the government derives its tax revenue mainly from indirect taxes (such as value-added tax and other consumption taxes), which account for about 57% of total tax revenue. Direct tax receipts, in the form of income and property tax, are much lower, amounting to about only 10% of total revenue in 2013. In addition, China taxed agriculture (a regressive tax) for over a thousand years – until 2006, when agriculture taxes were finally abolished.

In comparison, the tax structure in OECD countries relies heavily on income and property tax as the sources of revenue. In 2009, income and property tax accounted for about 69% of tax revenue, while indirect tax amounted to 31%, according to OECD data sources.

China's tax structure and collection system are still developing, with many loopholes for tax evasion and limited capacity for redistribution. Reform to property tax and inheritance tax, which are both redistributive, is being discussed but any changes are still far from implementation. Despite China's progressive income tax rate reaching 45% for monthly income over 80,000 yuan (about $12,900), in many respects, the current tax structure is regressive. This is because poor households bear a disproportionately larger burden of consumption tax, which dominates the total tax revenue, while the smaller share of income and property tax in total tax revenue limits its redistributive role. This conclusion is supported by the findings of Lopez, Thomas and Wang (2008).[8] Moreover, for low-income employees, companies have to pay as much as 40% of their wage bill to meet contributions to social security and social welfare, including housing, unemployment, pension and medical benefits.

In addition to the problems in the tax structure, China also needs to improve its fiscal sharing system between central and local governments. The central government currently shares 75% of the value-added taxes, while most local government expenditure is done through budgetary and extra-budgetary revenues from land-related sales and taxes. The mismatch between fiscal income and fiscal responsibility is serious and has affected normal governmental functions in many poor regions. The highly centralised revenue management and decentralised service provision has resulted in a heavy reliance on local financing through bank borrowing and land sales.

The central government has realised the problems with China's fiscal system and has initiated a series of reforms, including transforming the business tax (a type of sales tax for service sector companies) into value-added taxes, legislation of local budget laws for more transparency and accountability, streamlining pension and social security coverage and financing, preparation of property and inheritance tax by establishing central property registration system, experimentation of local government bonds, etc.

It should be pointed out that both government efforts and market forces are pushing China towards a more inclusive growth model.

The spatial difference in income is driving the flow of migrant workers from low-income regions to high-income cities. The preferential policies are quickly copied across regions as soon as their positive contribution to growth is confirmed. The one-child policy has also created an unusually high level of attention on families and on investment in education.

The advance of digital technology and big data may provide an opportunity for China to speed up its tax system reform so it can achieve lower tax rates and a fairer tax structure.

7 Lewei Zhang (2011), *Income Inequality in Urban China: A Comparative Analysis between Urban Residents and Rural-Urban Migrants*, working paper, Sanford School of Public Policy, Duke University.

8 Thomas, V, RE López and Yan Wang (2008), *Fiscal Policies for the Quality of Growth*, IEG Briefing 9, World Bank.

Sustainability and growth

China is facing severe 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 rapid expansion in energy-intensive heavy industries with predominantly coal-based energy use, inadequate policies and institutional measures for safeguarding the environment, and weak enforcement of environment regulations.[9] China's challenge is to change the mindset of 'grow first and clean up later' that has prevailed at all levels of government in China. The good news is that social awareness of environmental problems is now unmistakable, and the trend is rising.

Water: in crisis

The World Bank has warned that water scarcity will become an increasingly pressing issue in China.[10] The country's water shortage is a consequence of overuse and declining supplies. From 2000 to 2009, China's total water reserves fell by 1.5% annually, about 35 billion cubic metres of water a year, the Ministry of Water Resources said. Average annual water availability is only about 1,850 cubic metres per person – less than one-quarter of the world average. Among the top 600 cities by size, 400 suffer from water shortages, according to the Organisation for Economic Co-operation and Development's (OECD) *Environmental Performance Review: China* (2007).

The deterioration of water quality caused by widespread pollution further aggravates water shortages in China. According to the OECD report, about 30% of the rivers monitored are classified as worse than grade V (that is, highly polluted). Three-quarters of the country's major lakes are also considered to be highly polluted (grade V or above). One-quarter of China's coastal waters are very polluted (grade IV or above).

Water pollution in China has been caused primarily by chemical fertilisers and pesticides, industrial waste and raw sewage. China's first pollution census, published in 2010, revealed fertiliser use was a bigger source of water contamination than factory effluent. China's intensive use of both chemical fertilisers and pesticides is three to four times higher than the OECD average.

Air quality: among the worst in the world

Air quality in Chinese cities is among the worst in the world.[11] According to official statistics, in 2013, the concentrations of PM2.5 – the tiny airborne particles considered most harmful to health – were more than 30 times the World Health Organization's recommended standard in many Chinese cities. A World Bank study shows that 16 Chinese cities are among the world's 20 most polluted cities. Only 1% of China's 560 million of city dwellers breath air considered safe by European Union standards. About one-third of 113 surveyed cities failed to meet national air-quality standards in 2009, based on official Chinese data (air-pollution levels set by China's national air-quality standards are four to five times less strict than OECD standards).

The main sources of outdoor air pollution in China are coal combustion, motor-vehicle exhaust and the massive scale of urban construction, generating particles of soot, organic hazardous material, heavy metals, acid aerosols and dust, in addition to emissions of sulphur dioxide (SO2) and nitrogen dioxide (NO2). The particulate matter that is less than 10 microns (PM10) poses the biggest health threat. In China, PM10 accounted for about 72%, SO2 8% and NO2 0.3% of primary pollutants of concern between 2000 and 2007.[12]

Coal is the number-one source of air pollution in the country, and is also the principal source of energy. About 80% of electricity and 70% of total energy in China was produced from coal (much of it the highly polluting high-sulphur coal), compared with 45% in the US.

The rapid growth of private-car ownership in recent years has escalated air pollution problems in urban areas. Studies have shown that 45–60% of NO2 emissions and 85% of carbon monoxide (CO) emissions are from mobile sources in most Chinese cities.[13] It was estimated that by 2010 in Shanghai, vehicular emissions would produce 75% of total NO2 emissions, 94% of total CO emissions and 98% of total hydrocarbon (HC) emissions.[14] Even with stricter emissions controls and cleaner fuels, mobile-sourced pollution is likely to continue rising because of the increased use of individual vehicles and longer trip lengths. Respiratory diseases, such as infections, asthma and decreased lung efficiency, are common in polluted urban areas.

Energy: inefficient use

Along with China's structural transformation and rapid growth, the energy efficiency or intensity (measured by energy use per unit of GDP) has also evolved over time. China experienced rapid improvement in energy efficiency from 1978 to 2000. On average, the energy use of one unit of GDP is eight times less today than in 1980.[15] China's growth pattern prior to 2000 was characterised by labour-intensive light manufacturing. However, the trend in energy efficiency improvement reversed in the early 2000s. Between 2000 and 2008, total energy consumption increased twofold, with energy imports rising from 1% of total energy consumption in 1990 to 13% in 2008. The growth of energy consumption outpaced GDP growth, with energy demand elasticity (the ratio of energy demand growth to GDP growth) increasing from less than 0.5 between 1978 and 2000 to 1.5 between 2000 and 2006.[16]

9 Yang XL, LM Wang, Yan Wang (2014), *The Quality of Growth and Poverty Reduction in China*, Social Science Academic Press (China) and Springer 2014.

10 World Bank (2009), *Addressing China's Water Scarcity: Recommendations for Selected Water Resource Management Issues*.

11 Zhang, J, Denise L Mauzerall, Tong Zhu, Song Liang, M Ezzati and JV Remais (2010), "Environmental Health in China: Progress Towards Clean Air and Safe Water", *The Lancet* 375, pp1,110-1,119.

12 Andrews, SQ (2011), "Beijing's hazardous blue sky", chinadialogue.net/article/4661-Beijing-s-hazardous-blue-sky

13 Walsh, MP (2000), "Transportation and the Environment in China", *Technical Report* 3, Wilson Center, Environmental Change and Security Program, *wilsoncenter.org/sites/default/files/CES%203%20Feature%20Articles%20(p.28-50).pdf*

14 Jiang Y, Feng Liguang (2006), "Transport-related Resource and Environmental Issues in China", *World Transport Policy & Practice*, Volume 12.4.

15 International Energy Agency (2006), *World Energy Outlook*.

Thermal power plant, Hebei province

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Since 2000, China has embarked on a growth path dominated by energy-intensive industries, relying on scarce resources, including water and raw materials, while creating relatively fewer jobs and less GDP. These industries produced energy-intensive products, such as steel, aluminium and cement, to meet China's massive domestic demand for housing construction, transportation and infrastructure development, as well as exports to international markets. China now accounts for 48% of global cement production, 49% of global flat glass production, 35% of global steel production, 28% of global aluminium production and 11% of passenger car production.

Clearly, China is on a development path that features unsustainable energy-use patterns. Based on current energy consumption, the International Energy Agency (IEA) has raised its China 2030 forecast by 1.2 billion tonnes of oil equivalent, a 63% upward revision.[17] Under this scenario, China would account for 20% of global energy demand – more than Europe and Japan combined – and easily surpass the US as the world's largest energy consumer within the next decade.

Greenhouse emissions

In 2007, China surpassed the US to become the largest greenhouse gas emitter. China produced 6,200 tonnes of carbon dioxide (CO2) in that year, compared with 5,800 tonnes from the US, although Chinese CO2 emissions per capita remain relatively low – about one-quarter of that in the US and half that of the UK. Two factors are particularly important for the level of overall emissions: rising energy intensity and the carbon content of energy use.

Hidden health costs

The economic cost of disease and premature deaths associated with the incidence of diarrhoea and cancer in rural China is about 0.49% of GDP.[18] Recent studies suggest that drinking water contamination is a major factor for digestive system cancers, including stomach, liver, oesophageal and colorectal cancers. These cancers have the highest mortality rate of malignant neoplasms in China at 73 per 100,000 cases in 2005 (China Health Yearbooks).

Studies also show that outdoor air pollution is associated with a significant health cost. Based on existing evidence, outdoor air pollution in China is associated with about 300,000 deaths, 20 million cases of respiratory illnesses and 5.5 million cases of chronic bronchitis each year. The overall cost of health damage is estimated to be 1.8–4.7% of GDP,[19] and projected to reach 13% of GDP by 2020 by some estimates.[20]

Pollution as a growth barrier

Many studies have also shown that pollution also acts as a constraint on future economic growth. The increasingly fierce competition between energy and water has brought China to a choking point, limiting the country's future development prospects.[21] Agriculture

16 Rosen, Daniel H and Trevor Houser (2007), *China Energy: A Guide for the Perplexed*, "China Balance Sheet" project, Center for Strategic and International Studies and the Peterson Institute for International Economics, *https://www.piie.com/publications/papers/rosen0507.pdf*

17 International Energy Agency (2006), *World Energy Outlook*.

18 World Bank (2008), *International Trade and Climate Change: Economic, Legal, and Institutional Perspectives*.

19 Millman A, Tang D, Perera FP (2008), "Air Pollution Threatens the Health of Children in China", *Pediatrics*, September 2008; 122 (3): pp620-8.

20 Ho P, 2006, "Trajectories for Greening in China: Theory and Practice", *Development and Change* 37 (1): pp3-28".

21 Wilson Centre (2010), *Choke Point: China Research Briefs*.

and the coal industry are China's two largest water users, and consumed about 85% of the 599 billion cubic metres (158 trillion gallons) of water resources in 2010. The costs of cleaning up may also limit the country's future growth. In addition to the cost of cleaning up contaminated water, land and air, pollution is costing China billions of yuan in additional health costs, lost productivity and early mortality. According to World Bank estimates, China's environmental costs could come to around $100 billion a year, or about 5.8% of GDP, including the impact on mortality.

Measures to tackle the environmental challenges

China has become a key player in global climate-change negotiations. Contrary to suggestions by some that the country does not take climate change seriously, in recent years, the government has devoted enormous resources to the reduction of energy use and emissions, and to improve energy efficiency.

In the Twelfth Five-year Plan (FYP), the government set an array of targets to reduce CO2 emissions. These included reducing energy consumption per unit of GDP by 20% by 2010, increasing the share of renewable energy to about 10% of total energy use, as well as covering roughly 20% of the nation's land with forest by 2020.

President Xi Jinping and Premier Li Keqiang have both reiterated on many occasions China's determination in the war against environment pollution. More actions are coming, as the costs of environmental and resource degradation in China have already been astonishing.

The Chinese government has responded to the serious environmental challenges on several fronts:

- First, in recent years, it has committed to develop a comprehensive framework of environmental laws and regulations.
- Second, it has focused on how this legislation can be effectively implemented and enforced. To this end, a major effort has been made to clarify the roles of national and provincial governments and to strengthen the operation of the legal system.
- Third, it has significantly improved access to government-held environmental information, with the introduction of the Environmental Information Disclosure Decree in 2008.

China's Eleventh and Twelfth FYPs have incorporated binding environmental targets into national development policy. During the period of the Eleventh FYP (2005–2010), important progress was made in several areas: chemical oxygen demand and SO2 emissions decreased by 12.45% and 14.29% respectively, exceeding the emission-reduction targets.

Despite this progress, the overall trend of environmental deterioration in China has not been halted, highlighting the urgent need to continue efforts at all levels of government and the private sector, including enterprises, farmers and consumers. In the Twelfth FYP (2011–2015), the Chinese government placed a high priority both on climate change and environmental issues. Conserving energy and cleaning up the environment are among the five key goals set for the next five years (in addition to encouraging domestic consumption, developing the service sector and moving to higher-value-added manufacturing). Binding targets for a range of environmental and energy issues, including important air- and water-quality pollutants, are included for the first time in the national FYP. n

CHINA'S TWO MAJOR ENVIRONMENTAL COMMITMENTS

China's commitment in the Twelfth Five-Year Plan (2010–2015)

"[Between 2010 and 2015, China will] cut water consumption per unit of value-added industrial output by 30%, and increase the water efficiency coefficient in agricultural irrigation to 0.53. Non-fossil fuel resources will rise to 11.4% of primary energy consumption. Energy consumption per unit of GDP will decrease 16% and carbon dioxide (CO2) emissions per unit of GDP will decrease 17%. China will make significant reductions in the total emissions of major pollutants: chemical oxygen demand and sulphur dioxide) by 8%, ammonia nitrogen and nitrogen oxide by 10%. Forest coverage rate will increase to 21.66% and national forest stocks will increase by 600 million cubic metres."

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China's 12th Five Year Plan, 2010-2015, Chapter 3 main target, page 4. Available online at: *http://www.britishchamber.cn/content/chinas-twelfth-five-year-plan-2011-2015-full-english-version*

New commitment in joint US-China agreement

"US president Barack Obama announced a new target to cut net greenhouse gas emissions 26–28% below 2005 levels by 2025. At the same time, president Xi Jinping of China announced targets to peak CO2 emissions around 2030, with the intention to try to peak early and to increase the non-fossil fuel share of all energy to around 20% by 2030. Together, the U.S. and China account for over one third of global greenhouse gas emissions. Today's joint announcement, the culmination of months of bilateral dialogue, highlights the critical role the two countries must play in addressing climate change.

"The joint announcement marks the first time China has agreed to peak its CO2 emissions. China's target to expand total energy consumption coming from zero-emission sources to around 20% 2030 is notable. It will require China to deploy an additional 800–1,000 gigawatts of nuclear, wind, solar and other zero-emission generation capacity by 2030 – more than all the coal-fired power plants that exist in China today and close to total current electricity generation capacity in the United States."

The White House Fact Sheet: US-China Joint Announcement on Climate Change and Clean Energy Cooperation, November 11, 2014. Available online at: *https://www.whitehouse.gov/the-press-office/2014/11/11/fact-sheet-us-china-joint-announcement-climate-change-and-clean-energy-c*

Innovation and growth

Both President Xi and Premier Li have highlighted the importance of innovation in driving China's future growth, in addition to their call to reduce the bureaucratic costs of doing business in the country.

So why did China fail to make significant progress in innovative growth? To understand this, we need to appreciate how the nation managed to achieve its growth record so far, as well as the origins of its current problems, as discussed earlier in this section. The key is to see the continuity of China's 'trial-and-error' social-reform philosophy and strategy in its evolving growth model.

The trial-and-error approach, initiated by the late leader Deng Xiaoping, is similar to the scientific methodology where the basic assumption is that policy-makers and society may not know beforehand the best social reform approach and that they need to discover it through experimentation.

Since it is difficult to carry out low-cost controlled social experiments, it is inevitable that the new social institutions and practices tried are likely to bring both the benefits from successful experiments and the costs from failed experiments. So to achieve innovation in both the physical and social dimensions, it is impossible to avoid failures if one wants to innovate through the trial-and-error approach.

The real capacity for innovation through trial and error includes both the benefits of the trial of the new and uncertain – potentially good things, on the one hand – but also the necessity to absorb any losses from failed experiments.

The economics for generating and allocating the upside gains of innovation is covered by the theory of private property rights and market competition.

Internet technology dramatically reduces the information and transaction costs, crucial for more transparent and larger-scale market competition. The economics of allocating and absorbing downside losses from innovation is covered by the theory of sunk costs and the social and legal framework for bankruptcy. Companies are born and die locally through a social and legal process specific to the location, but have to grow nationally and globally through global market competition. Local governments, courts and regulators are key players here.

Over the past 35 years, China captured huge upside gains from the social and institutional innovation of creating and enabling markets and private companies, leveraging on 'good competition' among cities, companies and individuals. But this also generated significant downside losses in the form of laid-off workers from state-owned enterprises (SOEs), overcapacity, pollution and corruption caused by 'bad competition'.

When profits are diverted from SOEs to private companies, it is entirely normal to see at the same time the overcapacity in SOEs. When people leave small, remote towns and villages to megacities for better jobs, it is normal to see at the same time ghost towns and local debt crises as a result of the reallocation of human capital. When local governments are obsessed more with creating GDP and profits than with policing pollution and corruption, it is normal to see pollution and corruption increase faster than GDP and profits.

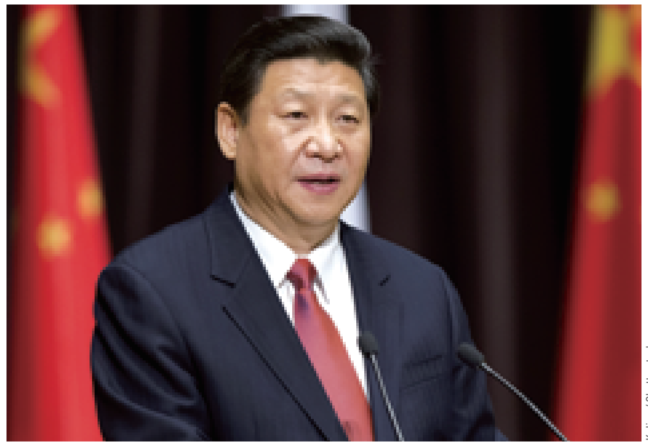
However, if the incentives of local governments are changed to inclusive, sustainable and innovative growth, the results can change. The diverging phenomenon we observe in China cannot simply be taken as a sign of economic and social collapse. Instead, one needs to uncover the true driving force of China's evolving growth model.

Competition quality

The quality of competition in China has also improved steadily over the past 35 years, particularly when the internet gained wide penetration. The Chinese ways of dealing with bankruptcy and tort are also evolving, with the establishment of deposit insurance and the term transformation of local debt. Moreover, low-income housing for laid-off or unemployed workers, stricter environmental standards and regulation and anti-corruption measures, as highlighted at the National People's Congress, are all necessary components of an emerging socioeconomic infrastructure for dealing with the downside losses of an innovative economy where 'trial' and particularly 'error' are the rule, rather than the exception.

> *"Lack of timely and sound bankruptcy procedures could create big problems for a slowing economy"*

One of the critical reforms for upgrading China's trial-and-error innovative growth strategy is related to China's capital



Kaliva / Shutterstock

President Xi Jinping

market reform, where the current initial public offering system based on government approval will be replaced by a registration-based system.

This reform, proposed for 2015, is intended to shift China’s financial system from a bank-dominated one towards a more balanced system where both stocks and bonds could have a much larger share.

Joint-stock companies with publicly traded shares are probably the most important invention for facilitating risk-taking and innovation because this allows for the voluntary absorption of limited losses by an unlimited number of shareholders when companies fail in their attempt to develop new products. It is no accident that the US economy, with its equity-dominated financial sector, is probably the most innovative large economy in the world. Its market capitalisation-to-GDP ratio is about 120%, compared with about 40% for China.

Another critical reform for supporting innovative growth is to develop regular and sound bankruptcy procedures for private companies, SOEs and local governments. Unfortunately, this is not yet on the government’s agenda for 2015. Lack of timely and sound bankruptcy procedures could create big problems for a slowing economy because a large amount of credit and production input could be tied up in many unprofitable projects.

China needs to draw lessons from its dealing with triangular debts among SOEs in the 1990s, when it successfully did the work of bankruptcy without bankruptcy law by putting the bad debts into state-owned bad asset management companies and then listing the good banks on the stock markets.

The debt restructuring dramatically improved the efficiency in the allocation of the stock of credit and laid the foundation for 20 years of solid growth.

China needs to do this again for some local government debt. It would be better to have a permanent institutional infrastructure for bankruptcy because, in an innovative economy, failure is the rule, rather than the exception – and, as the Chinese saying goes, ‘failure is the mother of success’.

INTERPRETATION OF THE RULE OF LAW IN THE FOURTH PLENARY SESSION OF THE CPC COMMITTEE

The Fourth Plenary Session of the Eighteenth Communist Party of China (CPC) Committee, which proposed the ‘rule of law’, and the reform direction mentioned at the Third Plenum in 2013 have both enlightened us that only by adhering to the philosophy of the ‘rule by law’ and the ‘rule of law’ can we realise our development goals.

Significant reform

Reform plans need to be made by relevant governmental departments with ratification from the National People’s Congress (NPC). That is, the State Council can endorse proposed rules over fiscal and taxation issues, but they do not become legislation until approved by the NPC. Since the Fourth Plenary Session, significant reforms must be made based on existing laws, with the approval of the Standing Committee or the plenary session of NPC. Many countries have a similar legislative procedure.

Take Russia as an example. At the beginning of the country’s economic reform, young economists intended to privatise state-owned businesses. They drew up specific legal drafts on steps to realise demutualisation and privatisation. However, the drafts could only be enforced after the agreement of the NPC.

This should be an important example for China to learn from for its own future legislation. Previously, the implementation of significant reforms has not always been carried out alongside changes in corresponding legislation, which has resulted in chaos in the legal system with its associated negative knock-on effects in society as a whole.

A good example of this is the land reform in the early 1990s. The former constitution prohibited the purchase, rent, mortgage and illegal exchange of lands. After the land usage rights policy was eased, the State Council had problems amending the legal terms.

The former constitution and the Land Management Law were amended, while the General Rule of Civil Law remained unchanged.

Jiang Ping

The law’s failure in reflecting the real-life situation resulted in controversy related to land trading and challenges for the authority of the rule of law. This highlights why significant reforms must be made in accordance with the law.

General reforms require a legal basis

General reforms also need to have their own legal basis. The CPC Central Committee and NPC have both proposed that significant reforms should be made in accordance with the law, but the resolutions of the Fourth Plenary Session did not mention general reforms. To solve this problem, the law needs a clearer definition. There are two meanings of law in China – namely, in a broad sense and in a narrow sense. In the narrow sense, laws refer to those approved by the NPC.

In the broad sense, the law includes rules and regulations adopted by the State Council, rules made its divisions and normative documents produced by local government.

Instead of following rules made by all levels of government, general reforms should be made according to rules made at least by the State Council, divisions of the central government or provincial government.

Otherwise, chaos will be caused by too many kinds of rules and regulations, and the implementation of reforms will be blocked.

Now some laws and regulations are needed to shape the reform policy, which will result in the conflict between the reform rules made by local government and divisions and former passed laws.

The Fourth Plenary Session proposed ‘rule by constitution’. The prerequisite of ‘rule by constitution’ is to establish an approach to detect and punish behaviours violating the constitution. But China has not established a ‘committee of the constitution’ yet.

As a result, the institution we have dealing with current constitution violations is far from sufficient. This issue needs to be addressed before we can address the conflict between reform rules and laws.

Jiang Ping is a tenured professor and former president of the China University of Political Science and Law.

Interview: Gao Hucheng

How would you assess the foreign trade position so far this year, given the target of 6% growth?

Premier Li Keqiang set a goal of around a 6% increase in foreign trade this year in the *Government Work Report*, delivered on March 5. So far, we have seen a fall in foreign trade of 10% since January. There was also negative growth in February, but the rate of decline had fallen, and we expect China’s imports and exports will return to positive growth in March.

To put this in context, you will recall that the economic outlook in 2014 from both the domestic and international perspectives was not strong, yet if we remove non-comparable items, China’s import and export trade increased 6.1%, with exports growing by 8.7%. This followed an average annual foreign trade growth rate of 9% for several successive years since 2008. The reason we did not hit the growth target of 7.5% last year was mainly due to the sharp decrease in the prices of imported goods. So far this year, there has been no rapid price change in international resources, energy or bulk goods, so if the general domestic and overseas environment does not change dramatically in 2015 compared with 2014, international demand will still grow slightly. In this context, are confident we can reach our goal of 6.1%.

Gao Hucheng

To do this, however, we must perform well in the following four areas. First, we must keep implementing long-established policy measures aimed at sustaining steady foreign trade growth, transform the export-sharing mechanism between central and local governments, establish a positive list of charges and fees, and further boost trade facilitation.

The second effort is to strengthen support for transformed, upgraded and restructured enterprises – in particular, add value to China’s export products and consolidate the competitiveness of Chinese companies through innovation.

The third area is to continuously develop and encourage new export marketing models – for instance, international e-commerce, market procurement and comprehensive foreign trade service firms.

The fourth is that we continue to improve the transnational competitive environment to stabilise and maintain foreign trade export growth for China’s enterprises.

What is the strategic view regarding the establishment and development of free-trade agreements (FTAs)?

The heads of state of China and South Korea jointly have agreed that a high-level, high-quality and balanced FTA between our two countries should be established. So, we have achieved that goal. This treaty contains openness in traditional goods, services and investment. It includes areas such as finance, telecommunications as well as so-called ‘twenty-first century new issues’ related to the environment, labour and competitive neutrality. China has also set up an FTA with Australia – a vital trade partner. This stipulates that China’s market access, investment and trading rules and related standards, as well as all management systems and frameworks, are close to full accord with those of developed western nations. China’s ability to reach a high-level FTA with Australia indicates we can be confident in our ability to carry out FTA negotiations with any nation or region.

According to the outcome of the Third Plenary Session and the requirement raised in the premier’s *Government Work Report*, China’s FTA development will radiate our ‘One belt, one road’ vision by establishing a high-standard FTA network. So far, we have signed FTA treaties with more than 20 nations and regions, covering nearly 30% of China’s total foreign trade. Currently, China is engaged in FTA development in south Asia, central Asia, Africa, Latin America and Europe. There are three categories: those where we are engaged in feasibility studies; those where we are engaged in consultations; and those where we have already started the development of FTAs.

In 2015, the most important FTA is the ‘FTA-plus’ with the Association of Southeast Asian Nations (Asean). The other important FTA is related to the Regional Comprehensive Economic Partnership (RCEP) negotiations, also known as the ‘Asean+6’ negotiations, including China, Japan, South Korea, India, Australia and New Zealand. According to targets set at the East Asia Summit (EAS), we will try to complete these negotiations by the end of the year.

How will China move to realise the vision of its ‘One belt, one road’ project this year? What will it mean for the countries along the routes?

President Xi Jinping put forward the idea of constructing the ‘Silk Road Economic Belt’ and the strategic concept of a ‘Twenty-first Century Maritime Silk Route Economic Belt’ (the Maritime Silk Road) when he visited Kazakhstan and Indonesia respectively in the latter half of 2013. The major goal is to enhance a full range of interconnection and co-operation among nations via policy co-ordination, facilities connectivity, unimpeded trade, financial integration and person-to-person bonds, so as to construct a community of shared interest, direction and responsibility, based on mutual political trust, economic integration and cultural tolerance.

China’s ‘One belt, one road’ initiative is not exclusive, and instead is designed to be open and inclusive to promote co-operation. It is not based on any individual nation’s development model or path, but adheres to the principle of openness and inclusiveness. Any nation, region, regional organisation or international organisation that is willing to participate is permitted to take part based on the principles of consultation, joint development and benefit sharing.

China views it as favourable to have a comprehensive opening-up and development of both land and sea routes in both the east and west. This would result in China's southwestern, northwestern and northeastern regions being transformed from interior regions to frontier regions. Nations along the way include both advanced nations and undeveloped nations. Whatever their state of development, China will aim to co-operate with them in regional and bilateral co-operation under the principles of consultation, joint development and benefit sharing, and act according to the circumstances of different countries.

China took the lead in creating the Asian Infrastructure Investment Bank (AIIB) and set up a $40 billion Silk Road Fund. China's commercial banking sector, insurance companies and commercial financial institutions as well as related funds will offer financial support for the 'One belt, one road' project, as the initiative will be not only be beneficial for China's development, but also for the economic growth of all nations and regions along the road.

What is China's role when it engages in international economics and trade?

Given our economic scale, no new investment and trade rules should be introduced in the international community without China's involvement. China should not be excluded from the negotiation and creation of new trade agreements negotiated by some of the developed countries. In addition, investment and trade activities are incomplete without China's participation, regardless of whether they are under regional arrangement, bilateral arrangement or multilateral arrangement. This is not only because of China's economic size, in terms of it accounting for 12% of global trade, but mainly because emerging countries such as China should be duly represented. In the past, other nations made the rules, and we submitted to those rules and obeyed. Now we want to be consulted so we can make the rules together. This illustrates the changing role of China during recent decades and how we want to be involved in the definition of new international trade and investment rules.

What is the role of the Shanghai Free-Trade Zone?

The Shanghai Free-Trade Zone (SHFTZ) is a stress test during the opening-up process. For a long time, our economy has maintained a double-digit growth rate. This is particularly true for foreign trade. In the past 30 years, we have maintained a growth rate of 17% on average, even during the global financial crisis (with the rate of 17.8%, -13.8% and 34.7% in the years of 2008, 2009 and 2010 respectively).

Will our management system still be able to adapt after the economy slows down? The SHFTZ was set up as an experiment to assess if we can pass the test. It has been a year since the SHFTZ was established, and it looks clear that China can withstand such challenges and tests. When China first joined the World Trade Organization (WTO) in 2001, there was a lot of room for manoeuvre with regard to our reform and opening-up policy. We could say for sure that a double-digit increase could be achieved easily after a measure came out. As the premier said, all the low-hanging fruit have now been harvested. Now we have to further open up, build a business environment that is governed by law, stimulate innovation and build an environment for fair competition. The first step to all this is the transformation of government functions and reform of administrative systems. For example, we can see that the new government is now focused on transforming government functions and decentralising approval power.

At the informal Asia-Pacific Economic Cooperation leaders' meeting that China hosted on November 11, 2014, president Xi Jinping announced the launch of the process of the Asia-Pacific FTA zone. What is the significance of this announcement?

President Xi said in the speech that calling it the Asia-Pacific Free-Trade Zone Beijing Road Map marks a historic and symbolic event, which fully reflects the importance of forming a greater free-trade zone area for this region. At the Informal Leaders' Meeting in November, this vital agreement was approved after leaders' consideration. It was a landmark event that indicated the beginning of the process.

The formulation of the Beijing Road Map during this meeting not only addressed the problem of the lack of substantial progress in the FTA process, but also set the future direction and work for building the Asia-Pacific FTA zone.

> *"China's 'One belt, one road' initiative... is designed to be open and inclusive to promote co-operation"*
>
> *Gao Hucheng, minister of commerce*

Many commentators are comparing the creation of the Asian Infrastructure Investment Bank (AIIB) and the Silk Road Fund to the US's Marshall Plan after World War II. What is your view?

There is nothing to compare between the two. The AIIB is actually a supplement to the global financial governance structure. The fact that Asian countries and 'One belt, one road' countries need infrastructure is indisputable. But the AIIB is open, with more than 20 nations negotiating to join, including developed nationals outside the region. So it is an open mechanism. This is no aid programme, as the Marshall Plan was back then. The aim is to promote co-operation and win-win development with complementary advantages and mutual prosperity.

What are the future prospects for Chinese exports?

There will continue to be a qualitative change in China's exports because China has entered an era of capital export. China's foreign investment and trade will become more closely connected. n

Gao Hucheng is China's minister of commerce.

Interview: Lou Jiwei

The screening of local government debt is currently in progress. Are you worried that the revealed scale of the issue will escalate, so creating a local debt crisis?

The problem of local government debt is undeniable. Before the revision of the Budget Act, local governments were not allowed to use loans to borrow, according to the related regulations.

But local debt still emerged due to various reasons. In general, the risk of local debt is controllable. For those regions with an excessive proportion of debt, we will need to pay extra attention.

To tackle this increasingly serious problem of local debt, we must adopt a strategy of "opening the front door while blocking the back door" and prevent the occurrence of systematic risk at the same time.

"Opening the front door" means granting local governments the right to issue debt, and this year's budget has included 600 billion yuan for local governments to issue such debt.

"Blocking the back door" refers to calculating and handling the historical debt burdens appropriately, and gradually "digesting" the existing debt stock, or in other words, to de-leverage.

A possible way to solve the problem is to convert local infrastructure projects into projects that can generate stable cashflows, eg by charging tolls (for roads) or fees (for others). If the collected fees are insufficient, these projects could be changed into the "PPP [public-private partnership] model" by providing suitable subsidies, which means the government and private capital invest and manage the infrastructure together (through granting concessions), and the government debts could then also be transformed into corporate debts.

For debts originating from the provision of purely public goods through urban investment vehicles,[22] local governments have the responsibility to repay them, and we have reported to the budget office of the National People's Congress Standing Committee to acknowledge these historical debts as legitimate public debt, and allow them to issue local government debt to replace the debt from urban investment companies (UICs), and thereby lower the interest rate.

Moreover, for historical debts resulting from bank loans, according to contract terms, the loan contracts cannot be annulled, so the loans have to be repaid. If the financing vehicle's situation has changed (eg if the UIC went bankrupt), the debt needs to be restructured through mutual renegotiation – hence, certain interim solutions should be adopted. We believe that by applying such methods, we are able to solve the debt problems that have accumulated over many years. Meanwhile, we will formally solve the problem by allowing local governments to issue debt based on the new Budget Act.

Lou Jiwei

How do you interpret proactive fiscal policy under the 'new normal'?

Not only has China's economy entered a 'new normal', but the global economy has also stepped into a 'new normal'. In 2008, the fall of Lehman Brothers highlighted the extent of the global financial crisis and economic downturn. The world is still in a process of de-leveraging. Under the 'new normal', the trend of global deflation and stagnation is becoming more serious, and there is no clear sign of economic recovery. All this has a huge impact on China's economy.

As for the domestic market in China, the driving forces of the economy are changing, and the problems resulting from the so-called 'three overlapping periods'[23] should be solved for the long term. During this process, we should de-leverage at a stable pace and avoid the tumbling decline of economic growth. To withstand the pressure of economic downturn, suitable expansionary fiscal policy must be adopted. For example, we plan modestly to increase the fiscal deficit rate, from 2.1% in 2014 to 2.3% this year, etc.

Will there be any changes in the national tax policy on personal income? For example, could personal income tax be reduced to stimulate consumption?

Overall, our personal income tax regime is still somewhat irrational in its design. Currently, personal incomes are levied by categories. The reform of the system was proposed at the Third Plenum of the Eighteenth Communist Party of China, changing it into an integrated income tax system. Such a system would be more scientific, since it is unfair to raise the threshold of individual income tax. However, an integrated income tax system requires higher capacity for tax collection and administration. A comprehensive system needed to collect and cross-audit personal income tax information, and the co-operation of different sectors (such as banking, security, insurance, industry and commerce, police, customs and real estate management) is also indispensable. It is still very difficult to implement the reform at the moment due to inadequate co-ordination.

Instead, we are considering making certain improvements based on the current situation. At the end of last year, we proposed the policy of adopting an EET (exempt, exempt, taxed) model on occupational pensions and enterprise annuities. That means that individuals are exempt from personal income tax when making contributions and depositing money into occupational pensions and enterprise annuity accounts, but that people need to pay individual income tax when pension payments are received. This is, in fact, a tax-deferral policy. Under the current tax system, this policy helps to encourage people make more contributions to pension accounts, and thereby improve the replacement rates, and it is beneficial to current consumption as well. n

Lou Jiwei is China's minister of finance.

22 Urban investment companies (UICs), urban development companies and local commercial banks are deployed to allow local governments to borrow money that otherwise is prohibited under the budget law.

23 The three 'overlapping periods' means shifting to lower growth rates, a painful period of structural change and a digesting period of the stimulus packages deployed after 2009.

Interview: Zhou Xiaochuan

The renminbi is being used in more foreign trade settlements, and efforts such as the Shanghai Free Trade Zone should help drive international use of the Chinese currency. But what is the proper pace and timing for the globalisation of the renminbi?

Firstly, as renminbi internationalisation or the use of the currency in cross-border trade and investment settlement started from a very low level in a short time, the growth rate looks very high. But, in fact, the share of renminbi in global trade and investment settlement is still relatively low. There was a development opportunity for renminbi globalisation presented by the outbreak of the global financial crisis.

After the crisis, people felt unsatisfied and lacked confidence in the existing global monetary system and so began to use the renminbi. However, we still need to do a lot of 'homework' before we can realise the globalisation of renminbi usage.

In the last few years, we have mainly focused on removing unnecessary restrictions on the use of the Chinese currency, including changing some laws and regulations. We should also eliminate discrimination against the renminbi, so it can circulate in all the areas where hard currencies are active. This work remains unfinished. So, overall, we are a long way from renminbi globalisation and need in particular to increase the renminbi's share in cross-border trade and investment settlement.


Zhou Xiaochuan

What is the role of the PBOC?

The People's Bank of China will not 'overpromote' the use of the renminbi. Instead, it will use its policies to create the conditions that support confidence in the acceptance of the renminbi in the international community.

The choice of whether or not to use renminbi will be left to market participants. Gradually, the barriers preventing its use will be eliminated for parties that want to use it. Another important issue included in our 'homework' is to steadily promote and gradually realise the convertibility of renminbi capital accounts. So the convenience of the renminbi in global use and people's confidence in it will substantially increase. From this perspective, we need to finish our policy reform first. But there is no prearranged pace or timeline for promoting the use of the currency.

Last year, the PBOC signed a currency swap agreement with the European Central Bank (ECB) and other European central banks. What can we expect with regard to financial co-operation between China and Europe this year?

Several European countries have shown great interest in developing renminbi business. From a Chinese perspective, we should enable those who are interested in creating offshore renminbi business centres. Whether these efforts will work or not is down to the efforts and opportunities of market participants in those centres.

With regard to our co-operation with Europe, firstly we reached a bilateral currency swap agreement for a large amount with the ECB last year. In addition, we have conducted co-operation with the European Union and the ECB in the areas of monetary policy exchanges, financial stability, cross-border financial regulation and financial standard formulation. In particular, we will work together to respond to a broad range of problems that emerged from the financial crisis, including mending financial stability standards. Frequent exchanges and co-operation have been carried out in all these aspects. The Sino-European financial relationship has been very close, and will continue to deepen and develop.

What is Hong Kong's future role in RMB globalisation?

Hong Kong's renminbi business is developing soundly, and is playing a central role not only in Hong Kong but also in the world. Hong Kong's renminbi business can help to promote the use of renminbi in many countries, especially South-east Asian countries.

Many have shown an interest in promoting renminbi business, which is good and has brought Hong Kong many opportunities. Other places also aspire to be the 'centre'.

But the real 'centre' should be recognised by the market because of its actual advantages and good levels of service. Hong Kong has obvious advantages over other places. Hong Kong has a tradition of being a financial hub, and has a world-class financial market, in particular its advanced equity market. Therefore, Hong Kong's position will be strengthened.

When will the control on deposit rates be removed?

Market forces are definitely driving interest rate liberalisation, and many new businesses and business models favour liberalised interest rates. The liberalisation of deposit rates should be the last step of interest rate liberalisation. Removing controls on deposit rates is surely part of the plan because many other kinds of interest rates have already been liberalised. I personally believe deposit rates will be liberalised in one or two years.

You have said the liberalisation of interest rates would increase interest rates in the short term. Will the corresponding market risk be pushed up?

In the process of interest rate liberalisation, opportunities that never existed before will definitely emerge because of the management and macro-control transition. These opportunities may bring high returns in the short term, and the market will seek out these opportunities – so, possibly, the interest rate will increase for a certain period. But with the market's role in resource allocation and broad competition, interest rates will ultimately reach a balance of general supply and demand. The effect of individual opportunities will diminish gradually. n

Zhou Xiaochuan is governor of the PBOC.

Driving the 'new normal'

Gu Shengzu, vice-chairman of the Financial and Economic Affairs Committee of the Twelfth National People's Congress, describes the three major elements that hold the key to driving forward the country's economy: stability, urbanisation and innovation

China's 'new normal' economic period will involve three important factors: stable and solid growth; new forms of urbanisation; and industrial upgrading. The first issue is related to stabilising the country's growth rate at levels lower than those witnessed in the past. The average annual growth rate during the past 30 years was around 9.8%, while in the new normal period growth should enter the '7% era'. Addressing downward pressure on the economy and stabilising growth is dependent on transforming the engine of the economy.

New urbanisation

Part of this will rely on the creation of a new engine for regional economic development. Chinese premier Li Keqiang pointed out two focuses of regional economic growth in the *Government Work Report* in 2014. First, the construction of the Yangtze River Economic Belt, relying on the 'golden waterway' and development of the urban agglomerations in the Yangtze River Delta, Pearl River Delta and the Beijing-Tianjin-Hebei region, to improve industry logistics. Second, the planning and construction of the Silk Road Economic Belt, with respect to international economic and technical co-operation.

Therefore, the blueprint of regional economic development in China has developed from the basis of the coastal economic zones over the past 30 years to the Yangtze River Economic Belt and the Silk Road Economic Belt in 2014. The coastal economic zone involves 12 provinces, the Yangtze River Economic Belt involves 11 provinces, while the Silk Road Economic Belt covers more than 40 countries and a population of 3 billion.

President Xi Jinping proposed five key aspects about the construction of the Silk Road Economic Belt: political communication; road connectivity; unimpeded trade; monetary accommodation; and personal communication. The key factor for the Silk Road Economic Belt is 'connection'.

To achieve this, China needs to construct multiple physical channels, including overground railways and highways, underground oil and gas pipelines, and develop the interregional economy of the Silk Road. The Silk Road Economic Belt, targeting the development of energy, is an open and co-operative economic zone as well as an important strategy for the development of western China.

The Yangtze River Economic Belt involves 11 provinces, which account for approximately half the country's GDP. The development of the urban agglomeration of the Beijing-Tianjin-Hebei area is also important in the regional economic development of China, which places environmental protection and transportation construction as a priority, including overcoming industrial logistical challenges.

From the point of view of driving the national economy, the urbanisation process will create huge demand for investment and consumption.

At present, there are six large urban agglomerations in the world, represented by New York, Chicago, Tokyo, Paris, London and Shanghai – the last of which covers the Yangtze River Delta. The key to the construction of an urban agglomeration is that of the central city. The Yangtze River Economic Belt covers eastern, western and central China. Three urban agglomerations in the Yangtze River Delta, the middle reaches of the Yangtze River and Chengdu-Chongqing area connect the entire region of the Yangtze River.

The lower reaches of the Yangtze River Delta, as mentioned, is already one of the six largest urban agglomerations in the world, while the middle reaches area is striving to become the fourth big urban agglomeration in China after the Yangtze River Delta, Pearl River Delta and the Beijing-Tianjin-Hebei region – leading the rise of central China. Relying on the 'golden waterway', the urban agglomeration in the middle reaches of the Yangtze River has an obvious advantage in water carriage, as the shipping cost is only one-sixth, one-twenty-eighth and one-seventy-eighth of the cost by railway, truck and air respectively, and therefore has huge potential for development.

The urban agglomeration in the upper reaches of the Yangtze River is in the Chengdu-Chongqing region, which is at the centre of western China. This urban agglomeration is an important base that links the Silk Road Economic Belt and the Yangtze River Economic Belt.

The urban agglomeration of Beijing, Tianjin and Hebei is centred on Beijing, the capital city. President Xi investigated Beijing's smog problem and proposed the pressing need for city reorganisation. He held a conference focusing on the collaborative development of the Beijing area and said the main cause of smog is automobile exhaust fumes, which is closely related to urbanisation.

The population of Beijing has exceeded 20 million and car ownership has almost reached 6 million. Organising industrial development and managing the city's population are currently high-priority tasks. Beijing once proposed limiting the population to 18 million by 2020, but it had already exceeded this 10 years before the target date. The population problem has become the primary issue. To solve this problem, we must rely on Hebei to expand its industry, in order to realise the goal of dispersing the population.

The development of new urbanisation, particularly as characterised by urban agglomeration as the main platform, will play an essential role in the stabilisation of growth because urbanisation is a process transforming farmers into city dwellers, constantly increasing consumption levels and driving huge demand for investment.

Industrial innovation

There is also a need to promote industrial improvement in regional economic development through innovation. So how we can realise innovation-driven development? In this case, institutional innovation is more important than technological innovation – and the most important institutional innovation is that in the financial arena. In addition, talent and technology are key elements to achieve innovation. China needs to create a social environment that encourages the development of business and innovation, as the current social environment does not match the demands of innovation, and the country is experiencing huge economic risks from the hollowing-out of the real economy. The software from an innovative entrepreneurship culture outweighs the hardware equipment in factories.

Regarding the strategy of how to realise development driven by innovation, my opinions are as follows:

- Create an environment in which people can acquire wealth through the development of industry and innovation so that the basis of the real economy can be strengthened. At present, China has entered the 'high-cost era' with the risk of damaging the real economy. If factories vanish, then innovation cannot be conducted any more.
- Revive the spirit of entrepreneurship, which is driven by innovation. Propelled by the government's decentralisation reforms, there is a new wave of entrepreneurship in China relying on the internet as a platform.
- Cultivate an innovative entrepreneurship culture that tolerates failure and encourages risk-taking as well as inclusiveness. Telecommunications firm Huawei is an example of going global through institutional innovation. Its employees hold 98.6% of Huawei's stock, while the chairman of the board, Ren Zhengfei, holds merely 1.4%. The company's success could be attributed to such an innovative equity structure.
- Promote co-operation and innovation within the economy to construct innovative alliances and cast off any insularity related to innovation. Within a technological monopoly, the aerospace industry has been forced to innovate independently. From the atomic bomb to manned space projects, China has achieved innovation because of a technological monopoly. The Three Gorges Reservoir project is also an example of an innovative domestic co-operation process, while the reliance of the development of the automobile industry on foreign technology is a counterexample.
- Innovation should be both technical and financial. Even though there are many problems in the US financial system, its finance and technology industries offer development lessons that are worth learning. The late UK prime minister Margaret Thatcher argued that the reason the country's high-tech industry lagged behind that of the US was due to risk investment. The development of finance and technology is important for driving innovation.

Regional economic development under the new normal needs a new engine – namely, new urbanisation, especially the planning and construction of urban agglomeration. To achieve industrial improvements, a new incentive is needed that is driven by innovation. n

Connection is part of China's ongoing growth (Nanjing Yangtze River Bridge pictured)

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Foundations for reform

Cheng Siwei, chairman of IFF and former vice-chairman of the Standing Committee of the Ninth and Tenth National People's Congresses, presents five objectives that lay down foundations for aiding the country's overall reform

At present, the slowdown of China's economy remains a concern. On the one hand, the worry seems justified. The economic cycle of China is about 10 years, and in the past 10 years, the country's average annual growth rate was around 10%. But from the beginning of 2012, economic growth slowed down, dropping to 7.3% in 2013. The growth rates of the first three quarters in 2014 were respectively 7.4%, 7.5% and 7.3%. On the other hand, perhaps we should not be unduly worried. China has started the process of reform, all of which is sustainable and all-encompassing. And this reform is not only related to the economy, but also involves society, politics, culture and ecology. Five interpretations help lay the foundation for a preliminary understanding of the next step of China's reform.

Changing focus

First of all, the existing development model, focusing only on GDP growth, must be changed to stimulate investment. Rapid growth in the past 10 years was mainly dependent on tremendous investment. Especially after the release of the 4 trillion yuan stimulus package in 2008, China's bad debts increased geometrically. If one included the issue of bad debts, the economic growth rate in 2009 would probably have been closer to 2%. To achieve the high-speed economic growth we actually saw in 2009, China tolerated the increase of bad debts. But after 2009, the consequences of these misleading incentives began to emerge. Many industries found themselves encumbered by overcapacity and excessive inventories.

Secondly, investment returns began to decline and environmental costs became increasingly serious. Research had been done in 2005 and 2010 respectively looking at the environmental costs, including pollution and inefficiency. According to this research, the costs accounted for approximately 13.5% of GDP in 2005 and 12.6% in 2010. However, GDP growth rates in 2005 and 2010 were both 10.4%. When the environmental costs exceed economic growth, they will be passed on to the next generation.

Thirdly, there has been a rapid accumulation of local government debt. Local government debt in mid-2010 reached 10.7 trillion yuan. What is more, according to estimates by the Ministry of Finance, total local government debt rose to 20 trillion yuan in 2013, increased by 5.4% proportionally, accompanied by the emergence of a real-estate bubble. In 2009, real-estate sales increased by 43% and house prices rose accordingly. From 2010 to 2013, the average annual growth rate of house prices was 6.58%.

China must transform its growth mode, avoid overinvestment and change its blind worship of GDP growth. Traditional economic reform has focused too much on GDP growth, as this is used as the benchmark for assessing the performance of local governments. There are many other problems. For example, some jerry-built projects contribute to inflated GDP statistics, but cannot achieve their aims after completion – various financial and technical problems hinder the operation of projects, and local governments have to subsidise the subsequent operation, which is also counted in GDP.

Once again, the system is biased towards the blind worship of GDP. For example, estimated investment in 2014 was 1 trillion yuan, 10% of which was exaggerated and could not lead to a higher GDP. Therefore, to achieve the same GDP growth rate in 2015, more capital is needed, which means total investment will reach 1.1 trillion yuan. The figure also illustrates why total investment in China has been increasing.

To fundamentally solve these problems, investment must be reduced and maintained at a reasonable level; at the same time, authorities must pay more attention to consumption and find ways to stimulate it. In addition, the environment is one of the key topics for future development. More resources should be devoted to environmental protection, including improving energy efficiency, reducing pollution and protecting the ecological system.

Tackling inequality

Fourthly, a pressing problem is the need to narrow inequality. At present, the most prominent inequality in China occurs between

Cheng Siwei

The environment is one of the key topics for future development (Pictured: offshore wind farm at Shanghai, east China sea)

chungking Penler / Shutterstock

urban and rural areas. The average income of urban citizens is three times that of rural citizens, and urban residents enjoy far superior public services. Urban-rural inequality can be attributed to two factors. First, agricultural productivity in China is low. According to a Chinese Academy of Science report in 2012, agricultural labour productivity is only 2% of that in developed countries and just 1% of US productivity levels. Second, there is surplus labour in rural areas, which has limited production capacity and provides a near-zero marginal consumption. What is more, surplus labour in rural areas has not been transferred to productive parts of the economy in an efficient manner.

At the time of the creation of the People's Republic of China, land was distributed to the nation's farmers. But under the commune movement after 1995, farmers' private lands were taken into public ownership in the form of people's communes, which had a major impact on rural development.

The government has recently introduced four reform measures, which aim to improve the wealth of the rural population. First, collectively owned land should be circulated in the land market, allowing farmers to transfer land in the market and obtain a higher price. Second, the title deeds of land should be transferable. Farmers could be permitted to gather more land to improve mass production. Currently, land-lease fees in Zhejiang province are equal to 50% of the output of farmland. Third, the usage rights of housing and land in rural areas should be separated. Fourth, the system of township enterprises should be reformed. These four policies guarantee that rural surplus labour can enjoy certain wealth and resources when relocated to urban areas, providing safeguards for their employment, housing and children's education in the cities.

Innovate to advance

Finally, future development relies on technological innovation. China is currently in the third stage of its industrial revolution period, marked by the introduction of computerised and internet services, such as cloud computing and mobile internet services. But none of the innovation in this stage is complete. The second industrial revolution, marked by the extensive use of electricity, also experienced some failures in initial stages. But the revolution wave has always driven forward the development of the social economy. Technological innovation will benefit consumers, and therefore China needs to further develop such innovation, especially in information technology, which will influence and change all industries, but particularly the finance industry. China cannot always rely on imported technology, and must invent its own technology, improve innovation, and create its own business models. Companies such as Alibaba, Tencent and Xiaomi are representative of innovative enterprises in China.

It is education that promotes the development of science and technology. I myself am an economist, and economists can only talk about today, but science ensures a better tomorrow, and education ensures safe and healthy development in the long term. So education should enjoy greater attention and investment.

Overall, in the economic cycle of the next 10 years, the annual GDP growth rate has the chance to reach 7% or 8%. How can we achieve such a high level of growth? The first step is to transform the current growth mode that blindly worships GDP. Second is to invest more in environmental protection. Third is to narrow the inequality between urban and rural areas. And finally, China must promote technological innovation. n

Alibaba is one of many innovative Chinese firms

Christopher Penler / Shutterstock

FINANCIAL DEEPENING AND MARKET REFORM

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China's path to financial deepening

Despite China's quick progress in the sphere of manufactured goods, the country's financial system has been a few steps behind, but that is steadily changing

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When compared with the rapid advancement in the manufacture of Chinese products, supported by some of the best physical infrastructure in the world, the Chinese financial system still remains relatively inefficient and closed. Most financial intermediation is conducted through banks. Capital markets activity – including bond and equity markets – is relatively small, with low participation by institutional investors. In addition, bank loans are subject to quantitative controls, so private enterprises often find it difficult to borrow. Interest rates and exchange rates are not fully liberalised and domestic residents face high hurdles to investing abroad.

The inadequacy of the financial system is being addressed through constant policy changes. Since the Third Plenary Session of the Eighteenth Party Congress, the Chinese leadership has increasingly promoted a more market-based system. The result is that there is likely to be a period of steady evolution of the old financial system, where policy-makers constantly strive for a balance between reforms to eliminate inefficiency and necessary risk management during liberalisation. In this section, China's path towards financial deepening is discussed, along with highlights of the latest developments, drawing on policy-makers' perspectives.

Current financial system

The Chinese financial sector contains the essential components of a modern financial system: banks, insurance companies, equity and bonds markets, as well as payment systems. But banks dominate financial intermediation, providing around 60% of loans to the private sector, according to the Asian Development Bank (ADB). The banking system is also concentrated, with the five largest banks providing about 50% of loans. Total social financing (which measures the total funding that the non-government sector obtains from the financial system) includes funding from bank and non-bank lending channels (see table 1).

As part of the legacy of the state-owned economy, the government still maintains significant influence on the financial system. The central bank sets the cap on retail deposit rates and the floor for retail lending rates. Over the last year, some of these restrictions have been relaxed, with a floating range of deposit rates being expanded and a market-based prime lending rate introduced as the benchmark rate for loans.

However, interest rate controls still have a powerful effect on both borrowing and lending rates. In addition, the volume of loans is controlled by quotas, and preferential sectors are still subject to direct or soft targets. Local governments also influence the lending decisions of regional bank branches at times, and this sort of lending has been particularly active in the years following the global financial crisis, when fiscal and monetary conditions were relaxed to shore up the economy.

Implicit and explicit guarantees are also prevalent in the financial system. For example, there are implicit or explicit guarantees offered for borrowings by state-owned enterprises (SOEs) and local government vehicles (the firms affiliated with local governments that borrow and invest in public-sector projects).

A deposit insurance, which would offer up to 500,000 yuan in compensation for deposit losses, took effect on May 1. Prior to this, it was widely viewed that the state implicitly insured all deposits.

Other liabilities of banks to retail investors – in particular, deposit-like wealth management products that offer market returns – have also been viewed as having implicit guarantees.

The state's influence and controls have also contributed to uneven access to finance. Moreover, as the formal financial system tends to favour larger SOEs and private companies – partly because of the lack of incentives for risk pricing under interest rate controls – small companies tend to face difficulties in accessing funds, and have to resort to self-finance or curb lending. This has in turn spurred the growth of peer-to-peer (P2P) lending in the past couple of years.

To a large extent, the still-primitive financial system reflects a cautious approach to liberalisation and its associated risks. China's financial reforms started in the 1990s (see appendix), yet the pace has been gradual and incremental with a view to managing shocks to the economy.

For emerging markets, the empirical evidence regarding the growth benefits of financial deregulation is mixed, and academics have highlighted that institutional thresholds and maturity are needed to favour a more comprehensive financial reform agenda.

Indeed, many have attributed the resilience of the Chinese economy following the global financial crisis to its underdeveloped financial markets and closed capital account. The Chinese government has therefore largely pursued an experimental approach towards financial reforms until recently.

'Decisive' role of market

In the Third Plenary decision of the Eighteenth Party Congress, the new leadership under president Xi Jinping and premier Li Keqiang stressed the need for market-orientated reforms. One key point was made about the need to change the role of the market from 'basic' to 'decisive', stipulating that the country will deepen its economic reforms to ensure market forces will play a more decisive role in the allocation of resources. At the same time, the Chinese government wants financial reform to support macroeconomic stability and the growth of the real economy. A modern financial system needs to include multi-layered capital markets, further interest rate and exchange rate reforms, capital account convertibility, and the development of private financial institutions. Financial regulation also needs to be strengthened.

The call for more comprehensive financial reform stems from the need for more balanced growth and better management of risk. Financial repression in the form of interest rate controls and loan quotas, along with preferential lending to state enterprises, has contributed to underpriced borrowing costs for and overinvestment by these companies.

Meanwhile, the dominance of banks in financial intermediation also implies inefficiency and a concentration of risk, and the rise of non-bank financing has challenged the traditional bank-centred regulatory approach. More broadly, a robust and sophisticated domestic financial system is needed to support China's outreach in global trade and investment (as outlined in sections one and three).

Main areas of financial reforms

Financial reforms involve changes to an ecosystem that is intertwined with China's growth model and the cyclical challenge it faces.

For instance, the banking system has been instrumental in deploying large financial resources quickly to fund investment projects. This helped to bolster economic growth, especially during cyclical downturns, but also contributed to duplicated capacity-building and an accumulation of bad loans. The merit of a more efficient financial system and further financial deepening is generally accepted within policy-making circles.

But in practice, the government needs to weigh the benefits and costs of each step, and consider the cyclical outlook and global conditions, among many factors, when pressing ahead with reforms. Carving out a path that allows the system to move towards a new and better equilibrium, while managing the risks along the way, features prominently in the view of policy-makers.

The details of the financial reform agenda were released a few months ahead of the Third Plenary decision, and represent a summary of the reform agenda for the financial system by the Chinese government (see *http://tinyurl.com/kuqyjwe*).

There are several main ingredients to the financial deepening process. First, there is a need to develop a multi-layered capital market to satisfy diversified needs of financial intermediation and enable a greater role for market forces (instead of government) to allocate resources. Second, factor prices must be liberalised without destabilising the macroeconomic environment.

And finally, risk management of an increasingly complex financial system is required to replace 'more regulation' with 'better regulation'. n

Table 1: Major sources of funding, 2002–2013 (billions of yuan)

Year	Loans	Foreign currency loans	Designated loans[1]	Trust loans[2]	Undiscounted bank acceptances[3]	Corporate bonds	Domestic equity financing[4]	Total social financing
2013	88,900	5,848	25,500	18,400	7,751	17,968	2,219	172,900
2012	82,000	9,163	12,800	12,900	10,500	22,498	2,508	157,700
2011	74,715	5,712	12,962	2,034	10,271	13,658	4,377	128,286
2010	79,451	4,855	8,748	3,865	23,346	11,063	5,786	140,191
2009	95,942	9,265	6,780	4,364	4,606	12,367	3,350	139,104
2008	49,041	1,947	4,262	3,144	1,064	5,523	3,324	69,802
2007	36,323	3,864	3,371	1,702	6,701	2,284	4,333	59,663
2006	31,523	1,459	2,695	825	1,500	2,310	1,536	42,696
2005	23,544	1,415	1,961	n/a	24	2,010	339	30,008
2004	22,673	1,381	3,118	n/a	(290)	467	673	28,629
2003	27,652	2,285	601	n/a	2,010	499	559	34,113
2002	18,475	731	175	n/a	(695)	367	628	20,112

Source: Asia Development Bank (2014)

Notes: n/a = Data not available. Negative values are placed inside parentheses. [1] Designated loans (also known as entrusted loans) are company-to-company credits for which a bank or other financial institution (such as a trust company or lease company) acts as broker. The bank typically manages the credit process, disbursements and repayments. It receives fees but bears no credit risk and the loan is off balance sheet. [2] Trust loans are provided by trust companies, which do not accept deposits but manage assets for entities and individuals. Often associated with a bank, they offer 'bank-trust co-operation wealth management products', which are essentially notes issued by trust companies that offer more attractive yields than bank deposits. [3] Bank acceptances are drafts or bills issued by a company and endorsed by a bank. [4] Domestic equity financing is the least transparent part of the shadow banking system, so it is unlikely to be captured accurately. Participants are entities and individuals that function as lenders or borrowers. As these interactions do not occur within the formal banking sector, there is little regulation. This private lending market reportedly offers rates of around 18–23%, compared with banks.

INTERVIEW: SHANG FULIN, CHAIRMAN OF THE CHINA BANKING REGULATORY COMMISSION

What is impact of the 'new normal' on the banking sector?

The Chinese banking sector has developed steadily during the past few years and generally performed well according to most operational and risk indicators. Major sectoral reform and opening up took place in 2014, with private capital making new inroads, the four reforms of banking business governance advancing smoothly, fresh headway made in policy bank reform and the banking sector opening wider to the rest of the world.

Moreover, the sector has served the real economy effectively, and supported steady and brisk growth of the national economy through improved financial services, lower financing costs and more efficient funding. Efforts to open up and service the real economy have been coupled with risk mitigation in key areas – banks have defended their profitability amid the absence of systemic and regional risks.

Under 'new normal' economic conditions, the banking sector has needed to embrace the re-stabilisation of loan growth, a narrowed spread between the deposit and lending rates, the evolving model of social financing and a rebound of non-performing loans. As a result, the banking sector had accelerated its adjustment strategy, transformed its profit model, boosted innovative capacity, averted and mitigated risks, and operated in a legal and compliant manner.

How can banks transform their profit models against a backdrop of a long-term narrowing of spreads?

First, they can seek profit from more sophisticated management, re-engineered business processes and reduced operating costs; second, they can enhance capabilities for pricing products and managing interest rate risks to ensure attainable profits, manageable risks and sustainable business; third, they can seek profit from risk control, with effective measures taken to improve asset quality; and fourth, they can benefit from service, with proactive efforts made to improve service quality, transform service models, segment markets, speed up service upgrades, and provide clients with more customised, professional and comprehensive financial services, so clients will be more sticky and the real economy can be more effectively served.

What challenges does the evolving social financing model present to banks?

The social financing model is changing remarkably, with competition in the financing market becoming ever greater. The banking sector needs to redouble its efforts to keep pace with mass entrepreneurship, drive its growth using innovation as a new engine, secure benefits from diversified financing and ensure the sector's development lies in its own hands. First, it needs to utilise information technology to promote business innovation – leveraging the internet, big data, cloud computing and other technologies, develop digital platforms for financial services, broaden and consolidate operating channels and expand its operating capabilities. Second, it must explore innovation in non-credit businesses, steadily developing wealth management, asset custody and other high-value-added business. Third, it needs to press ahead with innovation in the liability area, raising funds through a variety of means, such as financial bonds and certificates of deposit, and improving active liability management capabilities. Finally, it has to step up innovation in the credit business and open up new sources of profit.

What should banks do to respond to rising levels of non-performing loans?

In recent years, pressure to maintain economic growth has been reflected in the quality of bank lending, mainly through the rise of both the size and rate of growth of non-performing loans (NPL). Although the NPL rates of commercial banks largely remain low and generally controllable, we need to soberly realise more problems will manifest themselves in the performance of the banking sector in the period to come. In response, banking institutions need to make timely NPL write-offs, appropriately use the eased conditions for bad debt write-offs and other policies, make more voluntary bad debt write-offs without closing the cases or losing the recourse for the bad debts written off, and avoid the co-existence of both high provisions and high NPLs.

It is essential to revitalise the NPLs, and sell them to viable and willing investors via asset securitisation and asset transfer through legitimate channels. Furthermore, NPL restructuring can be attempted, so that for the projects compatible with policies and products related to core competitiveness, banks should try to help borrowers overcome their difficulties by relending, extending and renewing debt, as well as pushing restructuring and mergers and acquisitions. To liquidise the NPLs, it is advisable to make use of financial asset management companies and other channels, and look for effective mechanisms to dispose of NPLs in a wholesale and market-based manner.

What should be done to address the complex economic conditions and financial risks?

Deepening reform inevitably is the way to cope with the challenges posed by complex economic conditions and financial risks. As for next steps, the first is to support the introduction of private capital into various types of banking institutions through diverse channels, by expanding the scope of the pilots of private banks and consumer finance companies, extensively enrolling eligible private capital, allowing higher private stakes in village banks, and extending the scope for private capital to participate in institutional restructuring. The second is to push reform of banking management, to ensure banks operate in a more specialised fashion by deepening the migration towards business unit systems, pressing ahead with department specialisation and exploring the conversion of certain units and lines of business into subsidiaries. The third is to vigorously advance banking regulatory reform by further simplifying regulation, delegating powers, optimising regulatory processes and regulatory resources allocation, tightening the regulation during and after incidents and improving on-site inspections. The fourth is to solidify the five core systems, that is, the sectoral product registration, asset transfer, liquidity mutual-assistance, client risk and fraud information, and information publication systems, and speed up the development of financial infrastructure.

Developing capital markets

China's capital market is small. For example, in the US, the capital market accounts for around 115% of GDP, similar to the banking and insurance sectors combined.

The relative size of the capital market in Hong Kong is even higher than in the US, as may be expected for an international financial centre.

In China, however, the capital market only accounts for about 45% of GDP, or one-sixth of the size of the banking and insurance sectors combined, pointing to significant scope for further development.

Capital markets are still largely viewed as supplementing the activities of the bank-dominated financial services industry, even though they help to diversify risk.

The underdeveloped equity market in particular has contributed to the heavy reliance on bank financing and high leverage ratios in the corporate sector. Also, the capital market can help businesses and individuals to improve returns and manage their risks.

For example, commodity producers can use futures and other derivatives to help them hedge against commodity price cycles, and pensioners can benefit from more consistent returns from their retirement savings.

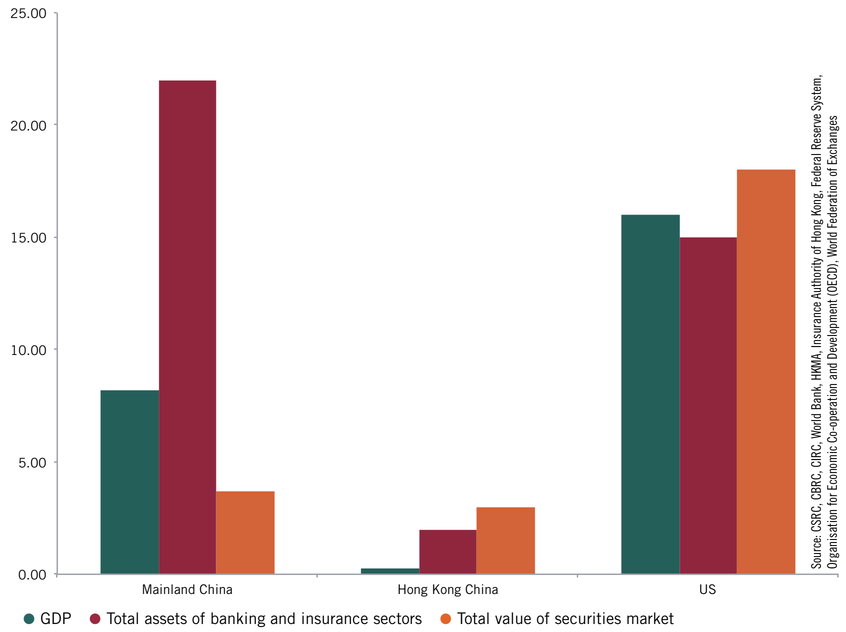
In the absence of a well-functioning capital market, an unregulated 'shadow banking' sector has emerged to satisfy unmet borrowing demand, and the associated 'regulatory gap' has given rise to concerns about financial stability.

There are several inter-related components required for capital market development: foremost, capital markets should become more diversified and multi-layered. This requires a fundamental change of the process for initial public offerings (IPOs) from an approval-based system to a disclosure-based system. For further details, see box on pp. 36–37, in which Xiao Gang, chairman of the China Securities Regulatory Commission (CSRC), lays out the key areas of reform in this area.

> *"The new system... will rely on pre-IPO information disclosure and post-IPO rules-based regulation, with harsh penalties for companies found guilty of breaching the rules"*

Other reforms that are also important include the development of an over-the-counter (OTC) equity market and encouraging institutional investors to participate in capital market activities to increase liquidity in the capital market.

Fig 1: Scale of capital market, GDP, banking and insurance sectors, 2012 ($ trillion)



The IPO process

The equity market has been particularly weighed down by an onerous IPO approval process. At present, the CSRC approves all new IPO applications based on the quality of the company, with the regulator also responsible for addressing any irregularities associated with listed companies. Such an institutional set-up traces back to the need to protect investors when the equity market started to develop in China at the start of the millennium.

Over the years, however, the CSRC appears to have taken on an implicit role for endorsing listed companies and has tightened its approval process in response.

New reforms under way will replace the approval process with registration requirements. The new system, due to be introduced this year, will rely on pre-IPO information disclosure and post-IPO rules-based regulation, with harsh penalties for companies found guilty of breaching the rules.

In addition to the Main Boards and the Growth Enterprise Market, the development of the New Third Board, an OTC market that is similar to the OTC Bulletin Board in the US will enable share transfers of companies that do not meet the listing requirements of other boards.

The development of the OTC market is critical for enabling better financial services for small and/or growth enterprises. China's OTC market is still insufficiently developed because of the process of reform in China.

In the past 20 years, one of the main features of the capital market is that legal and political systems were established with a focus on stock exchanges, with little focus on OTC markets. For instance, security institutions approved by the CSRC can deal with exchange-listed stocks, but almost none of them have OTC businesses.

This is inadequate in the view of Zhu Chongjiu, the former assistant chairman of the CSRC (see pp. 49–50), as one of the most important roles of the OTC market is to support small and medium-sized enterprises (SMEs) in their start-up and growth stages.

The development of the OTC market requires the relaxation of registration requirements for public equity raising, as well as the standardisation and proper regulation of crowdsourcing. Further steps include an equity trading platform dedicated to small companies being developed, and regional share-trading platforms expanded to serve the needs of non-listed companies.

There has been some progress in these areas over the past year. The development of a futures market, including foreign-exchange futures, could also play an important role in risk management, as well.

Derivatives markets, particularly financial futures markets, are an integral part of a modern capital market, as they facilitate hedging and risk management. China's financial futures market is still small, with only the CSI 300 stock index and five-year government bond futures being traded. In the National People's Congress (NPC) meeting in March 2015, Premier Li Keqiang noted in a government report that financial derivatives will be developed – the first time such a statement has been made in the yearly government report.

The chairman of the China Financial Futures Exchange (CFFEX), Zhang Shenfeng (see pp. 53–54), has said that significant efforts will be made to expand derivatives – particularly the futures market – by introducing interest rate and foreign-exchange futures and options in the coming years. n

XIAO GANG: REFORMING THE IPO PROCESS

IPO reform is a top priority as part of overall capital market reform in 2015. It involves major participants in the market and represents an important breakthrough in regulatory reform by the China Securities Regulatory Commission (CSRC).

Why does the IPO process need to be reformed?

Since March 2000, when the approval-based IPO system was introduced in China, about 1,700 companies have been listed, with a combined market value of 5.31 trillion yuan. This has represented an important role in raising capital. In addition, from the end of 2006 to September 2014, public companies have issued 2.97 trillion yuan of cash dividends.

Meanwhile, the operating incomes of public companies in 2013 accounted for 47.56% of GDP and tax contributions accounted for 21% of the entire country's tax revenues. So public companies are playing an increasingly important role in the development of our economy.

However, with the deepening of reforms and the development of the markets, the defects of the current IPO approval-based system have become visible.

Firstly, government endorsement of the likely profitability of companies and the sound value of their equity has lowered risk awareness among investors. Meanwhile, the CSRC has had to take on a high burden of responsibility, while the responsibility of issuers, sponsors and accounting firms has been weakened.

Secondly, under the approval-based system, the CSRC controls the new stock's price, issuing pace and scale.

Although these measures can stabilise investor expectations in the short term, they hamper self-regulating mechanisms, distort demand and supply, and hurt the mid- and long-term development of the stock market.

Thirdly, the approval-based system necessitates excessive administrative intervention and high levels of subjectivity. To solve all these problems, IPO reform is needed.

The registration-based system is a highly market-driven IPO regulatory system and lies at the core of reform aimed at improving the relationship between the government and the market. It can resolve problems caused by information asymmetry between investors and issuers, and also help to draw the boundary between the market and the regulator – thereby preventing excessive intervention.

The government will no longer act as a guarantor for the issuer or pay much attention to businesses' performance and prospects. Investors will have to make their own judgements and choices.

The volume of the stock issued and its price will be driven by market participants, so the market will play a decisive role in allocating resources. Meanwhile, the regulatory institution will maintain market order and protect the rights of investors.

So our overall goal of IPO reform is to establish a market-orientated IPO system with an emphasis on information disclosure and effective regulation.

zhaoliang70 / Shutterstock

What are some of the risks during the reform process?

Risks exist in pushing through the reform. For instance, the risk of fraud by companies may increase, so there is a need for gradual and steady reform.

It also needs to be systematic, targeted and co-ordinated, maintaining a balance of long-term versus short-term profit, and balancing the reform, development and stability of the capital market.

This will also require an integrated and co-ordinated effort that strengthens the design of the market to promote healthy and stable development, and risk-monitoring, -warning and -management systems that can strengthen the ability to identify, guard against and deal with risk will need to be further developed.

What are the key ingredients needed to support the new system?

Firstly, driven by investor demand, we need to address and balance some key relationships:

- The relationship between the unity of information disclosure and the diversity of investor demands. To try to satisfy different demands of different groups without bias.
- The relationship between the amount and the quality of information. To simplify the disclosure process while increasing the readability and clarity of the disclosure.
- The relationship between the comparability and usefulness of the information disclosure. To formulate and improve rules intended for particular industries and areas.
- The relationship between market participants' information and regulatory information. To ensure information disclosure truly satisfies the demands of market participants.
- The relationship between information disclosure in the issuing stage and that in the following stage, thereby strengthening different parts and different levels of information disclosure in the capital market.
- The relationship between compulsory and voluntary information disclosure. To encourage market participants to comply with voluntary principles to provide useful information for investors.
- The relationship between regular reports and temporary reports – increasing the consistency of market participants' information disclosure to avoid overlapping or conflicting information.
- The relationship between the stability of the information disclosure system and its flexibility.

Secondly, different layers of regulations are needed under the Securities Law, Corporate Law and other legal requirements:

- Divisional regulations that include measures to establish, manage and regulate the information disclosure system.
- Regulatory documents that fully integrate current rules and form specific information disclosure rules for different market levels and areas.
- The self-regulating rule. The Shanghai Stock Exchange, Shenzhen Stock Exchange, national stock exchange companies and industrial associations should improve their respective information disclosure rules according to the divisional regulations and regulatory documents formulated by the CSRC.


Xiao Gang

Thirdly, we should clarify the information disclosure system and the division of responsibilities. The group in charge of information disclosure affairs should speed up plans to assign tasks that include formulating organisational rules, regulatory documents and self-regulating regulations to all the related organisations as soon as possible in 2015.

Meanwhile, the information disclosure group should reinforce integration and co-ordination to avoid overlapping rules and unevenly balanced requirements. The day-to-day regulation of information disclosure should be grouped and managed according to the respective information disclosure obligator.

What would be the procedure for investor protection under the new system?

In 2013, the General Office of the State Council introduced its *Advice on Reinforcing the Work of Protecting the Rights of Medium and Small Investors* and comprehensively established a protective system for those investors. The work of protecting investors began to penetrate every aspect of the system and the entire process of the regulatory work. The requirement of protecting investors is applied to mergers and restructuring, delistings, the second-board markets and the new OTC 'Bulletin Board' reform.

This helped intensify regulation and encourage the actual controllers of public companies – controlling shareholders and affiliated parties – to honour their promises by improving profit-allocation disclosure systems, supervising cash dividends and increasing the number of companies giving cash dividends.

In 2015, we should continue to implement the General Office's instructions, by strengthening system construction, properly dealing with complaints and disputes, and by continuing to evaluate the new system.

This box contains a summary of a speech, "Deregulation of the OTC, PE and futures markets", made by CSRC chairman Xiao Gang this year at the National Work Conference on Securities and Futures Supervision.

Financial deepening and market reform

Factor price reforms and the macroeconomic policy impact

Another key component of financial reform is to allow factor prices, or input prices, to better reflect economic fundamentals, rather than being controlled by policies. The government has implemented measured liberalisation of interest rates and exchange rates over the past 10 years. While the need for financial reforms to support sustainable growth is accepted in principle among policy-making circles, the timing and the pace have always been controversial as losses in the near term will concentrate on certain segments of the economy, while benefits will be widely dispersed.

The move towards interest rate liberalisation amid weak domestic growth and ultra-low global rates has proven particularly controversial. The reform pains are viewed as acute during economic downturns, such as the one at present marked by sluggish global demand, China's own structural impediments and a downturn of the construction cycle. For instance, bank lending has tended to favour state-owned companies, and overcapacity and high leverage are already placing a heavy burden on these sectors that need to reform.

Adding to this pressure are interest rate reforms, which have occurred incrementally but are already having an impact, which tend to push up the borrowing costs of banks. In particular, the rapid increase of 'wealth management products' offered by banks and other financial institutions effectively puts pressure on banks' borrowing costs from savers – either directly or indirectly through competition. Better risk pricing should also be reflected in an increase of the credit spread between good and bad borrowers. Both developments will lead to an increase in the cost of funding for weak companies – at present concentrated in cyclical sectors and exhibiting overcapacity. Therefore, interest rate reforms tend to push up the risk-free rate, and widen the credit spread between good and bad borrowers.

Easing of monetary policy?

Should monetary policy be eased substantially because of this structural change? A higher interest rate, and in particularly higher borrowing costs for weak borrowers, would force economic restructuring towards higher efficiency and better allocation of capital, which is an intended result of interest rate reforms. The overall impact on the corporate sector will be partly offset by the relaxation of the overall financial envelope. In the past, financial repression comprised low interest rates and credit rationing. With financial reforms, loan quotas are being relaxed (such as the latest change in the calculation of the loan/deposit ratios), allowing more lending to take place at a somewhat higher average rate than before. For those borrowers that had to rely on self-financing before, the deregulation of non-bank financing helps to lower their funding costs.

A higher interest rate is therefore perhaps a necessary process for China's reform and transition. China's structural problems have manifested themselves into rising leverage in recent years. Loosening monetary conditions will perpetuate some of these problems.

Learning from Japan's mistakes

The Japanese experience has served as a cautionary tale, where loose monetary policy can delay necessary adjustment. The Japanese experience in the 1990s, when 'zombie' companies were given a lifeline via low interest rates and loose monetary policy conditions, wasted financial resources and dragged down long-term growth.

Timing is also a factor: China is moving quickly towards an ageing society, so politically difficult reforms will need to be conducted during a period when growth fundamentals still remain relatively favourable. The former research chief of the People's Bank of China (PBOC), Jin Zhongxia, who is now executive director at the International Monetary Fund, discusses how interest rate liberalisation should be pursued with an eye towards macroeconomic conditions (see box below).

There is another (albeit comparatively easier-to-manage) challenge: China is liberalising interest rates in a world economy where central banks have deployed extraordinarily low interest rates and quantitative easing to hold down long-term rates. The interest rate gap between China and developed economies widened substantially in 2013 and early 2014, before narrowing in the second half of 2014 as inflation pressures in China declined. While the interest rate gap has narrowed, it will likely remain positive, putting pressure on the exchange rate.

Two trends have so far balanced this pressure. The first is the portfolio diversification of Chinese residents into overseas housing and equities. The second is the fast expansion of global investment by Chinese companies and state sectors (see section three, pp. 59-84). Therefore, despite the positive interest rate gap, there has been little reserve accumulation since early 2014, and capital flow pressure should continue to ease as the US enters its phase of likely interest rate hikes.

Constraints on significant monetary easing during the cyclical downturn are partly balanced out by the more active fiscal stance now pursued by the Chinese government. The annual budget announced during the National People's Congress (NPC) meeting in March 2015 envisaged an increase of fiscal deficit from the previous year (2.3% of GDP in 2015 versus 2.1% of GDP in 2014). In fact, finance minister Lou Jiwei said the underlying deficit target is still higher, amounting to 2.7% of GDP, once adjustments have been made for technical factors. In addition, the government now plans to "appropriately issue project-linked government bonds", implying a more explicit use of fiscal tools to support the economy during the economic downturn.

> "The move towards interest rate liberalisation amid weak domestic growth and ultra-low global rates has proven particularly controversial"

In light of the still-modest government debt (less than 50% of GDP) and the robust balance sheet of the government, a more active fiscal stance should ensure a favourable balance between growth and financial reforms. n

INTEREST RATE LIBERALISATION AND MACROECONOMIC CONDITIONS

Some parties believe the lending rate only affects resource allocation and the deposit rate only affects income distribution. As a result, deregulating lending rates can basically fulfil the requirements of interest rate liberalisation, while the deregulation of deposit rates can be put on hold.

This judgement may be desirable at the beginning of interest rate liberalisation, but with the advance of interest rate reform, there is a need to understand that deposit rates also affect the allocation of resources.

The reason for this is because low deposit rates drag down lending rates in terms of the cost of capital while also exaggerating the rate of return in social capital investment by banks by keeping their profit margins artificially high.

The consequence is that banks are more likely to overexpand than other financial institutions, so reducing the role of indirect financing. Moreover, if deposit rates are kept deliberately low, it may cause asset price bubbles, as depositors are likely to put their money elsewhere by investing in property, stocks or other assets. Therefore, deposit rates not only influence income distribution, but also resource allocation.

The soft budget constraint

Another view is that interest rate liberalisation in China is hard to advance rapidly because of the existence of the 'soft budget constraint'. For example, state-owned enterprises or local government financing platforms, which are by nature owned by the government, are not sensitive to the changes in market rates. As such, the impact of interest rate liberalisation on curbing investment is reduced. But this can be challenged on two fronts.

First, for some state-owned enterprises or local government financing platforms, insensitive interest rates do not equate to invalid interest rate adjustment. The fact that interest rate changes do not immediately affect the profit and loss does not mean the signals released to asset owners are invalid.

The reason why they didn't go bankrupt immediately after is that their interest rate costs tend to be fixed for a certain period of time. Once such a 'lock-up' period is over, the impact is felt. Therefore, insensitivity within a short time window doesn't mean invalidity.

Second, those state-owned enterprises that are sensitive to interest rate changes should be managed in a more systematic way to deal with the (potentially negative) effect of interest rate reform. For example, the authorities could design a series of plans before interest rate liberalisation that replaces implicit subsidies under interest rate controls by explicit subsidies, thereby reducing distortions in the system. This would be favourable to the economy. Therefore, failure and re-capitalisation caused by interest rate liberalisation is actually beneficial for the structural adjustment in large institutions.

Macroeconomic control

Another concern is that interest rate liberalisation may cause trouble for a country's macroeconomic control, as it is likely to raise the overall interest rate when the economy is experiencing downturn and economic growth slows down. This should be analysed from two viewpoints.

First, both deposit and lending interest rates are dual-track rates. This means that depositors and lenders, banks and real economic agents face the weighted average price of the official price and the market price. The lower the official rate, the higher the market rate. Therefore, banks are actually using the market rate to subsidise the official rate. Businesses – especially small, medium and micro-sized enterprises – are subsidising large and medium-sized enterprises with

Jin Zhongxia

higher interest rates. Although the official interest rate is low, it is hurting the real economy. This manifests itself in financing difficulties and high cost for small and micro-sized enterprises. After interest rate liberalisation, the equilibrium must be within the range of the current official interest rate, the base deposit rate and market interest rate. Nevertheless, adjustments in monetary policy would be needed if the new equilibrium rate is still high after interest rate liberalisation.

Second, China's financial market liberalisation needs to be speeded up compared with advanced economies and other emerging economies. Both bond markets and stock markets should attract international investors, with foreign companies issuing bonds and going public in China.

Previously, the international development was delayed out of consideration of Hong Kong's position as an international financial centre. But supporting Hong Kong should not be at the cost of delaying the liberalisation of the mainland's financial market.

Jin Zhongxia is executive director for China of the International Monetary Fund.

DBS

Defining the 'new normal'

Setting ambitious targets and reaching them fast has been essential to China's dizzying economic success story for more than three decades. But this growth-at-any-cost push is now being replaced with what China's leaders call the 'new normal'. By *Chris Leung*, senior economist, and *Lily Lo*, economist, DBS Group Research

The 'new normal' is billed as a balanced and holistic development approach that strives for 'quality' – even if that means lower – growth. And, overriding importance is being placed on ethics, equality, justice and social harmony.

This sweeping sea change is powering a comprehensive policy overhaul, and investors and businesses – both outside of and within China – must understand that many old ways have either already gone or are on their way out.

There have been some major reforms already, such as deregulating key utility prices, experimenting with free trade zones, amending budget laws to allow local governments to issue debt conditionally, reforming the hukou (household registration) system, trying out mixed-ownership for some state-owned enterprises (SOEs), strengthening the foundation of law and even relaxing the one-child policy. And, more far-reaching change is to come.

Macroeconomic management

Monetary policy recalibrated

The government seems willing to accept slower growth rates as it presses on with structural reforms. This year, it lowered China's gross domestic product (GDP) growth target to around 7%, down from around 7.5% last year (see table 1).

"China is slowing, but I do not believe there will be a hard landing. Growth is tipped to come in at 7%, or maybe in the high 6% range in the short term. That is still a lot of growth. There is growing consumption, trade and investment in China, and the economic energy remains palpable. Even at 7%, that is substantial growth on which to build business," says Piyush Gupta, chief executive of DBS.

"I also do not see China facing a systemic fiscal, financial cliff on the back of its macro issues. While debt levels have increased significantly, China has the resources to deal with this at a macro level. With more than $4 trillion in reserves, they can quite easily recapitalise the system if they need to, and choose to do so."

Andrew Ng

The inflation target has also been lowered to around 3% from around 3.5% in 2014. The government has stressed the importance of 'monetary prudence', despite decelerating domestic demand. Nowadays, the aim of monetary policy is not to engineer a V-shaped rebound, but to support growth, which is a profound departure from past macroeconomic policy.

There is also a new approach to dealing with excessive credit-driven growth. Even though annual GDP growth has dipped below 8.0% since 2012, and decelerated to 7.4% in 2014, monetary loosening has remained largely restrained. The central bank mitigated the impact of temporary liquidity crunches with short-term liquidity operations, standing lending facilities and medium-term lending facilities. It has also lowered the reserve requirement ratio (RRR) for designated banks to boost lending to rural and small businesses. Moreover, sparing interest rate cuts have been counterbalanced by interest rate liberalisation in the form of deposit rate ceiling relaxation.

"With the new deposit insurance scheme, covering deposits of up to 500,000 yuan, effective on May 1, the time to liberalise the deposit rate is fast approaching," says Andrew Ng, head of treasury and markets at DBS. "The major impact is that net interest margins will come down. At the same time, banks will be able to effectively compete with shadow banks and internet non-bank players, and may benefit from capital market reform. So their revenue mix should become more healthy. Some smaller banks may struggle a little, but the negative impact is not likely to be that great."

However, capital account reform is likely to remain limited in the near term. "I do not believe the capital account will be fully liberalised in the next one to two years. Instead, there is likely to be ongoing partial liberalisation and a simplification of procedures," says Ng. "However, the free trade zones in Shanghai and elsewhere are good places to test how full-capital account liberalisation could work on a nationwide basis."

Moving ahead, the People's Bank of China (PBoC) is likely to pay more attention to property prices than to blips on the Consumer Price Index (CPI). With property prices still moderating, one more rate cut and a further 100 basis point reduction in the RRR could be on the cards (see figure 1).

Fiscal reform accelerates

Most of China's local governments are debt burdened, with limited autonomy to raise their own funds. For decades, revenues have been divided between the central and local governments more or less equally, even though the latter are responsible for nearly 80% of public expenditure (see figure 2).

To make up this shortfall, local governments have resorted to wasteful transfer payments from the central government. They have also pursued extra-budgetary land revenues, often resulting in unfair land expropriation and overinvestment in property. Many took on mountains of debt via local government finance vehicles.

The central government has acknowledged the urgent need for reform, particularly as the economy slows. In mid-2014, China's Ministry of Finance set up a pilot programme in which 10 local governments – including Beijing, Shanghai and Guangdong – were empowered to issue bonds. To help make this work, budgetary information is being made more transparent. The central government is also seeking better long-term solutions, which might include local governments raising their own taxes.

Meanwhile, some quicker fixes have been put in place. The Ministry of Finance has permitted local governments to convert as much as one trillion yuan of high-yielding debt (out of 17.9 trillion yuan) into lower-yielding municipal bonds. This is to reduce interest rate burdens on local governments.

"In the quest for market-oriented reform, I believe that all state entities will no longer receive the same kind of support they once did, and this could cause problems, particularly in the property and property-related sectors," says Gupta. "There could also be idiosyncratic counterparty risks, as the ongoing anti-corruption drive could create risks for companies related to the affected individuals. What this means is that a rising tide will no longer carry all boats. With structural reform, some individual companies will go. It is therefore important to focus on the kind of business you're doing and the relevant counterparties."

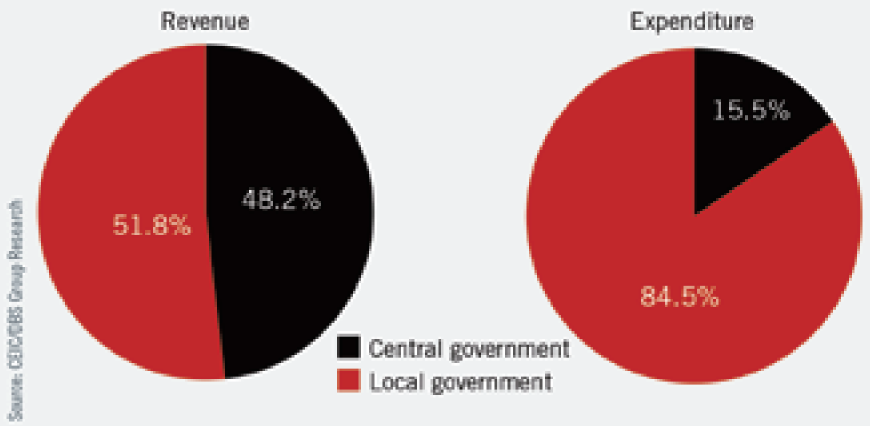
Table 1: Key macroeconomic targets

	2015	2014
Real GDP growth	around 7%	around 7.5%
CPI	around 3%	around 3.5%
M2 growth	around 12%	around 13%
Total exports and imports growth	around 6%	around 7.5%
Fixed assets investment	15%	17.5%
Retail sales	13%	14.5%
Registered urban unemployment rate	not to exceed 4.5%	not to exceed 4.6%
Budget deficit to GDP	2.3%	2.1%

Source: Report on the Work of the Government/DBS Group Research

Figure 1: Monetary policy 2003–2015

Figure 2: Average share of national government revenue/expenditure 2010–2014



Flexible exchange rate management

China's growth rate is slowing, while disinflation in the CPI and deflation in the producer price index (PPI) deepen. Against this backdrop, Beijing is permitting the renminbi (RMB) to weaken against the US dollar via cuts in both interest rates and the RRR. This is a major departure from the past, when China steadfastly kept the RMB stable against the US dollar during crisis episodes (see table 2).

A turning point came in the Q1 2014 when the PBOC engineered RMB depreciation and altered expectations of a one-way bet on the currency. Although the RMB stabilised by Q3 2014, an interest rate cut in November triggered market expectations of further RMB depreciation in 2015. Indeed, the RMB continued to weaken in Q1 2015.

There are several possible explanations for what was a clear divergence from past exchange rate management:

1. Exchange rate depreciation is being used to help cushion China's economic slowdown.
2. Many currencies are depreciating against the US dollar, including the Japanese yen and the euro, thanks to new rounds of quantitative easing. As a result, the RMB appreciated 6.2% against other currencies in trade weighted terms in 2014. Moreover, China's cost of labour had risen substantially since its entry into the World Trade Organisation.
3. The Chinese government is now committed to greater exchange rate flexibility. In March 2014, the RMB trading band was widened from 1% to 2%.

"Many attributed the renminbi depreciation last year to the central bank. But the depreciation of the renminbi this year seems to have been driven by corporates, including the multinationals," says Ng. "The end of US quantitative easing and an expected Federal Reserve rate hike has led the dollar to appreciate significantly against all the major currencies except the renminbi. So, for major corporates, it is prudent to pare down US dollar borrowings and switch from renminbi to US dollar. But most of the US dollars are still sitting in the Chinese banking system, with the US dollar deposit share in the Chinese banking system rising in the first quarter."

Table 2: RMB behaviour during export growth decline

	Asian financial crisis
1997	21.0%
1998	0.5%
Swing	20.5%
RMB appreciation	0.0%
	US tech bubble burst
2000	27.9%
2001	6.8%
Swing	21.1%
RMB appreciation	0.0%
	Global financial crisis
2008	17.4%
2009	-16.0%
Swing	33.4%
RMB appreciation	0.0%
	European sovereign debt crisis
2011	20.3%
2012	7.9%
Swing	12.4%
RMB appreciation	1.0%
	Current situation
2013	7.8%
2014	6.0%
Swing	1.8%
RMB appreciation	-2.4%

Source: CEIC, DBS Group Research

Socio-microeconomic management

Thirty years ago, fewer than 200 million people lived in China's cities and towns. Today, this figure is around 700 million. This migration supplied the urban labour force needed by China's export-driven economic boom. Urbanisation remains a key policy and the government wants to reach a 60% urbanisation rate by 2020. That will be a tall order, as it will require a 1.1% increase in the annual urbanisation rate on average, compared with 1.0% from 1978 to 2013.

Rapid urbanisation in the past was largely driven by pull factors such as employment opportunities in cities and large urban-rural wage gaps. But these gaps have narrowed in recent years and, from now on, push factors need to play a bigger role. For instance, the benefits of rural residency – primarily the allocation of a plot of farmland – sometimes outweigh the benefits of migration to a city. A 2011 survey in Sichuan province found 90% of migrant workers wanted to keep their rural status and did not want an urban hukou as, under existing laws, farmers are unable to transfer or sell their rural land use rights even if they have moved to an urban area.

Also, many cities were simply overcrowded in the past. The three largest cities contained 14% of the population, but took up less than 3% of China's land area. Migrant workers with rural hukou status were not entitled to many of the social welfare benefits that were afforded to registered city dwellers. Urbanisation under the new normal is likely to emphasise efficiency and equality, particularly through hukou and land reforms.

In the area of hukou reform, migrants coming to cities must meet a set of criteria before they can apply for local resident status – the larger the city, the more stringent the criteria. This serves to minimise overcrowding in the most populous cities and encourage migration to the less populous. Eventually, local governments are expected to go further and scrap rural-urban distinctions altogether.

Institutional reform

Much of China's future success will depend on institutional reforms that engender the credibility of governance and deepen trust.

President Xi Jinping's anti-corruption campaign is currently centre stage. The temporary crackdowns of the past simply purged political opponents and asserted authority, but this campaign is perpetual in nature and seems to be intensifying. During the past two years it has ensnared both 'tigers' (top party leaders) and 'flies' (low-ranking officials). According to reports, close to 200,000 corrupt officials have been arrested, demoted or dismissed.

The other big wave of reform is the simplification of the bureaucratic structure. China has recently abolished the Ministry of Railways, which was folded into the Ministry of Transport. It has also dismantled the State Population and Family Planning Commission.

> *"There is growing consumption, trade and investment in China, and the economic energy remains palpable. Even at 7%, that is substantial growth on which to build business"*
>
> *Piyush Gupta, chief executive, DBS*

But deeper institutional reform will require the state to cede active participation in the economy. Although privatisation of SOEs is not uncommon nowadays, the state still retains effective control of many of them. Major tangible benefits are likely to come if the state lets go. When disinflation and deflation hit between 1996 and 2003, China ended direct subsidies to SOEs and made them accountable for their performance. The number of SOEs in that period fell from 262,000 to 146,000. The corporate performance of the remaining SOEs, in terms of return on equity (ROE), improved markedly from 0.4% in 1998 to 6.7% in 2003, according to the Ministry of Finance. The government, however, did not allow SOEs to be sold or shut down easily after 2003. As a result, many inefficient SOEs survived simply because the banks continued to lend to them – regardless of risk – on the assumption that the government would not let them fail. Unsurprisingly, the financial performance of SOEs deteriorated until now.

Foreign policy

Beijing is starting to flex its economic strength as it pursues its foreign policy goals. This approach is embodied in a grand international infrastructure and development initiative dubbed 'one belt, one road'. It aims to build highways, ports, railways and so on throughout a Silk Road Economic Belt across the Eurasian land mass. Similar ambitions are planned for the Maritime Silk Road, or 21st Century Maritime Silk Route Economic Belt, which is to take in the South China Sea as well as the South Pacific and Indian Oceans.

To do this, China is setting up, and largely funding, the Asian Infrastructure Investment Bank (AIIB), a multilateral lender for development projects. In the process, Beijing is showing it is now an economic giant with significant diplomatic clout. Dozens of countries in Asia and Europe – many of them long-time allies of the US – as well as Russia and India, signed up as partners in the AIIB. This was despite initially strong misgivings from Washington, which for decades has dominated the international developmental lending space. But, even American resistance seems to be softening. The AIIB initiative could also hasten the internationalisation of the RMB.

Conclusion

China is embracing long-term change and ongoing reform. Monetary and fiscal policies are being recalibrated in the pursuit of quality growth. GDP and other targets have been lowered. And, the old one-way bet on the RMB no longer prevails. Fears about massive local government debt promise to be assuaged by evolving policies aimed at long-term fiscal sustainability. Some progress has already been made in institutional reform, although much more needs to be done as the government reassesses its relationships with SOEs and presses on with its anti-corruption campaign. On the world stage, China's economic power has given it real diplomatic clout as it pursues new foreign policy ambitions. Welcome to the new normal – which will have massive ramifications on how business is done in China from now on. ■

Financial deepening and market reform

Coping with risks associated with financial liberalisation

While financial reforms will lead to better resource allocation over time, there could be complications during the process. International experience generally points to an increase of volatility in interest rates, associated with an increase of financial fragility and loss of output. Credit and liquidity risks are two prominent areas of vulnerability associated with interest rate reforms, deleveraging and a slowing economy, as is the case with China.

Coping with credit risks

The large economic stimulus in response to the global financial crisis was associated with a significant rise of leverage. Between 2008 and 2014, total social financing – a measure of the non-government debt by the non-financial sector – increased from 130% of GDP in 2008 to 200% of GDP in 2014, although the pace of increase has moderated in the past two years, according to International Monetary Fund data. The deleveraging process in the manufacturing sector will likely be accompanied by a cyclical rise of defaults, which will need to be managed carefully during the economic transition.

Many observers believe it should be possible to manage the debt defaults. The credit risks associated with leverage are mitigated as the balance sheet risks are concentrated in a few state-related sectors, while systemic risks are limited. Chinese households enjoy a healthy balance sheet, with remarkably low debt (20% of GDP) and high savings (30% of GDP). Chinese government direct debt is also low, accounting for less than 30% of GDP. Corporate debt, on the other hand, is relatively high, at 220% of GDP.

Debt burdens are particularly high in two areas: local government and construction-related cyclical sectors. Local government financing vehicles are the main borrowing channel used by subnational governments to supplement their off-budget spending and local construction projects (direct municipal borrowing has been prohibited until now). As a property downturn sets in, local government finds that land sales – the key source of funding for local finances and repaying debt – are dwindling significantly. The financing gap is likely to be greater in lower-tier cities where the housing slump is particularly steep. In response, fiscal remedies, such as more direct central government transfers combined with an improved local debt system, have been proposed to backstop the financing slippage of local governments. Institutionally, the fiscal system of local government and central government, though independent on the surface, is integrated. Central government relies on local government for tax collection and shares local income (70% of tax revenue has been attributed to the central government since 1994), and is also in charge of providing direct transfers.

"Credit and liquidity risks are two prominent areas of vulnerability associated with interest rate reforms"

Cyclical sectors that have high leverage include the overcapacity sectors such as steel, cement and some property developers. Much of this debt will have been restructured, and industrial consolidation/bankruptcy will likely be an inevitable and constructive process to reduce excess.

Financial deepening and reform imply a potential tightening of financial conditions for low-quality borrowers. Indeed, borrowing costs for these companies have increased since last year, as banks have become more sensitive to default risks. So far, the government has chosen a deliberate approach to allow selective default in an effort to curb the rise of moral hazard (whereby parties take on more risk in the knowledge they will be bailed out should a problem arise), while containing the spread of financial panic. The process has been a lot more measured and slow than the corporate restructuring in the late 1990s, possibly out of concerns for employment.

Liquidity risk concerns

Liquidity risks could also arise during interest rate liberalisation. First, for the system as a whole, there could be the risk of a disintermediation of deposits, given the widening gap between controlled and market rates. In addition, the rapid expansion of wealth management products and money market funds lately has broadened the channels of deposit outflows.

At present, overall liquidity is still ample. Indeed, excess reserves as a share of deposits have risen in the last few years (as other regulatory requirements such as the loan/deposit ratio constrains the ability of banks to lend), pointing to an abundance of liquidity. Banks are largely domestically funded, and mostly by deposits. This contrasts with international examples, such as in the Nordic countries and South Korea, where the reliance on external wholesale borrowing was the cause of a significant liquidity crunch. Chinese banks maintain nearly 20% of deposits with the central bank, even after the recent cuts, and these can be used as a liquidity buffer.

Interbank friction

The second reason for liquidity risks can arise from friction in the interbank market. Despite the system-wide abundance of liquidity, distribution is very uneven. Large commercial banks account for about two-thirds of overall deposits. Regulatory requirements, and in particular the loan/deposit ratio and loan quotas, mean that the large banks have surplus funding to be placed in the interbank market. In contrast, smaller banks, non-banking institutions and foreign banks are structurally short of liquidity as they lack a deposit base and need to access funding from the interbank market. These institutions bear the largest part of the cost of the more expensive interbank funding.

Liquidity pressure was prominent in the second half of 2013, as seen from the spikes of interbank rates. To reduce the liquidity risks, the People's Bank of China (PBOC) added new instruments to its policy toolkit to lend to banks in time of stress. The short-term liquidity facility and short-term liquidity operations were announced by the PBOC in 2013, and the scope of bank eligibility has been expanded in the ensuring months. Central bank funding is now directly available to a broad range of banks when they face liquidity shortages, which should prevent potential systematic contagion. In 2014, the PBOC also introduced pledged supplementary lending, which may be initiated by the PBOC, to offer funds over a three-month to five-year horizon. The introduction of these facilities, along with policy easing, resulted in the volatility of interbank interest rates dropping significantly in 2014. n

INTERVIEW: YI GANG, DEPUTY GOVERNOR OF THE PBOC, DIRECTOR OF THE STATE ADMINISTRATION OF FOREIGN EXCHANGE

What progress has been made in deepening reform, streamlining and decentralising administration, and promoting free trade investment? What are the next steps?

We have stressed five changes in our foreign exchange management philosophy that are vital for the development of our long-term administrative framework.

The move from an approval-based approach to a monitoring-based approach, the switch from pre-regulation to management in the aftermath of an issue, and also the change from behaviour-based management to subject-based supervision – whether it is a financial institution or a company, we will supervise it and it will be responsible for its conduct.

Fourthly, we switched from an assumption of 'guilty until proven innocent' to a philosophy of 'innocent until proven guilty' and finally from using a 'positive' list of approved activities/parties to a 'negative' list of restricted activities/parties.

The five transitions have been in practice for a few years and we have already seen the effects.

Firstly, trade and investment facilitation has improved. We have abandoned the system of mandatory foreign exchange settlement and sales, and comprehensively reformed the verification system for forex payments (imports) and forex receipts (exports), completely cancelling the verification and approval previously needed for each transaction.

This reform has largely benefited enterprises. Our research indicates the average time for settling a transaction used to be 20 minutes, and it is now less than 10 minutes.

Meanwhile, we have greatly simplified the foreign exchange administration for trade servicing, shortening the receipt and payment time from 20 minutes per transaction to five minutes per transaction, so enterprises have enjoyed increased convenience and lower transportation costs.

We have also made progress in capital accounts. Through streamlining administration and delegating power to lower levels, particularly simplifying foreign debt, direct investment and overseas direct investment, we have steadily promoted the convertibility of capital accounts. Thirdly, we have considerably reduced administration approvals. In the recent few years, we have cut this by about 70%, which helps improve the competitiveness of Chinese enterprises and financial institutions.

Yi Gang

Lastly, I should emphasise that while we have streamlined approval procedures, we have still needed to strengthen supervision because of all kinds of uncertainties, including liquidity risks associated with cross-border capital flows that still exist in volatile global financial markets.

Therefore, while promoting facilitation, we must pay great attention to risks. We must strengthen supervision to prevent systemic problems. At the same time, we will continue to streamline administration and delegate power to lower levels and further increase the competitiveness of Chinese enterprises and economy.

What do you make of the recent depreciation of the renminbi?

A country's foreign exchange rate is one of the main instruments measuring the overall soundness of its economy and its finances. In 2014, the euro and yen fell by more than 10% against the US dollar, while the renminbi declined by 2%.

This means the real effective exchange rate and nominal effective exchange rate of the renminbi has increased compared with the euro, the yen and a basket of global currencies.

If the US dollar is the strongest currency, it is fair to say that the renminbi is the second-strongest one. In many developing countries, capital is flowing out and currencies are depreciating considerably.

The renminbi remains the most stable and strongest currency among all the Brics nations (Brazil, Russia, India, China and South Africa).

We should assess the trend of renminbi exchange rates comprehensively against a basket of global currencies, rather than against the dollar alone.

From the perspective of the international balance of payments, economic growth rates and the degree of renminbi globalisation, China's exchange rate absolutely has the basis of a fundamental stability and reasonable equilibrium.

What is the long-term trend for the renminbi?

Firstly, the prospects for Chinese economic growth still look good. Although the past high speed of growth is lowering and becoming medium-high, the growth speed is still relatively high compared with the majority of the world.

Secondly, the Chinese current account surplus is still big. Exports exceed imports, which is extremely important for the stability of the fundamentals of the foreign exchange market.

Thirdly, renminbi globalisation has accelerated. The world has a demand for the currency in areas such as trade, overseas investment and capital allocation.

Foreign capital management companies and individuals are willing to hold renminbi bonds, stocks and other assets.

Interview: Xiao Gang

Xiao Gang

What are the specific tasks and measures with respect to comprehensively deepening the reform of the capital markets?

The reform of the capital markets has involved four aspects. The first is to further develop the multi-level stock market, including the main boards, small cap boards, the Growth Enterprise Market (GEM) and the New Third Board – a national share transfer system for small and medium-sized enterprises (SMEs). The State Council has made the decision to extend the scope of the New Third Board nationwide. The second aspect is to further deepen the reform of the bond market. Third is to further develop futures and derivatives markets and fourth is to vigorously develop the private market. In the past few decades, we mainly took measures in the public offering market, while now we need to vigorously develop the private market with regard to the improvement of a multi-level capital market system.

How should you balance the need for reform and stock market volatility that may emerge in reaction to the reform process?

Stock market volatility occurs not only in emerging markets but also in developed countries. China's capital markets are still not very deep, so we need to advance reforms to assist market, legal and international development. Along the way, it is essential to control or balance the reforms at a manageable level for the market, which is a challenge for the China Securities Regulatory Commission (CSRC). We should always pay attention to this balance when we research the measures to propel reform. The Third Plenary Session agreed to promote a registration system to reform the offering of stock, so we need to follow the spirit of this gradually to propel the reform. I believe that through constant market-orientated reform, our markets will become increasingly mature. But even in mature markets, fluctuations are inevitable.

Is there any reform regarding securities margin trading?

The financing business has developed rapidly over the past two years. When dealing with margin trading business, some securities companies have violated laws or rules. So we have conducted on-site inspections of two groups and dealt with the violations by certain companies. During the two inspections, we corrected the irregularities, but also heeded the voices of market participants, such as customers and securities companies, with respect to margin trading business. Now we are revising the regulations for margin trading business.

While some areas may be relaxed, others will need to be tightened with the aim of promoting the development of margin trading businesses while guarding against systemic risk.

What is the role and task of the capital markets in the future?

This is a period of historic opportunities for enhancing the proportion of direct financing and for developing the capital market. The economy has entered the 'new normal', but the proportion of direct financing remains low and the financing costs of society as a whole are high.

The solution to these problems and the adaptation to the 'new normal' will depend on a well-developed capital market. Some have argued the proportion of direct financing in China remains low because financing mainly falls on the banks. This problem refers to the imperfections in the reform and the system of our capital market. There are underlying reasons why direct financing develops fast in China while indirect financing develops slowly. The development of direct financing also needs to be supported by an improved legal environment, culture and credit system.

What about the changes to listing rules in China?

We are working on the registration system reform of stock offerings, and there is no obstacle to the amendment at present. All parties in the market have been engaged in discussion about how the registration system should work.

The main view is that the verification of registration system should be devolved to stock exchanges, but the final decision needs a legal basis. In terms of the CSRC's preparation, we have been working on registration system reform for more than a year, and are confident that after two years of preparation, we will conduct a sound reform of the registration system once the revised Securities Law is passed.

Superficially, the registration system reform is the shake-up of the initial public offering (IPO) system. However, it actually involves all aspects of the capital market, as it will push market entities into playing their respective roles. Therefore, the reform involves all aspects of the capital market.

Can you explain the impact for the IPO process?

Prior to the launch of the registration system, the quota of stock offerings in 2015 was distributed equally each month, and increased where appropriate.

The specific verification schedule depends on the progress of the Issuance Examination Committee, and we will not artificially set a specific quota. According to current forecasts, the total number is expected to exceed that of last year.

Does this include IPOs of enterprises that are not yet profitable?

This is also one of the items in the revised Securities Law. Companies that are not yet profitable often belong to emerging industries, so we must pay attention to their characteristics and corporate governance, such as management options and staff incentive schemes. At the same time, we should set appropriate requirements for investors operating at different levels in the market.

According to the revised draft of the Securities Law, which is going to be published soon, we should call off the profitability requirements of businesses that are still waiting to be listed. That means listed companies may not necessarily be profitable, but it does not mean that junk stocks can be listed. Firms that are not yet profitable may have a promising future, which should be determined by the market. And we should further specify the requirements of information disclosure, including firms' business models, revenues, customer base, research and development, equity incentive mechanisms and corporate governance, to let the investors make decisions.

What is the transfer board mechanism?

The transfer board mechanism in a multi-level market is complex. Currently, a pilot project will start in the second half for a transfer board mechanism between the New Third Board and the GEM. The formulation of the transfer board plan is one of the important tasks in the reform process. Currently, we are conducting research about the regional equity markets. As the regional markets are complex and different, we are still formulating plans for the adoption of common standards in regional markets.

And the Shenzhen-Hong Kong Stock Connect programme?

The preparation for the programme is under way. Once conditions permit, the CSRC and the Hong Kong Securities and Futures Commission will conduct a joint examination and issue an announcement. The Shenzhen-Hong Kong Stock Connect programme is likely to be authorised in the first half of the year, with technical preparations made following the announcement. However, the preparation period is relatively short, so the scheme is expected to operate formally in the second half of the year.

The investment quota may be determined based on the formula used for the Shanghai-Hong Kong Stock Connect programme. At present, we do not intend to emulate the experience of the Shanghai-Hong Kong Stock Connect scheme by conducting similar co-operation in markets of other countries or regions.

"Now we need to vigorously develop the private market with regard to the improvement of a multi-level capital market system"

Since A shares will become accessible, will they be included in the MSCI Index?

Work to ensure A shares are included in the MSCI Index is ongoing, and we are likely to see results within a year. Once included, the A share market will be open to investors worldwide. Therefore, the main obstacle to the realisation of A shares being included in the MSCI Index lies in whether renminbi can achieve free convertibility under the capital account and the corresponding quota. But it is expected that crude oil futures trading will be officially launched this year.

Since it is the first time that foreign traders and brokers can directly be involved in the internationalised crude oil futures market, the relevant authorities have been trying to standardise rules and regulations.

The CSRC has drawn up its *Interim measures for the administration of futures trading of overseas traders and brokers involving domestic specific varieties (draft)*. The solicitation of public opinion has ended, and the draft will be released officially after being modified and submitted to the State Council.

How will enforcement change?

The CSRC intends to shorten the cycle of law enforcement, and the preliminary plan is that a case should be closed within 12 months after it is placed on file. At present, among the cases being investigated, only a few of them have not passed the investigation phase. For the cases that were placed on file recently, we should complete the investigation within 12 months and come to a timely conclusion.

What about the development of equity-based crowdfunding?

At present, the revised draft of the Securities Law leaves room for equity-based crowdfunding for the public offering of shares but there is no specification in the law. n

Xiao Gang is chairman of the China Securities Regulatory Commission

GuoZhongHua / Shutterstock

Creating a multi-layered capital market

Dai Xianglong, former chairman of China's National Social Security Fund (NSSF) and former president of IFF, describes four steps needed to develop a multi-layered capital market, which includes addressing important data issues

The Chinese government has attached great importance to the expansion of direct financing, the reduction of the corporate asset-liability ratio and the improvement of economic growth. For example, the Third Plenary Session of the Fourteenth Communist Party of China (CPC) Committee decided in 1993 to expand the ratio of direct financing. In 1997, the Fifteenth CPC National Committee report pointed out the importance of multi-channel capital raising in building up funds for state-owned enterprises. And in 2007, the Seventeenth CPC National Committee report again proposed the need to increase the percentage of direct financing.

Possible monetary policy malfunction

Regarding the corporate asset-liability ratio, because of the lack of capital, corporations tend to have an intense demand for credit. This can be a problem, as when there is a need for tightening monetary supply from the macroeconomic point of view, companies that totally rely on credit would find it hard to maintain their businesses. Therefore, with an underdeveloped capital market and a high corporate asset-liability ratio, the central bank's monetary policy could malfunction.

Dai Xianglong

Data disparity

Because of missing data in the national statistics system, the Chinese government's proposals have not always achieved the expected results. A gap between the registered capital and actual capital of China's state-owned and collectively owned enterprises was revealed in the statistical yearbook issued by the country's Industrial and Commercial Bureau. This has resulted in the absence of concrete data for the net assets held by industrial and commercial enterprises. Unfortunately, China's National Bureau of Statistics (NBS) does not have comprehensive data. It is therefore not feasible to test if the amount of capital and direct financing has improved. According to the data, the quantity of loans increased by more than 20% from 1992 to 2012, whereas the registered capital of all kinds of companies increased by about 18%, as reflected by the statistics from the Industrial and Commercial Bureau.

The fact that capital raising grows more slowly than credit leads to the increase in companies' asset-liability ratios, which builds up financial risk, blocks the implementation of monetary policies and puts pressure on the banks.

Social capital statistics needed

Therefore, a social capital statistics system needs to be established as soon as possible to facilitate the creation of a more substantial capital market. The government – through the NBS and the Industrial and Commercial Bureau, for example – is responsible for leading the data collection of companies' asset and liabilities and analysing the data included in the Fifth Economic Census of China, to establish a capital statistics system centred on companies' assets.

A clear demonstration of the channels, direction and returns involved in the transformation from social capital to corporate capital funding is favourable to expanding direct financing and developing the capital market. A clear development expectation for the multi-layered capital market would provide the dynamics and pressure to push forward reforms.

The NBS has obtained statistics from all kinds of corporate assets, setting a solid foundation for gathering more detailed data. Universities should participate in the study of raising and the market allocation of social capital. In China, capital allocation is the most important issue. Lending without knowing the capital amount can only be detrimental to economic development.

"A gap between the registered capital and actual capital of China's state-owned and collectively owned enterprises was revealed"

Steps to a multi-layered market

To achieve a multi-layered capital market, important steps need to be taken.

First, more work needs to be done to implement initial public offering (IPO) reform and strengthen the supervision of public companies. The loose structure of the debt market requires oversight and approval before debt is issued. Public companies need approval from the China Securities Regulatory Commission (CSRC), while private companies need to be approved by the National Development and Reform Commission (NDRC) and the People's Bank of China (PBOC).

Renminbi internationalisation

It is impossible to fulfil real renminbi internationalisation without a fully fledged debt market. The PBOC has quoted the total amount of social financing needed to develop a multi-layered capital market. The first variable is loans, which have fallen by 30% in the decade to 2013, according to PBOC statistics. The second factor is direct financing, including capital financing, debt financing, entrusted loans, trust loans and bond issues. In addition to the stock market and debt market, it is important to develop private equity and over-the-counter profit-sharing equity trading to form a multi-layered capital market.

Second, more institutional investors are needed. The development of the capital market largely relies on institutions and the public. Existing commercial insurers hold 9 trillion yuan of assets, with the urban workers' pension insurance holding 3.3 trillion yuan. The National Social Security Fund has reached 1.3 trillion yuan. The Third Plenary Session of the eleventh CPC National Committee decided to inject state-owned assets of as much as 30 trillion yuan into the social security system. So it is important to strengthen the participation of institutional investors, including those from overseas.

Third, improving the bond industry. Financial institutions comprise commercial banks (which cover currency, lending, buying and selling) and investment banks (which manage capital and property). Data from the Securities Association of China shows that, at the end of 2013, there were only 115 investment banks and bond companies in China, with total assets of 2.1 trillion yuan and average revenue of only 1.4 billion yuan. The biggest – CITIC Securities – is around one-sixth the size of US financial institution Morgan Stanley. It is necessary to restructure large security companies and attract foreign investment banks.

At present, the overseas (including Hong Kong) banking industry's assets – which reached 2% after the country joined the World Trade Organization (WTO) – comprise 1.8% of the industry's total assets. Foreign capital stock makes up 3% of the revenue of China's securities industry and overseas capital in the insurance industry is about 4%. The proportion of the banking, securities and insurance industries in the market are 2%, 3% and 4% respectively, as China continued to remain cautious to opening up after joining the WTO, at the time of the Asian financial crisis.

Within the past decade, China's financial reform has equipped it with more competitiveness, and it is therefore more able to attract overseas securities companies. For instance, China's WTO agreement restricted securities companies' foreign stock capital to no more than one-third of their total capital, which was raised to 49%. But this still poses challenges for overseas securities companies. n

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China joined the WTO in 2001

Reform and the Shanghai Free-Trade Zone

Zhou Hanmin, vice-chairman of the Shanghai People's Political Consultative Committee, describes how the creation of the Shanghai Free-Trade Zone represents China's fourth phase of opening up, and stresses the next steps are for China to be included in US and EU-led free trade agreements

It has been over a year since the Shanghai Free-Trade Zone (SHFTZ) started operations. This revolutionary achievement is the culmination of a 36-year period of reform and opening-up that can be divided into four phases. From the late 1970s and early 1980s, China established four Special Economic Zones and 14 open coastal cities.

Then, the Shanghai Pudong New Area was introduced in 1990 and a total of 14 new districts established, including the latest, Qingdao West Coast New Area. Another critical development was China successfully joining the World Trade Organization (WTO) after 15 years of negotiation in December 2001. The fourth phase of reform is the establishment of the Shanghai Pilot Free-Trade Zone.

Comprehensive reform in SHFTZ

The SHFTZ represents policy innovation and has required reform of both policy mechanisms and the legal system. The development can be summarised by four points.

First, two revolutions took place regarding the introduction of the pre-establishment National Treatment and the Negative List of Special Management of Foreign Investment policies. There were legal obstacles that would have prevented the implementation of these two new policies.

In particular, China's three basic laws – the Law of the People's Republic of China (PRC) on Chinese-Foreign Equity Joint Ventures, the Law of the PRC on Sino-Foreign Co-operative Enterprises, and the Law of the PRC on Wholly Foreign-Owned Enterprises – require foreign investment projects to be examined and approved by government sectors and be managed according to the State Council's terms. But the new policy implemented in the SHFTZ has converted the usual examination and approval system to more of a monitoring system.

In addition, measures for the management of foreign investment were adopted through the use of a 'negative list', a list of business areas that were not allowed to participate in the SHFTZ.

Therefore, at the fourth session of the Twelfth Communist Party of China's (CPC) Standing Committee on August 30, 2014, an important decision was made: for the subsequent three years, the implementation of the three basic laws would be suspended in the SHFTZ.

This was the first time such a step had been taken since the establishment of the PRC in 1949. Obstacles were removed, while legal guidance and protection were established. On August 1, 2014, the Shanghai Pilot Free-Trade Zone Regulations were implemented, with 59 articles comprising nine chapters covering both the central and local administrative authorities.

This set an example for China's further reform, driven by the rule of law.

Second, was the publication of two 'negative lists'. Around the world, 76 countries use negative lists to stipulate investments that are not allowed in their respective countries. China's first negative list was formulated in 2013, including 190 restrictive and prohibitive measures, accounting for 17.8% of the 1,069 small-economy industries. Any activity that is not on the list is considered legal.

The second negative list was formulated in 2014, with fewer special management measures, as 51 articles were removed. However, the openness and transparency of the list was strengthened, moving it closer to the international standard.

Zhou Hanmin

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Third, two significant opening-up policies were implemented. Since its start on September 29, 2013, the SHFTZ has gradually opened up business sectors, including the financial, shipping, commerce, professional services, cultural and social segments. Within nine months, 23 reform measures on 18 aspects in six sectors have been successfully carried out. The 31 new articles were introduced on July 1, 2014, with 14 articles focusing on the service industry, 14 on manufacturing, two on mining and one on infrastructure. A total of 54 measures had been carried out through the two policy reforms.

Fourth, two great reforms occurred in the government examination and approval system. On December 21, 2013, China's State Council passed a bill to suspend the 32 examination and approval regulations in the SHFTZ. And in September 2014, the council approved the suspension of 27 examination and approval regulations in the SHFTZ, with the total number of regulations suspended reaching 59.

The four points listed above demonstrate the comprehensive nature of the reforms implemented in the SHFTZ and show how China's reforms have converged on international standards.

Negotiation and development of SHFTZ

Further development of the SHFTZ should focus on three multilateral negotiations and one bilateral negotiation.

The first multilateral negotiation is the Trans-Pacific Partnership (TPP) agreement, led by the US. It has been ongoing for about 10 years, focusing on tariff exemptions and the enhancement of non-tariff measures.

Although the US has stated it will not accept any new members before any agreement is reached, China's participation in this negotiation would certainly be meaningful for the present and future agreements reached.

The second negotiation is the Transatlantic Trade and Investment Partnership (TTIP), led by the US and European Union, which would have an influence on China despite the lack of Chinese participation.

This negotiation has been going on for two years. Once concluded, the TTIP, covering 29 sovereign states, would lead to the world's largest free-trade zone and promote economic and trade co-operation between both sides of the Atlantic Ocean. The third negotiation is the Trade in Services Agreement (Tisa), which now has 50 members and covers 70% of the world's trade in services. The three negotiations are related to tariff issues, non-tariff issues and the expansion of core investment.

International finance and investment are closely connected. The expansion of the investment sector is not only linked to direct and indirect investment, but also the internationalisation of the renminbi. Before the full internationalisation of the renminbi, we should guarantee foreign investors can profit freely and transfer funds in a timely manner. Since China joined the WTO in 2001, the country has fulfilled two-thirds of its promise of opening up the service and trade sector.

The rest of its undertaking – that is, the opening-up of the remaining sectors – is much harder to fulfil. Future investment disputes should be presented to the International Centre for Settlement of Investment Disputes, which is located in the US. The measures China took to settle an anti-dumping WTO dispute in 2013 is a good reference.

In addition, there are the important China and US negotiations on bilateral investment, which started in 2009 and have gone through 13 rounds.

China is emerging as a net capital outflow country for the first time. However, the country has still not established a bilateral investment agreement with either the US or the EU. The SHFTZ should have foresight, actively initiating comprehensive experiments, establish a fair investment environment and protect investors' and workers' rights, the environment and intellectual rights. The SHFTZ is expected to be fully prepared for the new challenges included in the negotiations mentioned earlier.

Impact of Shanghai-Hong Kong Stock Connect

First of all, the Shanghai-Hong Kong Stock Connect programme has given Shanghai, particularly the SHFTZ, an opportunity to be further globalised. The connection between the Shanghai and the Hong Kong stock exchanges will bring more direct fair competition at an international level, and it also strengthens the idea of liberalisation. The Shanghai-Hong Kong Connect's most profound impact on the SHFTZ is the deepening of the idea of the rule of law. The public companies' self-management, annual reporting systems, etc, will all be included in the framework of the rule of law.

Finally, as UK prime minister Winston Churchill said during the Second World War, "this is not the end". This is not even the beginning of the development of the SHFTZ. But it is, perhaps, the end of the beginning. ■

> *"This year, China will reach a milestone, becoming a net capital outflow country for the first time"*
>
> *Zhou Hanmin*

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国际金融论坛（IFF）是非营利、非官方独立国际组织，2003年10月由中国、美国、欧盟等G20国家、新兴经济体，以及联合国、世界银行、国际货币基金组织等相关国际组织及领导人共同发起成立，是全球金融领域高级别常设对话机制和多边合作机构，被誉为全球金融领域的“F20（Finance 20）”。

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An effective equity market

Wang Jianxi, member of the Eleventh Session of the CPCC National Committee and chairman of Shenyin and Wanguo Securities, sees the delicate balancing act of supervising the financial markets as key to developing a multi-layered capital market

China's total debt now stands at as much as 260% of its GDP, the highest debt-to-GDP ratio among developing countries, according to a number of studies. Only a few developed economies have higher debt ratios. For example, the total debt-to-GDP ratio for the US is around 300% and Japan at around 400%. Importantly, China's overall debt ratio has rocketed by 80 percentage points from the start of the global financial crisis, when it stood at just 180%. This growing debt burden raises the prospect of the build-up of unsustainable risks that threaten China's future economic growth. The development of effective capital markets, particularly a fully functioning equity market that reaches out across the country, would help to alleviate some of the pressure.

China currently has an inefficient capital market and therefore an unequal resource-allocation mechanism. Financing is centred on indirect credit extended by commercial banks – the major means of funding development. More effort is therefore needed to enhance financing practices, including improving the current low levels of equity financing.

Improvements in equity financing are not just related to large initial public offerings on the main stock exchanges. Just as social demand for resources cannot be fulfilled by debt financing and state-owned commercial banks whose nature, structure and operational processes are not designed for serving small institutions and individuals, so too, the main boards – while undoubtedly important – cannot cover a sufficiently broad scale of institutions. The main stock markets cannot efficiently serve small and medium-sized institutions. What is needed is a multi-layered capital market.

The concept of developing such a market was highlighted in China's Twelfth Five-year Plan, the Seventeenth National Congress of the Communist Party of China's report and various government policy reports. The China Securities Regulatory Committee (CSRC) has also emphasised the need to develop a multi-layered capital market. At present, though, a number of factors weigh against the development of China's capital markets, including regulatory restrictions and restraints placed upon financial intermediaries.

Take the regulation of the debt market: it is not centralised. Debt issued by publicly listed companies is regulated by the CSRC, debt issued by non-listed companies is regulated by the National Development and Reform Committee (NDRC) – formerly the State Planning Commission – and debt issued in the interbank and short-term bill markets is regulated by the People's Bank of China and the National Association of Securities Dealers (NASD). The lack of unified regulation of the corporate debt market has been a concern for the CSRC for a long time. So much so that the body has now given up its authority for the regulation of debt issued by listed companies because of the surveillance difficulties.

While listed companies that are already registered on the CSRC system still fall under the supervision of the CSRC, other corporate debt will now fall under the NDRC. There is a similar issue in the supervision or the 'third market' and the over-the-counter market.

The CSRC had considered passing the authority to the Securities Association of China, but has yet to take action for fear of causing chaos in the market. But the supervision and regulation of the corporate debt market will be taken over by the NDRC.

In addition, the information disclosure system is underdeveloped. The New York Stock Exchange (NYSE), established in 1792, has listed debts issued by the government and companies worth hundreds of millions of dollars without implementing an information disclosure system until 1920. The information disclosure system comprised only a piece of paper. The implementation of the Securities Exchange Act and the establishment of the Securities and Exchange Commission was not realised until 1933. In the mid 1990s, most of the deals on the NYSE involved professional managers.

Wang Jianxi

Shanghai Stock Exchange

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In comparison, China has had collective quotation trading, paperless and primary clearing since the first day of its market establishment. China has had a standard and advanced system from the very beginning. This up-to-date and standard management model would, however, be constrained, especially when financing practices needed to be approved by the CSRC, which would choose to be conservative to assume less responsibilities. And no financing was allowed outside the stock exchange.

Therefore, to develop a multi-layered capital market, it is important to change the approach towards the main board and regional markets from proactive to supervisory, allowing financing only if fraud and other illegal behaviour can be punished, with companies investigated to ensure they meet their legal responsibilities. Supervision is beneficial to the establishment of a multi-layered capital market, which needs to be recognised by the whole of society, including investors and government leaders. It is the fraudster's fault, not the CSRC's, if there is trouble in the market.

Last but not least, central and regional supervisory institutions need to be built at the same time. The CSRC, the China Banking Regulatory Commission and the China Insurance Regulatory Commission are three supervisory institutions under the leadership of the central government. But their resources are far from sufficient to supervise financing behaviour in regional markets.

The regional supervisory bureau established in Wenzhou City, Zhejiang province, is a good example of how to create regional supervisory institutions that can facilitate a multi-layered capital market. At the front line of reform and opening up, Wenzhou has set up a local supervision board that helps to regulate local financial activities and develop local capital markets. Of course, too much supervision constrains development – what we need is appropriate supervision over the capital markets. n

> *"More effort is needed to enhance financing practices, including improving the current low levels of equity financing"*
>
> *Wang Jianxi*

Future-proofing risk

Zhang Shenfeng, chairman of the China Financial Futures Exchange (CFFEX), argues that a real multi-layered capital market must include an active financial futures market to facilitate real-world risk management

The development of the financial futures market is an important building block for a multi-layered capital market, which should include primary issuance, secondary circulation and tertiary risk management services to fully realise an effective allocation of risk and resources. The derivatives market, especially the financial futures market, is an indispensable part of the system. Looking at the past decades of capital market development around the world, whenever there is a spot market, there are also futures and options markets irrespective of whether the underlying are stocks, debt or foreign exchange. There are no exceptions in any major world economy.

Building risk platforms

Thanks to the rapid growth of Chinese financial development over the past few years, up to the third quarter of 2014, financial assets reached 190 trillion yuan, bank deposits 113 trillion yuan, household savings 50 trillion yuan, debt market value of 32 trillion yuan, stock market value 28 trillion yuan and foreign reserves of $4 trillion.

As a result, small fluctuations in equity, interest rate or currency markets will have a major impact on economic and social wealth. So there is a stronger demand for risk management capabilities and an urgent need to have more financial futures and other tools to help hedge against risk.

China needs to build a management platform in a faster and more comprehensive manner to provide instruments and channels for managing risk, especially credit risk.


Zhang Shenfeng

China's financial futures market

China's financial futures market has essentially realised its basic objective. Despite a late start – China did not create its first financial futures product (the CSI 300) until April 16, 2010 – the past four years have seen the positive influence of this index on the overall capital market.

First, stock index futures have acted as a cushion and stabiliser, improving the intrinsic stability of the stock market. Since the Hushen 300 futures started trading on the market, the number of days that the index had risen by over 2% has dropped from 168 to 69 – a decrease of 58.9% – while the number of days that the index dropped by over 2% has declined from 155 to 64, a decrease of 58.7%. Additionally, the annualised volatility of the stock market has dropped by 25%, indicating a decline in systematic risk in the market.

Second, stock index futures have increased innovation in the capital markets, attracting a range of institutions and long-term capital, thereby boosting the core competitiveness of the stock market.

For example, since 2010, financial institutions have issued 1,143 stock products, 770 of which are stock index futures, taking 67.4% of the total, with an asset size of over 120 billion yuan.

Third, stock index futures have acted as a catalyst for the creation of a more prudent investment culture within the stock market. Investors avoid risk through futures, for instance, by purchasing insurance against a fall in their equity portfolio holdings.

The next financial futures products to debut in recent years were five-year treasury-bond futures. These derivatives have been trading on the market again for over a year, and the market has operated smoothly while gradually helping to boost development of the spot market for treasury bonds.

At the same time, the CFFEX has actively adapted to market developments by optimising rules, reducing costs, enhancing efficiency and improving the function of the market. It has achieved several goals:

- Reduced the transaction fee for index futures by 50% (to 0.025%), which has benefited the market and investors.
- Gradually increased the position and day open limit . The position limit was raised from 100 shares to 300 shares, then 600 shares to the current 1,200 shares, which has helped to meet hedging and trading needs.

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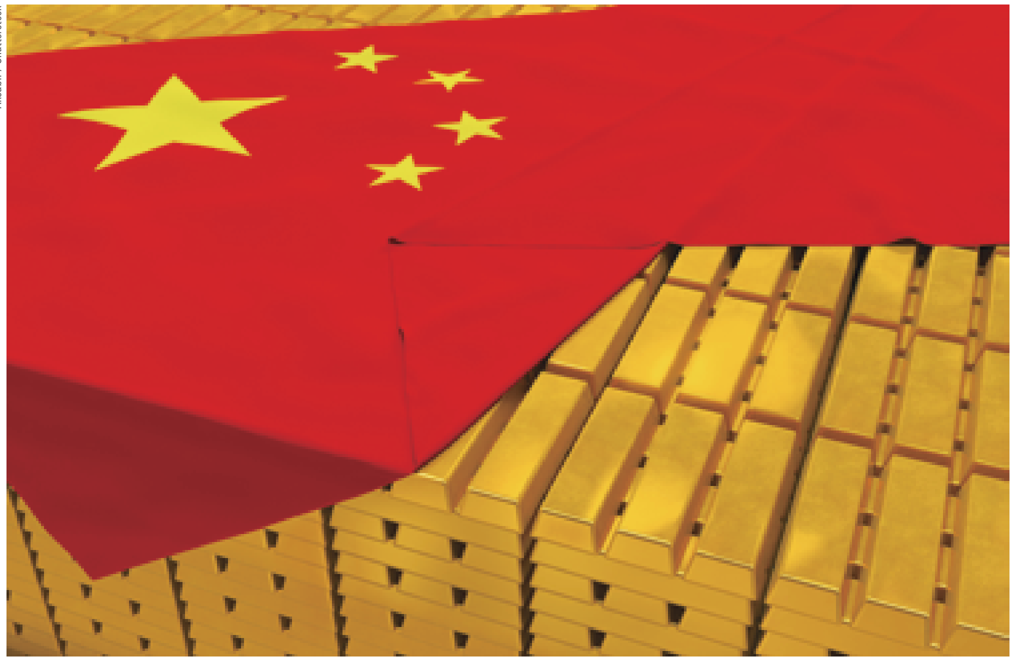

- Implemented a trade-optimised deposit system, which has reduced to 10% the deposit needed for index futures. With the improvement in supervision and risk resilience of participants, there is room for further reduction.
- Created a management support system to meet the needs of all kinds of risk management, simplifying the business process and improving the transparency and efficiency of rules and regulations.
- Diversified the types of trading, and implemented safer and more efficient guidelines, with the aim of facilitating innovation and the balanced development of the market.

Future solutions

Although China's financial futures market has made some progress in recent years, it is still in the early stages of development because of its late start, slow growth, lack of variety and small scale. The development and function of the futures market has therefore been limited and far from sufficient to meet the increasing needs of risk management. The factors that limit the development of the futures market stem mainly from ignorance and prejudice towards futures, as well as a lack of experienced people. Therefore, the futures market needs to be developed in three aspects.

First, there is a need to deepen the understanding of financial futures, overcoming ignorance and prejudice. At present, there is not enough knowledge and understanding about the emergence of the culture of hedging. Some parties have even blamed stock index futures for the continuous decline of the stock market in the past. Second, there is a need to learn lessons from the international financial markets and avoid misunderstandings.

For example, a major source of the 2007 US crisis were subprime mortgages, derived from multiple securitisations that grew into a derivatives market worth tens of trillions of dollars. These multi-dimensional, highly leveraged derivatives no longer represented their early foundation of sharing mortgage risk, and ultimately were instruments of speculation. They highlighted the systematic risks linked with highly personalised, non-standard contracts with low liquidity, poor transparency and insufficient supervision that overtook some of the over-the-counter (OTC) derivatives trading.

Since the G20 consensus in 2009, there have been efforts to address risk in the OTC derivatives business, with high regulatory charges against bespoke products and the requirement for standardised products to be cleared through central counterparty clearings.

Meanwhile, stock index futures and other exchange-traded products operated relatively smoothly during the crisis, seeing increased trading volumes that helped to mitigate and transfer risk. Unlike the US, China does not have sufficient experience in innovation and development. Lessons need to be learned from the subprime crisis, but without overemphasising the risks. We do not want to block innovation and development.

Third, it is necessary to scientifically use the market for economic decision-making. Currently, there are many factors that restrict the development of the financial market, including: the fragmentation in the surveillance of the financial markets; strict administrative control; and the long period before shares are listed on the market.

We should put into practice the proposal raised during the Third Plenary Session of the Eighteenth Central Committee of the Communist Party of China, and actively reduce the length of approval processes, deregulate the market and release more systematic reform benefits. While the government can provide effective macro-control services, the market needs to exert more influence in allocating social resources.

Mature international financial futures products have been used for decades, performing a reliable market risk management function that helps to address price fluctuations and improve economic resilience. It is therefore possible to have the market and government both facilitating development more efficiently.

Currently, the CFFEX is pushing forward the research and innovation of new products, following international market rules and demands, to diversify the system in the following ways:

- Completing the product line of stock index futures by introducing the CSI 500 and SSE 50 futures on the market as soon as possible, and further extending the product lines for small and medium-sized listed companies to meet all kinds of needs in the market.
- Completing the product line of treasury-bond futures, developing a 10-year contract and other major term treasury-bond futures. n

Appendix: Chinese financial reforms

Date	Reform measures	Comments
April 1979	Insurance business resumes	The People's Bank of China (PBOC) announces that domestic insurance business will restart after absence of 20 years.
April 1980	Beijing assumes Chinese relations with the International Monetary Fund	
May 1980	Beijing assumes China relations with the World Bank	
September 1983	Roles of the PBOC changed	The State Council agrees to let the PBOC take the role of central bank.
April 1985	Foreign banks return to China	Foreign banks allowed to set up branches in Special Economic Zones.
December 1990	The Shanghai Stock Exchange opens	30 IPOs on the first day.
July 1991	The Shenzhen Stock Exchange opens	
October 1992	China Securities Regulatory Commission founded	
December 1993	Decision by the State Council announced on the reform of the financial system	The State Council proposes setting up a financial system so that under the leadership of the State Council, the central bank is responsible for implementing monetary policy independently, while commercial banks and policy-orientated banks are separated.
January 1994	Dual-track exchange rate regime removed	Officials announce the adoption of a market-based, unified and managed floating exchange rate regime.
1994	Three policy-orientated banks founded	The China Development Bank (CDB), Export-Import Bank of China (China EximBank) and Agricultural Development Bank of China set up.
January 1996	China Interbank Offered Rate (Chibor) created	A nationwide interbank market set up. As of June 1996, the upper limit of Chibor was removed, marking the first step for interest rate liberalisation in China.
December 1996	Renminbi convertibility under current account achieved	
January 1998	Quota control on credit removed	
November 1998	China Insurance Regulatory Commission founded	
May 1999	Shanghai Futures Exchange founded	
1999	Four state-run asset management companies founded with an aim to deal with nonperforming loans (NPLs)	China Huarong, China Orient, China Cinda and China Great Wall asset management corporations set up, clearing up about 1.4 trillion yuan worth of NPLs in China's banking industry.
February 2002	Rules for Implementing the Regulation of the People's Republic of China Governing Financial Institutions with Foreign Capital revised	Restrictions on foreign banks largely relaxed.
March 2002	China UnionPay founded	China UnionPay set up to facilitate the use of bank cards across different banks and regions.
November 2002	Security investment category in capital account liberalisation moves forward	Qualified Foreign Institutional Investor (QFII) scheme formed and inward portfolio investment liberalised, but controlled by quotas.
March 2003	Administration of Foreign-invested Venture Investment Enterprises Provisions established	Foreign venture capital inflow permitted.
April 2003	China Banking Regulatory Commission founded	
December 2003	Central Huijin Investment Corporation founded	The aim was to fund large state-owned financial corporations and stabilise the financial system.
October 2004	Upper limit of loan interest rate and lower limit of deposit interest rate removed	
November 2004	Other investment category liberalisation in capital account moved forward	Renminbi deposit business of individuals permitted in Hong Kong. Individuals allowed to buy and transfer foreign exchanges cross-border under quota controls.
April 2005	Reform of shareholder structure of listed companies initiated	Shares that formerly were precluded from trading are unlocked.
July 2005	Managed floating exchange rate regime adopted	The PBOC officially introduces a market-based managed floating exchange rate regime with reference to a basket of currencies.
September 2005	Security investment category liberalisation in capital account moved forward	International development organisations are allowed to raise debt denominated in renminbi. Asia Development Bank issues 1 billion yuan worth of debt in China.
January 2006	Pricing mechanism for the middle price of renminbi exchange rate altered	Market-maker system with inquiry scheme introduced by the PBOC to determine the middle price of renminbi exchange rate.

Appendix: Chinese financial reforms (continued)

Date	Reform measures	Comments
July 2006	Outward direct investment largely liberalised	Quotas on firms' investment in foreign currencies abroad were removed.
September 2006	China Financial Futures Exchange (CFFEX) founded	
December 2006	Insurance and banking industries opened up to foreign institutions	
January 2007	Shanghai Interbank Offered Rate (Shibor) created	
May 2007	Flexibility of renminbi exchange rate increased	The PBOC announces the daily trading band of the renminbi against the US dollar in interbank market is widened from ±0.3% to ±0.5%.
June 2007	Security investment category in capital account liberalisation moved forward	The Qualified Domestic Institutional Investor (QDII) scheme is formed. Outward portfolio investment is liberalised, but controlled by quotas.
June 2007	China-Africa Development Fund (CADFund) founded	CDB is the main shareholder, with an aim to support Chinese firms investing in Africa.
July 2007	Security investment item liberalisation moved forward	Renminbi-denominated debt is allowed to be issued in Hong Kong.
September 2007	China Investment Corporation (CIC) founded	CIC serves as a sovereign wealth fund. CIC invests in Blackstone and Morgan Stanley as of 2007.
April 2009	Current account liberalisation moved forward	Trials for settling cross-border trade accounts in renminbi are initiated.
May 2009	Second board market initiated in addition to previous A share stock markets	It took more than 10 years to finally embark on the second-board market with the aim of setting up China's Nasdaq.
March 2010	Margin trading and short-selling introduced	Shanghai Stock Exchange and Shenzhen Stock Exchange start to accept margin trading and short-selling.
April 2010	China-Asean Investment Cooperation Fund (CAF) established	Mainly funded by China EximBank, with the aim of investing in the infrastructure and resource projects in Association of Southeast Asian Nations (Asean) countries.
November 2010	Security investment category in capital accounts further relaxed	Foreign banks gain access to the domestic interbank bond market.
April 2011	New statistics published, aimed at gauging total financing	*Aggregate Financing of the Economy*, covering almost all financial channels, published every quarter by the PBOC.
May 2011	New regulatory framework of banking industry in China about to be formed	Guiding opinions on the implementation of the New Regulatory Standards in China's Banking Sector stated by China Banking Regulatory Commission.
October 2011	Foreign direct investment (FDI) liberalisation moved forward	Outward foreign direct investment (OFDI) and FDI in renminbi permitted, but large-scale investment requires approval.
December 2011	Security investment category in capital accounts further relaxed	The Renminbi Qualified Foreign Institutional Investor (RQFII) scheme was introduced to allow qualified firms to invest offshore renminbi back into China, subject to an overall ceiling.
April 2012	Increasing flexibility of the renminbi exchange rate	The PBOC announces that the daily trading band of the renminbi against the US dollar in the interbank market is widened from ±0.5% to ±1%.
July 2012	Regulations on interest rate relaxed	The upper bound of deposit interest rate is relaxed to 1.1 times of benchmark rate, and the lower limit of lending interest rate widened to 0.6 times of benchmark rate.
September 2012	The Twelfth Five-year Plan for the Development and Reform of the Financial Industry published	
December 2012	Other investment category in capital accounts further liberalised	Cross-border renminbi loans were trialled in Shenzhen.
January 2013	Measures for the Capital Management of Commercial Banks (for Trial Implementation) enacted	Move is highly applauded by the Basel Committee on Banking Supervision, marking a crucial step for facilitating China's banks going global.
July 2013	Lending interest rate completely liberalised	
September 2013	FDI liberalisation moved forward	Foreign investment in domestic financial institutions in renminbi is permitted.
September 2013	China (Shanghai) Pilot Free Trade Zone founded	Negative listing scheme introduced for managing foreign investment. Restrictions on investment, capital account convertibility and firm entry are largely relaxed within the zone.
March 2014	Increasing flexibility of renminbi exchange rate	The PBOC announces that the daily trading band of the renminbi against the US dollar in the interbank market was widened from ±1% to ±2%.
July 2014	The New Development Bank (originally called the Brics Development Bank) was founded	Five member countries sign the agreement with the aim of supporting infrastructure investment in the Brics countries (Brazil, Russia, India, China and South Africa) and other developing nations.
October 2014	The Asian Infrastructure Investment Bank (AIIB) founded in Beijing	There are 32 member countries so far, as of March 2015, with the aim of facilitating infrastructure investment in Asian developing countries.

Appendix: Chinese financial reforms

Date	Reform measures	Comments
November 2014	Security investment category in capital accounts further relaxed	Renminbi Qualified Domestic Institutional Investor (RQDII) scheme is introduced to allow qualified firms to invest in offshore renminbi-denominated financial products.
November 2014	Shanghai-Hong Kong Stock Connect programme initiated	The stock market in Shanghai is opened to Hong Kong investors and the stock market in Hong Kong is also opened up to investors in China, both with restrictions: only institutions with approval can engage in the programme. Investable stocks are limited and daily net purchases are restricted by ceilings.
November 2014	The Silk Road Fund proposed	It is mainly funded by the State Administration of Foreign Exchange (SAFE) and the central bank and open to other investors, with an aim of supporting the 'One belt, one road' strategy.
December 2014	Deposit Insurance Act (draft) announced	The compensation for deposit losses is set to no more than 500,000 yuan.

INTERNATIONAL TRADE, INVESTMENT AND CO-OPERATION

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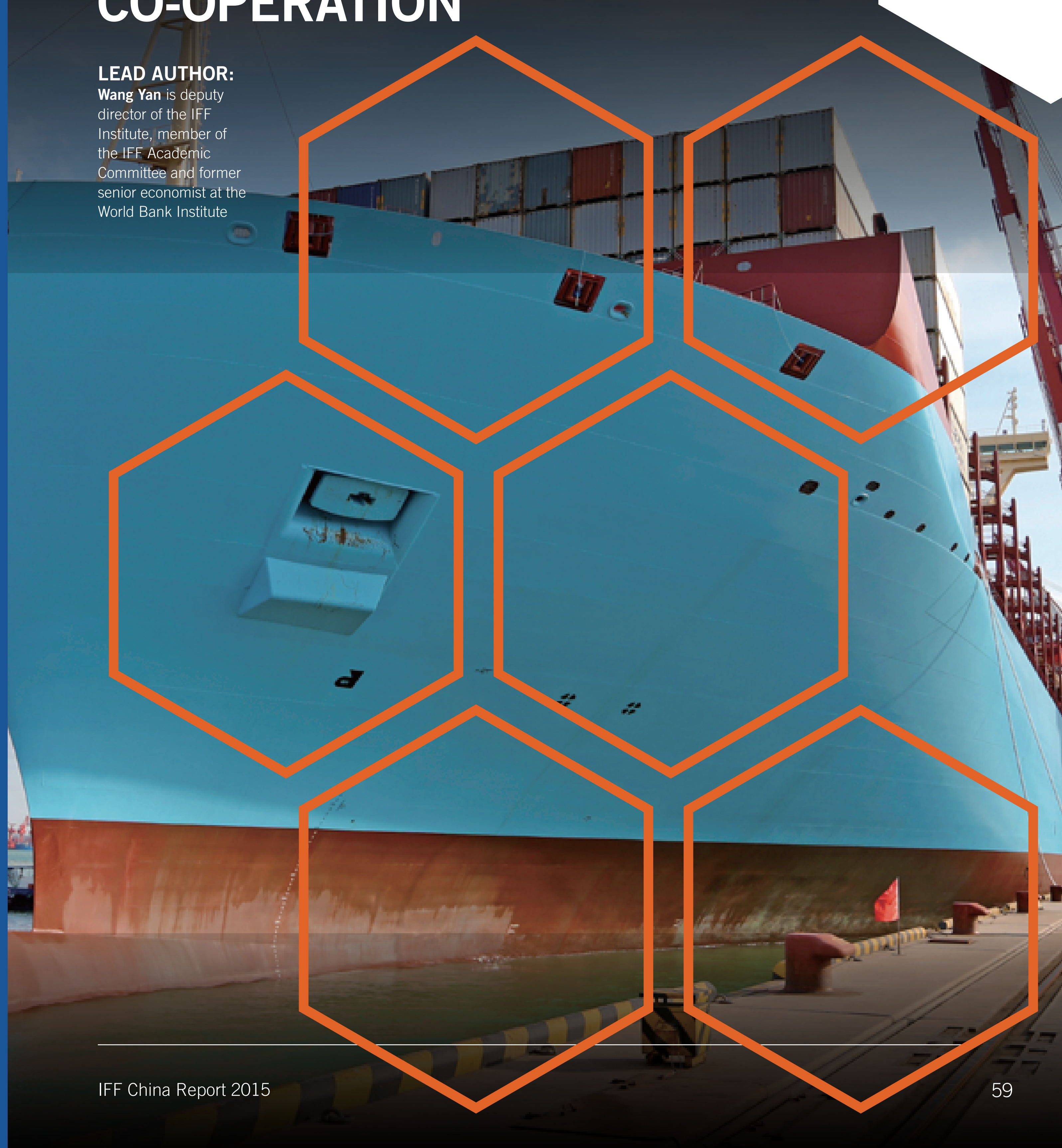

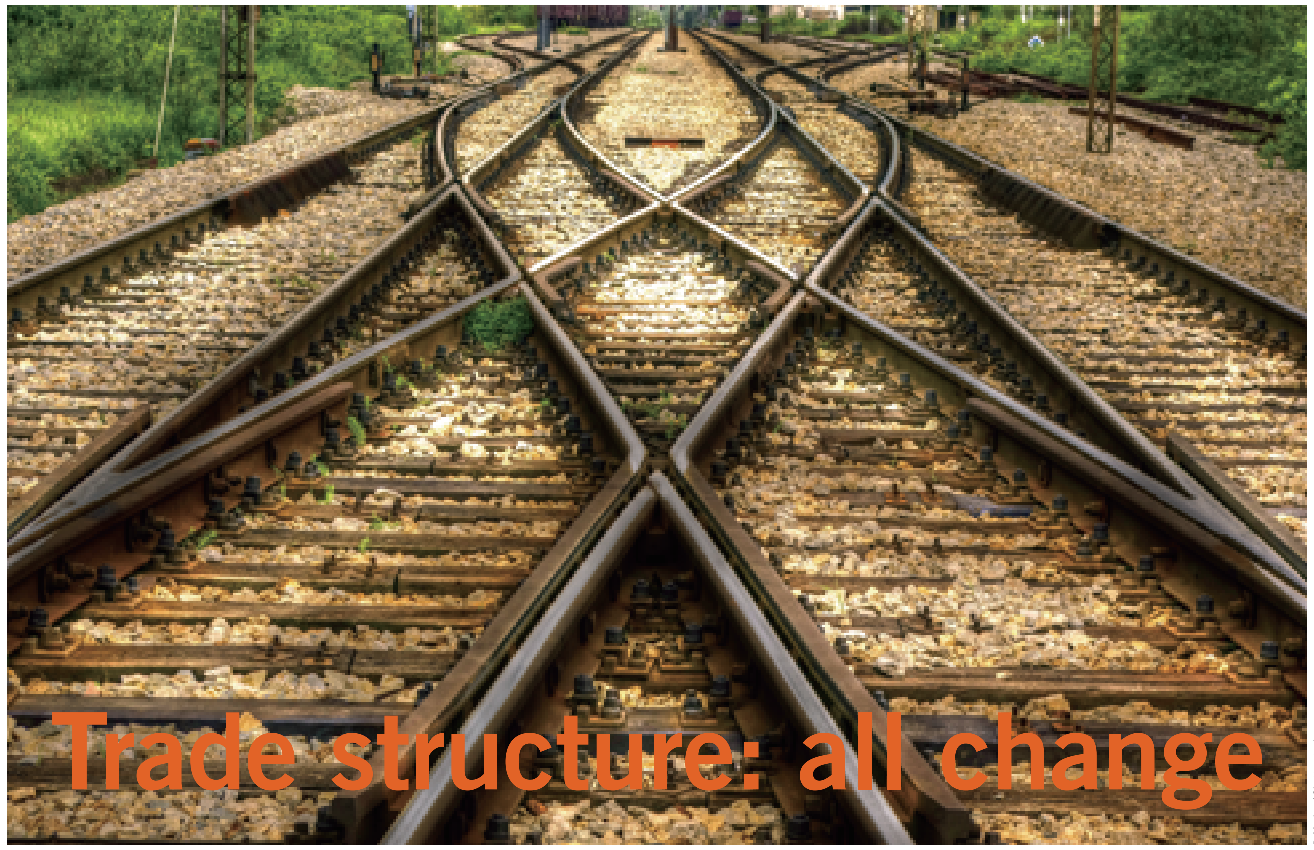
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Trade structure: all change

China's export structure has changed radically over the past three decades, moving from being dominated by raw materials in the 1980s to machinery and services in the 2000s. Even after coming from a low base, the country has prospered by adopting a 'learning by doing' attitude

China has come a long way over the past 30 years, albeit from a low base. As late as 1984, 50% of the country's exports were in crude oil, coal, food, animals and other base materials. Today, following 36 years of reform and opening up, the Chinese economy is becoming fully integrated into the global economy: China has become the world's largest trading nation (excluding intra-EU trade). Both exports and imports of goods have expanded rapidly, with exports totalling \$2.21 trillion, and imports amounting to \$1.95 trillion in 2013 (see WTO 2014).

According to official statistics released on January 13, 2015, China's total trade volume was \$4.3 trillion in 2014, with \$0.58 trillion in service trade and \$0.38 trillion in net exports. China is now ranked number one in terms of the trade in goods, accounting for approximately 12.2% of the world's goods trade (WTO 2014).

Behind the headline numbers are some remarkable shifts in the country's economic system. When China started its economic transformation in 1978, it was an agrarian economy with agriculture accounting for 71% of total employment. Its per-head income was \$154 in 1978 – less than one-third of the average in sub-Saharan African countries.

Like many developing nations today, China was an exporter of primary products. Thanks in part to its unique reform approach of "crossing the river by touching the stones at the bottom", spear-headed by the late leader Deng Xiaoping, Chinese principals and workers have "learned by doing", experimenting with various institutions and practices such as special economic zones (SEZs), household responsibility systems, township and village enterprises and fiscal decentralisation – Chinese style.

The "learning-and-experimenting" approach allowed the economy to grow rapidly for 35 years without any of the large disruptions witnessed in Russian and other east European transition economies.

China has been taking advantage of its relative backwardness by learning and imitating – and, increasingly, by innovating. Its industrial upgrading, or "moving up" the value chain, took at least three steps:

- The first industrial upgrade happened in 1986, when exports of textiles and clothing exceeded crude oil. Incentives were provided to foreign direct investments coming to SEZs. This signified China's transition from exporting resource-intensive products to producing labour-intensive textile and clothing, consistent with China's comparative advantage.
- The second upgrade happened in 1995, when China's export of machinery and electronics exceeded textiles and clothing. This indicated that China started the transition from exporting traditional labour-intensive exports to "assembling" non-traditional labour-intensive products. The dominant approach was still as a low-end original equipment manufacturer (OEM).
- The third upgrade happened after China's accession to the World Trade Organization (WTO) in 2001, when high-tech and new-tech exports grew rapidly, and the level of product sophistication increased. Central and local governments conducted regulatory reforms to improve the investment climate. Some exporters have become an integral part of the global supply chains of multinationals in automobiles, computers, mobile phones and aircraft parts.

In recent years, because of efforts by the Chinese government to liberalise the economy and sign several free trade agreements (FTAs), the structure of exports has continued to move up the value chain.

In 2013, manufactured products remained the dominant component of China's exports, accounting for 94% of the total. Among manufactured products, office machines, telecoms equipment, textiles and clothing continued to be the country's main exports. Intra-industry trade is of growing importance, as measured by manufactured imports accounting for 58% of imports in 2013. This indicates that China is very much an important part of the global supply chain, engaging in the "supply chain trade" or "import for export" model (Baldwin 2013).


Anton Balazh / ArtWell / astudio / Shutterstock
The Chinese economy is becoming fully integrated into the global economy

Since joining the WTO in 2001, China has negotiated and concluded 13 FTAs with more than 20 states and regions. FTAs in force include those with Chile, Costa Rica, New Zealand, Pakistan, Peru and Singapore. China has recently signed FTAs with Australia, Iceland, South Korea and Switzerland, but they are not yet in force. Currently, FTAs are under negotiation with the Gulf Cooperation Council (GCC) countries, Japan and Norway. Supplementary agreements were added to the initial Closer Economic Partnership Arrangement (CEPA) with Hong Kong, China and Macao. Unilateral preferences are granted to the least developed countries (LDCs) (WTO 2014, p. 10).

Trade in goods

In the trade in goods sector, China has continued to liberalise its tariff regime and to facilitate trade by a series of reforms, including the introduction of paperless customs clearance procedures. China's average applied most favoured nation (MFN) tariff rate in 2013 was 9.4%, almost unchanged since 2011 and 2009 when the average stood at 9.5%. The applied tariff continued to be higher for agricultural products, at 14.8%, showing a slight decline from the average for 2009 and 2011. The average tariff on non-agricultural products has remained unchanged since 2009 at 8.6%. Import licensing, restrictions and prohibitions are maintained on grounds of state security, human health, environmental protection and to comply with international commitments.

Trade in services

Imports of services became more important as a component of total imports, while travel gained considerable market share, accounting for 39.1% of total imports. Transportation is another important item among services imports, accounting for 28.7% of the total.

In terms of services exports, the structure has changed dramatically in the period from 2000–2013. Figures 1 and 2 show that the export share of other business services has increased from 25% in 2000 to nearly 39% in 2013.

China's export of financial and insurance services increased its share of the total, in parallel with the gradual relaxation of China's capital control for outward investment and other outflows. The share of computer and information services have also risen significantly, although travel and communication lost some of their share in 2013.

The share of construction services expanded from 2% to over 5%, which is related to the construction sector gaining global competitiveness. A joint paper (Lin and Wang 2015) has shown that through "learning by doing", China has gained a comparative advantage in construction, especially in building large hydroelectric power-generation projects, with increased experience, design and engineer capacity, as well as the relative inexpensive cost of site managers and foremen.

The labour cost of Chinese foremen, at $9 per hour, is nearly one-eighth of that of the US ($76 per hour) and European Union countries. Even if Chinese companies pay their overseas workers three times the domestic rate (that is, $27 per hour), that would still be only 36% of the cost for a US foreman. This is one of the reasons why China has gained global competitiveness in providing infrastructure investment and construction projects (see 'China's comparative advantage in renewable energy: hydropower' box, p. 65).

Future trade prospects

It is widely recognised that China maintains a large number of export support programmes at sectoral, regional and business levels to achieve economic growth and employment generation objectives. The government has also provided industry-specific subsidies for land and technology to firms deemed "strategically important" by central and local governments. In recent years, these policies and subsidies have caused an increasing number of trade disputes, including antidumping and countervailing or "double AD plus CV" investigations.

However, in recent years, subsidies and trade support policies are becoming more expensive in terms of socioeconomic cost and environmental degradation. Moreover, since 2009, net exports are no longer a significant driver of economic growth, mainly because of weak global demand. A major rethink of trade policy is in order.

Figure 3 shows that after 2008 the contribution of net exports to GDP turned largely negative, with the exception of 2010, implying that net exports are no longer an engine for growth, but a drag on growth. In the last three years, governmental export growth targets have been missed for four consecutive years.

Meanwhile, Chinese leaders have realised that the current model of growth relies too much on investment and external demand, and is not sustainable in the long run. Continued support or subsidies to the export sector has lost its economic rationale. The mercantilistic view of "exports are better than imports" or "exports are better for economic growth" has lost its popular support, as people realised that "it is no longer worthwhile" to subsidise exports with a large amount of domestic natural and fiscal resources, benefiting foreign consumers, while leaving the solid waste, and various pollutants at home.

Strong empirical evidence suggests that China is losing its comparative advantage in certain labour-intensive industries because of rapidly rising labour costs, especially in the coastal regions. Using Comtrade data (Standard International Trade Classification Rev 3 at two-digit level), revealed comparative advantage (RCA) can be calculated for many countries, including China. The findings show that China's RCAs have been declining in labour-intensive, light-manufacturing sectors, such as textiles, clothing and footwear.[1]

Even though export volumes in these labour-intensive sectors have continued to grow or have remained stable, China is losing competitiveness in those sectors – as labour costs are rising rapidly and these labour-intensive sectors have become sunset sectors.

Figure 4 shows the export sectors with declining RCAs: textiles, clothing, footwear as well as all resource-related sectors. There are, however, sectors with rising competitiveness, including electronics, computers, machinery and equipment, and other manufacturing items (including power-generation equipment, locomotives and railcars).

In conclusion, a major rethink of the trade and investment policy is expected, resulting in a dramatic change in China's trade structure.

Domestic subsidies and support policies for exports are likely to be reduced, while tariff and non-tariff barriers are expected to be further liberalised, along with signing FTAs with many more countries. More generous unilateral preferences are expected to be granted by China to the LDCs.

With regard to the trade in services, the establishment of the China (Shanghai) Pilot Free Trade Zone (CSPFTZ), the Shanghai-Hong Kong Stock Connect programme, CEPA, and further deregulations in the financial sector (see section two, pp. 31–58), will facilitate provision of financial services, other business services and tourism across borders.

These reform measures will strengthen China's position in the proposed new trade negotiations including the Free Trade Area of the Asia-Pacific (FTAAP), which was proposed by China in the Asia-Pacific Economic Cooperation (Apec) meeting in November 2014. n

Fig 1: Composition of service exports (2000)

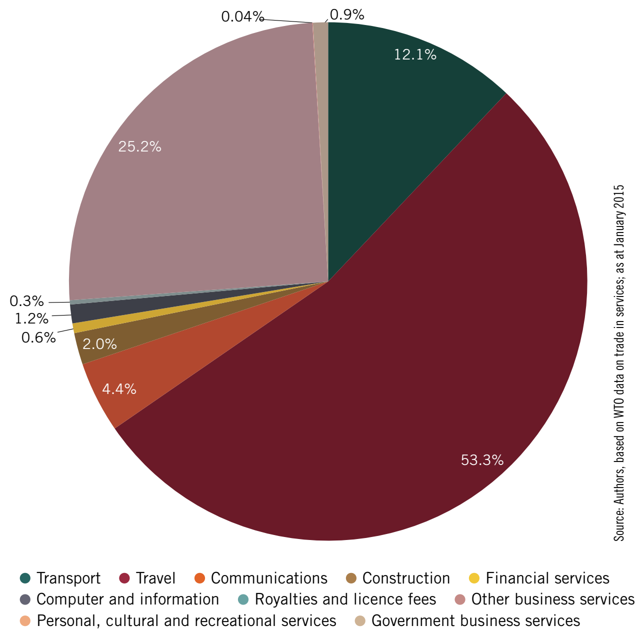


Fig 2: Composition of service exports (2013)

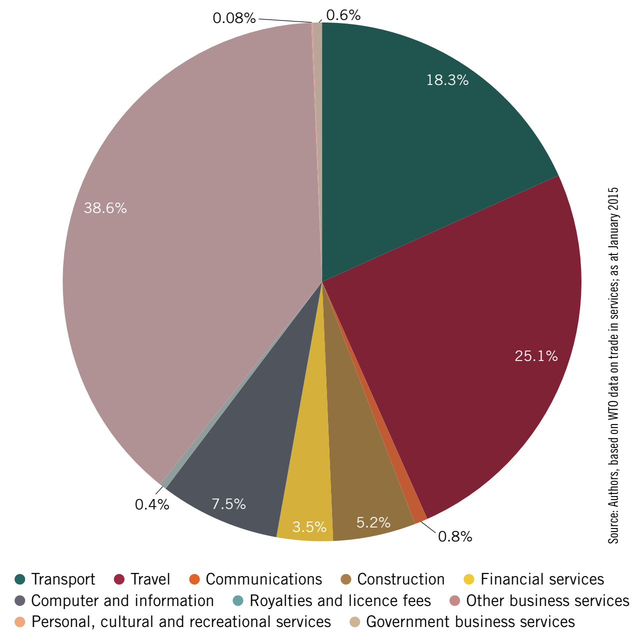


Fig 3: China's net exports' contribution to GDP (%)

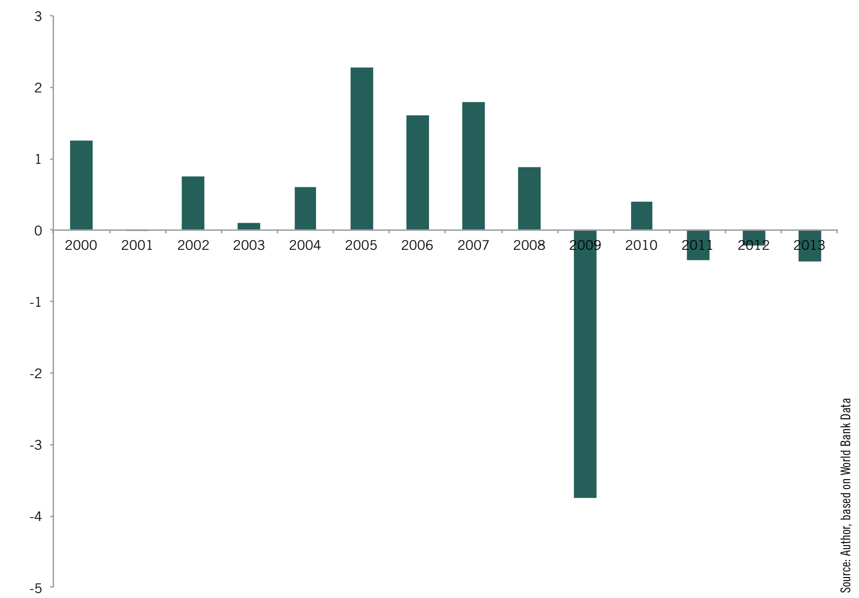
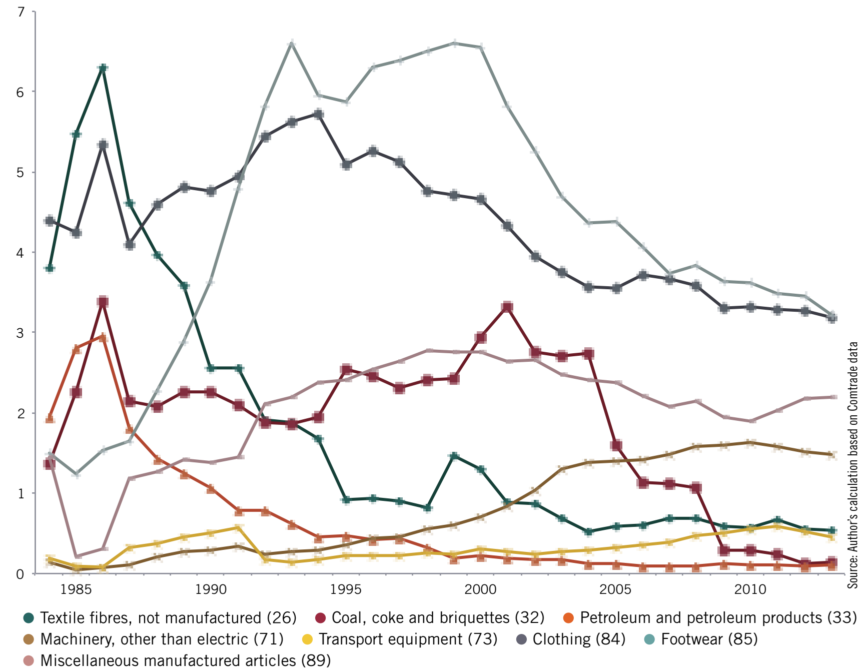


Fig 4: China is losing competitiveness in labour-intensive sectors (RCA declining over time to below 1)*



Note: * = A sector gains comparative advantage if RCA is rising above 1 (in sectors 71 and 89), and it is losing steam if RCA declines over time (in 26, 32, 33, 84 and 85). The chart cannot show all the 65 sectors because of space limitations.

1 Following Balassa 1965, Revealed Comparative Advantage (RCA) is to measure whether the country has a revealed comparative advantage in a commodity that the country is already exporting. It is calculated as follows: $RCA = \frac{x_{ij}/X_{it}}{x_{wj}/X_{wt}}$ Where x_{ij} and x_{wj} are the values of country *i*'s exports of product *j* and world exports of product j and where X_{it} and X_{wt} refer to the country's total exports and world total exports. Thus, if RCA<1, the country has a revealed comparative disadvantage in the product, while if RCA>1, the country has a revealed comparative advantage in the product.

Outward direct investments: overtaking other EMEs

China has entered the stage that western developed economies and Japan reached during the 1970s and that other Asian newly industrialised economies found themselves in during the 1990s. As labour-intensive industries matured, wages increased and firms moved into more technologically sophisticated industries.

For example, the share of manufacturing employment in the US fell from 17% in the 1980s to 9% in 2004, and in Japan from 18% to 12% during the same period. When labour-intensive industries in the high-wage countries shut down, their jobs relocated to other lower-wage economies, such as those in east Asia.

Now China's labour costs are rising rapidly, while the structure of its industries, exports and employment is changing. Many Chinese economists argue that the country has already absorbed its surplus labour and has approached the 'Lewisian turning point'.

Recent data indicates that China's labour costs rose rapidly from $150 a month in 2005 to $500 in 2012, and over $600 a month in coastal regions in 2013, growing at the rate of 15% a year (in addition to currency appreciation of nearly 3% annually in recent years).

The real wage level could approach $1,000 a month within a decade or about the level of some of the higher middle-income countries (eg Turkey and Brazil) and $2,000 a month by 2030, or the level of South Korea and Taiwan today. More Chinese enterprises are facing the pressure of seeking low-cost locations – they have no choice but to move west or 'go global'.

The 'going global' strategy was initially proposed by former president Jiang Zemin as early as 2000. By 2013, approximately 153,000 domestic investors had established 254,000 companies in 184 countries around the world, with accumulated outward foreign direct investment (OFDI) reaching $0.66 trillion, according to the Ministry of Commerce (Mofcom).

It is expected that in 2014, outward investment will reach $116 billion, surpassing inward investment for the first time.

In December 2014, premier Li Keqiang called for the enhancement of financial support for going global in a regular meeting of the State Council. The measures included speeding up the approval process and facilitating finance channels.[2]

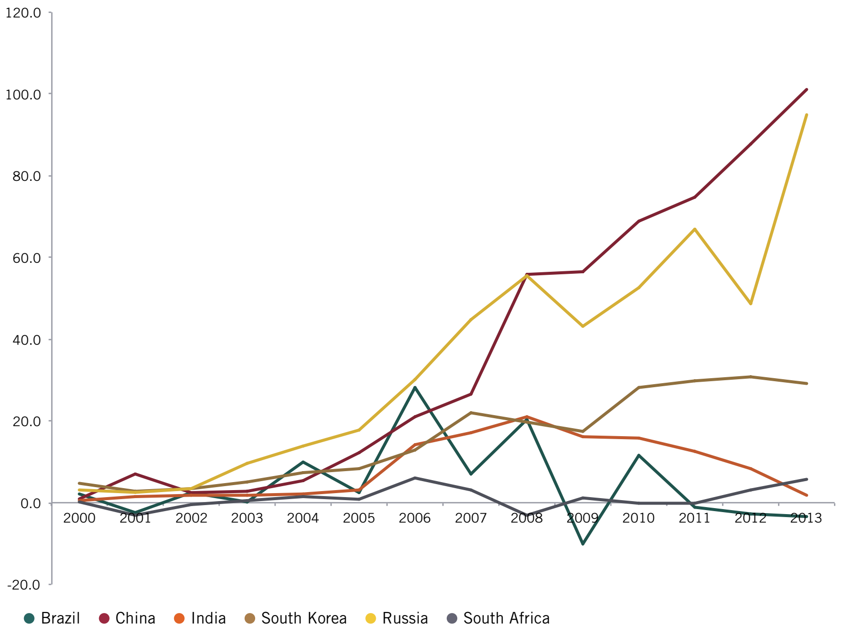
For instance, the China Development Bank (CDB) has supported the going global strategy for many years, with about 80% of its foreign loans aimed at going global projects. For example, the China-Africa Development Fund (CADFund), which is under the umbrella of the CDB, was involved in more than 70 projects in Africa across around 30 different countries by the end of 2013.[3] However, this is insufficient.

China has an estimated 100 million workers employed in manufacturing, most of them in labour-intensive sectors, compared with 9.7 million in Japan in 1960 and 2.3 million in South Korea in 1980, when these countries were at a similar state of development.

The reallocation of Chinese manufacturing to more sophisticated, higher value-added products and tasks will open up great opportunities for labour-abundant, lower-income countries to produce the labour-intensive light-manufacturing goods that China leaves behind (Lin 2012d, Chandra, Lin and Wang 2013).

China has also taken the lead among the Brics countries (Brazil, Russia, India, China and South Africa) in OFDI, with the net amount rising to more than $101 billion in 2013 (UNCTAD 2014). Roughly 60% of OFDI from developing countries went into other developing countries, mostly in the form of 'greenfield' investments that typically can open the door for the South-South relocation of various industries from China and other emerging economies (see figure 1). While there is widespread suspicion of China's

Fig 1: Outward foreign direct investment by Brics states and South Korea 2000–2013 ($ billions)



Source: Based on UNCTAD data, accessed in August 2014

2 www.gov.cn/zhengce/2014-12/25/content_2796264.htm

3 http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/english/africa/2013-12/03/c_125796229.htm

International trade, investment and co-operation

CHINA'S COMPARATIVE ADVANTAGE IN RENEWABLE ENERGY: HYDROPOWER

China is currently the world's largest producer of renewable energy, and hydroelectricity is its dominant clean energy source. Currently, over 281.5 gigawatts (GW) of hydroelectric power is installed domestically. But just 6% of China's electricity comes from hydroelectric sources. The government has signalled its intentions to increase hydroelectric capacity to 290GW by 2015 (KPMG "Infrastructure in China: Sustaining Quality Growth" January 2014).

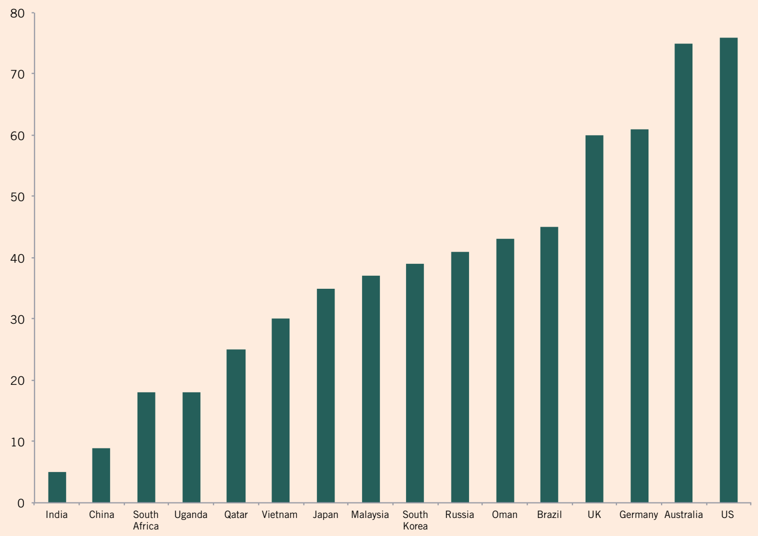
In 2013 alone, China's pure hydro installed capacity increased by 28.8GW to reach 260GW, with a further 1.2GW of pumped storage commissioned to reach a total of 21.5GW. China now has more installed pure hydropower capacity than the next three countries combined (Brazil, the US and Canada). The total 2013 investment in hydropower of 124.6 billion yuan ($20.1 billion) was roughly the same level as for the previous year (IHA 2013).

It can be further argued that China has a demonstrated comparative advantage (DCA) in exporting construction services in the hydropower sector, including design, engineering and implementation, based on the following evidence:

- existing domestic capacity of hydropower, built by Chinese companies;
- lower cost of labour and foremen (see figure 2);
- ability to bring financiers to these projects;
- and large-scale hydropower projects that have been implemented in Africa and the rest of the world.

Justin Lin and Yan Wang

Fig 2: Average hourly labour cost for site foremen (PPP, 2013)



Source: Based on data from the International Construction Cost Survey 2013

outward investment motivations and criticism of its record of following international standards, a number of studies have found that China's OFDI has contributed to the generation of employment in both developing and industrial nations. See "Development Results in Four Months: Huajian in the Oriental Industrial Park, Ethiopia" box, p. 66, for more details (Shen 2013, Weisbrod and Whalley 2011).

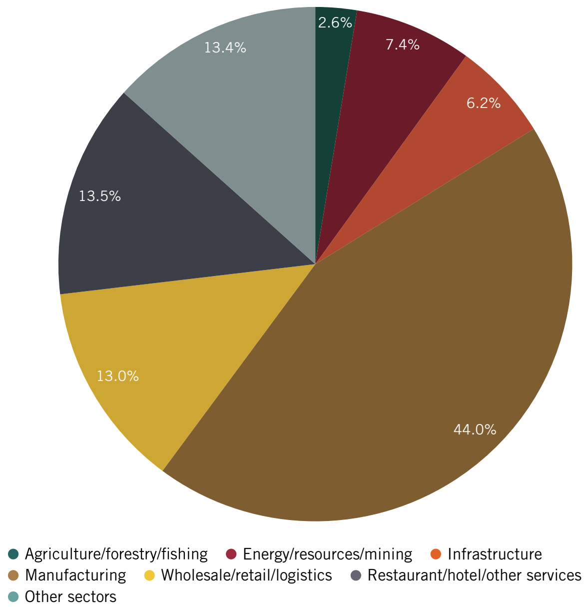
According to Mofcom statistics, total gross OFDI in 2013 reached a peak of $107.8 billion, but only $3.13 billion (or nearly 3% of the total) went to Africa and 45% of China's total OFDI was attributable to private-sector participants.

"Private Chinese firms have become aggressive in Africa in recent years, with their accumulated project numbers increasing from 52 in 2005 to 1,217 by 2013, representing 53% of all Chinese OFDI projects currently in the continent," said Xiaofang Shen in *Private Chinese Investment in Africa: Myths and Realities*, published in 2015. "There is a stark contrast between private and government investment in terms of sectors. The former is overwhelmingly concentrated in manufacturing and services, with the latter in construction and mining."

However, these official statistics may understate the level of actual private investment in Africa. Another study by Shen in 2013 found that:

- Based on host government data, Chinese government statistics have significantly underestimated the size of China's OFDI, to the order of 3 to 1.
- The government plays a lesser role in OFDI: the private sector – usually small to medium-sized enterprises – is responsible for 55% of Chinese FDI in Africa.

Fig 3: Sectoral distribution of Chinese investment in six sub-Saharan African states



Source: Xiaofang Shen 2015. 'Private Chinese Investment in Africa: Myths and Realities', *Development Policy Review* 33(1): 83-106, p. 91

- Manufacturing accounts for the bulk of private Chinese investment. Based on host country data, Chinese private investment is heavily concentrated in labour-intensive manufacturing activities, accounting for 44% of the total number of projects in six countries (Ethiopia, Ghana, Liberia, Nigeria, Rwanda and Zambia), followed by service industries.

- Chinese investment produces jobs, which African leaders appreciate, although they are concerned about "technology transfer" and "language and cultural barriers".
- Chinese firms come to Africa because their domestic market is saturated and African labour costs less than Chinese labour.
- Operating in Africa is expensive due to infrastructure gaps and security issues. n

DEVELOPMENT RESULTS IN FOUR MONTHS: HUAJIAN IN THE ORIENTAL INDUSTRIAL PARK, ETHIOPIA

African countries can also achieve rapid growth if their governments can facilitate the development of private enterprise in areas of comparative advantage and grasp the opportunities of labour-intensive sectors relocating out of China. They can bolster their limited resources and capacity by building up industrial parks/special economic zones to overcome the constraints of poor infrastructure and business conditions.

The quick success of the Huajian shoe factory in Ethiopia provides a convincing example of such an approach.

The wage rate of the footwear industry in Ethiopia is one-tenth to one-eighth of that in China, while labour productivity is about 70% of that in China, so Ethiopia can be highly competitive in the footwear industry.

The late Ethiopian prime minister Meles Zenawi came to Shenzhen to invite Chinese shoe manufacturers to invest in Ethiopia in August 2011.

The chairman of the Huajian Group, Zhang Huarong, visited Addis Ababa in October in 2011, and subsequently established a shoe factory in the Oriental Industrial Park near the Ethiopian capital in January 2012, hiring 550 Ethiopian employees and expanding to 2,000 by December 2012.

Within one year, Huajian had more than doubled Ethiopia's shoe exports. Huajian's employment reached 3,500 by December 2013, and is projected to employ 30,000 people by 2016.

Without the joint effort in establishing the Oriental Industrial Park supported by China's South-South development co-operation (SSDC), it is highly unlikely that Huajian could have achieved so much in four months.

Justin Lin and Wang Yan

African delegates visiting a Suzhou industrial park

Photo: Wang Yan

South-South development co-operation: transformation

China's South-South development co-operation (SSDC), or foreign aid, has been the subject of many heated debates, which have escalated in recent years. Many critics may have forgotten that 'China is big, but not yet rich' – and that it was a low-income country when it started providing development co-operation to African countries in the 1960s. The past 50 or so years have witnessed a joint learning process for economic transformation in China and Africa.

China's approach in SSDC differs from the international aid of established donors, focusing on using 'what China owns and knows best' by combining trade, investment and development co-operation. What are the unique features of China's SSDC? As one of the poorest developing countries in the 1980s, China has used its comparative advantage, working together with African countries to enhance the capacity for self-development.

In official language, China follows the principles of equality and respect, reciprocity, mutual benefit and noninterference in domestic affairs. Aside from adherence to the 'One China' principle, no political strings are attached to China's co-operation (State Council Information Office 2011).

This is not to say that the country's aid or development co-operative activities are 'altruistic' – they are not. The government "never regards such aid as a kind of unilateral alms, but as something mutual" (State Council, White Paper 2011). This "mutual [economic] benefit" is based on the simple idea of "exchanging what I have with what you have" (*hutong youwu* or 互通有无) from which both can gain, as was taught by the economist Adam Smith.

Second, the size of China's aid and South-South co-operation is small and commensurate with its per-head income level. Many analysts have tried to compare the amount of official development assistance (ODA) between China and established donors such as the US without considering the huge differences in income per capita, which is rather misleading.[4] When China started to provide development assistance to African countries 50 years ago, it was poorer than most of the sub-Saharan African (SSA) countries. Even now, China's per-capita income, at $7,589 in 2014, is only one-quarter or one-eighth of that for the established Organisation for Economic Co-operation and Development (OECD) donor countries (see figure 1, p.68).

China's definition of aid differs from that of the OECD-Development Assistance Committee (DAC), and therefore, direct comparison is not appropriate.[5] According to the State Council Information Office's *White Paper on China's Foreign Aid* (2011), China provides grants, interest-free loans and concessional loans, with eight types of foreign aid: "complete (turn-key) projects, goods and materials, technical co-operation, human resource development co-operation, medical teams sent abroad, emergency humanitarian aid, volunteer programmes in foreign countries and debt relief".[6] There are other official flows (OOF) and OOF-like loans and investments, which are not included in the official definition of foreign aid (Bräutigam 2011).

Based on strong demand from African countries, new types of SSDC have been added in recent years, including: OOFs (large but less concessional loans and export credit provided by the Export-Import Bank of China); resources for infrastructure (RFI) packages; equity investment by China-Africa Development Fund (CADFund) fund; infrastructure investment by the China Development Bank (CDB) and other commercial banks (which are OOF-like loans and investments intended for development, but non-concessional, and suitable for long-term infrastructure investment).[7]

Emerging donors contributing to Africa's infrastructure

Non-traditional bilateral development financiers – such as China, India, Arab countries and Brazil – have emerged as major financiers of infrastructure projects in Africa.

Overall, infrastructure resources committed to Africa by these countries jumped from $1 billion a year in the early 2000s to over $10 billion in 2010. China held a portfolio of some $20 billion in active infrastructure projects in more than 40 African countries. Chinese financing for African infrastructure structure projects is estimated to have reached a record level of roughly $5.1 billion in 2009, although it fell to around $2.3 billion in 2010 (Chen 2013).

In fact, the global 'South' is no longer a homogeneous backward group. Nagesh Kumar stated in 2008: "Different countries and even regions within the countries are at vastly different stages of development. Thus the complementarities within the group have increased tremendously. The relevance of [SSDC] arises from the replicability of development experiences of one country in other co-developing countries. In the process of their development, developing countries accumulate valuable lessons. These skills and capabilities are due to shared development challenges faced by them."[8]

4 Studies include, for example, Wolf et al (2013) from Rand, and Strange et al (2013) from the Center for Global Development.

5 The Organisation for Economic Co-operation and Development (OECD) definition of ODA includes grants or loans that are: a) undertaken by the official sector; b) with promotion of economic development and welfare as the main objective; and c) "concessional in character and convey a grant element of at least 25% (calculated at a rate of discount of 10%)". See *www.oecd.org/dac/stats/officialdevelopmentassistancedefinitionandcoverage.htm*

6 Turn-key projects and in-kind assistance were developed in the 1960s and 1970s, when China itself was in shortage of foreign exchange. These types of projects allowed poor countries to help each other without using US$ or other foreign exchange. The Tazara railway was completed in 1975 by Chinese and African workers working together using labour-intensive technology. This is also a unique way of avoiding issues of misuse of funds of both partners.

7 The World Bank 2014, *Resource Financed Infrastructure*.

8 *www.un.org/en/ecosoc/newfunct/pdf/background%20study%20final.pdf*

In particular, China has been working in bottleneck-releasing sectors such as power generation and transmission. While "donors have neglected power since the 1990s" (Foster and Briceño-Garmendia 2010, p. 25), 50% of China's commitment on infrastructure was allocated to electricity (Chen 2013). A recent study found that China has contributed, and is contributing, to a total of 9.024 gigawatts (GW) of electricity-generating capacity, including completed, ongoing and committed power projects. The impact of this investment is likely to be transformative when one considers that the entire installed capacity of the 47 SSA countries, excluding South Africa, is 28GW.[9]

Figure 2 shows empirical evidence that China-financed infrastructure projects in 2001–2010 have, to a significant extent, targeted and addressed African countries' bottlenecks in five sectors: water, electricity, road and rail, air transport and telecoms (based on PPIAF-China project data). The total number of project in the dataset is 168 allocated in the five sectors, and the probability of these China-funded projects 'hitting the bottlenecks' is 62.5% in the period of 2001–2010. There is, however, much room for better targeting and improvement, especially in the water sector.

Challenges within China's SSDC

The first challenge is the lack of transparency in China's SSDC projects – official data at the project level is not readily available. The publication of the white paper on China's Foreign Aid (State Council 2011 and 2014) and China Africa Economic and Trade Cooperation 2013 (Ministry of Commerce 2013) represent progress in the right direction. The government needs to be more open and proactive in providing more accurate data, making laws and regulations clear on development co-operation. This would be favourable to increased accountability to tax payers in China, as well as to the international development community. China does not have a legal framework governing foreign aid, nor does it have an independent aid agency.

It is therefore difficult for Chinese citizens to participate in the decision-making process on foreign aid, for Chinese officials to be held accountable, and for international bodies and governments to seek collaboration on international development or financing issues. Drafting China's law on foreign aid and co-operation, as well as establishing an independent aid agency, should be a priority for the policy agenda.

The second concern is about 'tied aid' and inadequate technological diffusion and spillover effects. Most of China's aid is tied, a practice the members of OECD-DAC agreed to move away from progressively since 1995, since tied aid may increase costs and reduce efficiency.

However, China's own experience indicates that tied aid has some advantage of facilitating 'learning by doing' and 'learning by implementing' projects. According to Ricardo Hausmann, "the tricks of the trade are acquired from experienced senior workers" (Hausmann 2013). But there is academic literature on aid and trade, which found mixed results (Wagner 2003, Lloyd et al 2000, Morrissey and White 1996).

The value of implementing actual projects in learning and development seems to be underappreciated by economists and the donor community. In the 1980s and 1990s, most donor-financed projects located in China comprised tied aid, and Chinese

CHINA'S SOUTH-SOUTH DEVELOPMENT CO-OPERATION

Reflecting the fact that 'China is big, but not yet rich', one can take into consideration different stages of development, and compare China's total official development assistance (ODA) as a percentage of gross national income (GNI) to those of the Organisation for Economic Co-operation and Development (OECD) countries.

China's aid to developing countries started from a relatively low per-head income level in the 1960s. The analysis uses a recent estimate of China's ODA carefully done by Kitano and Harada 2014, which puts China's net ODA at $7.1 billion in 2013. They also estimated the net disbursement of preferential export buyer's credit of $7 billion in 2013.

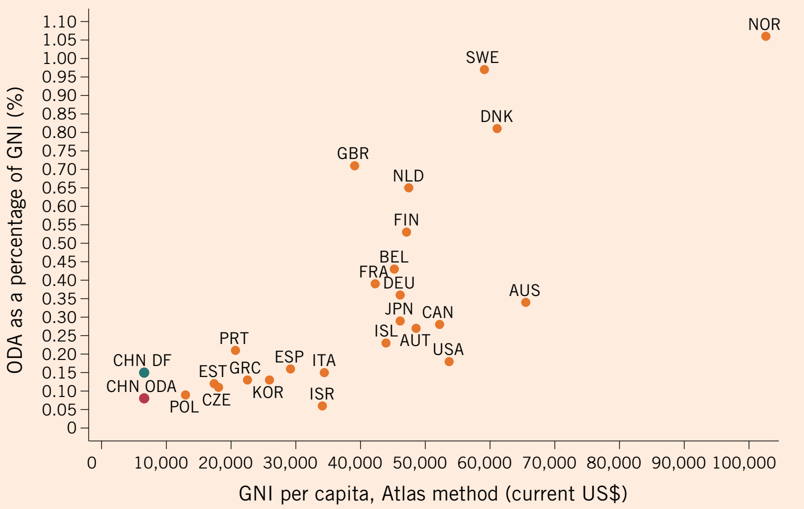
Adding the two elements together, one would reach a total of $14.1 billion as China's development financing (which is a conservative estimate).

China's net ODA accounted for 0.08% of GNI in 2013, while China's development fund (DF) reached 0.15% of GNI in the same year. The first ratio is lower than some of the OECD countries.

However, if one draws a linear regression line on this scatter chart, China is located well above the regression line, indicating China is contributing a relatively significant proportion of its GNI to aid and development co-operation as compared with its per-head income level of $6,560 in 2013.

To summarise, China, at its current stage of development, is more generous in providing development financing than some of the rich countries.

Fig 1: Comparison of ODA as percentage of GNI and GNI per capita between China and OECD-DAC members (2013)



Source: Yan Wang (2011), p. 22, updated based on AidFlow data. OECD (2014), Net ODA (indicator).

9 The US's Hoover Dam in Colorado, by comparison, is a 2 gigawatt facility, producing on average electricity for about 390,000 US homes. See Chen 2013.

workers and project managers have learned and benefited from them. Actually, 'learning from aid projects' is one of the reasons why Chinese companies are so competitive in implementing construction projects (see "China's comparative advantage in renewable energy: hydropower" box, p. 65).

The third concern is that Chinese aid projects seem to have generated few local employment opportunities. Many African officials are concerned that Chinese workers are displacing local workers. Although data and evidence needs to be reviewed on a case-by-case basis, clearly, the indirect employment generation from China-financed economic infrastructure has been under-researched.

The International Monetary Fund (IMF) found that in recent years, China has become the largest single trading partner for Africa and a key investor and provider of aid and that a 1 percentage point increase in China's real domestic fixed asset investment growth has tended to increase sub-Saharan Africa's export growth rate on average by 0.6 of a percentage point (IMF 2013, p. 5).

Better education and training should be provided to Chinese companies to abide by laws and regulations regarding labour, social and environmental standards. In addition, better training and capacity development programmes should be provided to African workers and managers, in order to complete projects in a timely manner and to show tangible results.

No two countries are the same in their economic transformation. China has made some mistakes and paid a price for them. For instance, the country's strong drive for rapid growth and industrialisation is associated with widening rural-urban income disparities and a damaged environment.

In March 2007, former Chinese premier Wen Jiabao pointed out that China's growth was imbalanced, inequitable and unsustainable. Since then, there has been tremendous effort to 'rebalance' the economy, reducing its reliance on exports, investment and paying more attention to the quality and efficiency of growth. However, making deep transformations and upgrading industries is proving extremely difficult, as reforms often go against the vested interest groups.

In this sense, African countries need to be selective, to avoid the mistakes China has made. African governments, non-governmental organisations and civil societies can play important roles in providing pressure to 'push' development partners, including China and Chinese companies, in the right direction. n

CHINA HELPS TO ADDRESS THE INFRASTRUCTURE BOTTLENECKS IN AFRICA

A recent study ranks the donors/providers of infrastructure in sub-Saharan Africa for the period 2001–2008. China is shown to be the largest infrastructure financier, followed by three multilateral organisations, the International Development Association, the European Commission and the African Development Fund.

In total, there are three southern providers in the top 10: China, India and the Islamic Development Bank. China alone accounts for 34% of the total official financing amount on infrastructure in SSA, higher than any northern partner.

In a study conducted in 2014, we used a three-step method to address the questions of whether, and to what extent, China-financed infrastructural projects match Africa's bottlenecks?

The short answer is that they seem to have matched in 63% of the 168 infrastructure projects in 2001–2010.

Step 1, five indicators from the World Bank database are used to define African countries' bottlenecks, including water, electricity, roads and rail, air transportation and telecommunication.

We then compare the ranking numbers for sectors 1 to 5 for the country, *i*, and select the lowest-ranking sector to be the bottleneck 1 for country *i*; and then exclude the selected sector *j**, select the next lowest-ranking sector as bottleneck 2, and continue to follow this process for bottleneck 3.

This process can be expressed as:

Bottleneck 1 *for country* i = min ($R_{i,j}$), *where* j = 1, … 5.

Bottleneck 2 *for country* i = min ($R_{i,-j^*}$), *where* j = 1, … 5.

In Step 2, the World Bank-PPIAF Chinese projects database is used to find the location and number of infrastructure projects financed by China in each sector during the period 2001–2010. There are 168 projects allocated in five sectors.

Step 3, the two datasets are merged by country code, to see if the locations of the Chinese-financed projects match the bottlenecks. We have also calculated some probabilities of projects 'hitting' the bottlenecks. Results are as follows:

- Probability of hitting one of the 3 bottlenecks = 105/168 = 0.625 = 62.5%
- Probability of hitting bottleneck 1 = 39/168 = 0.232
- Probability of hitting bottleneck 2 = 31/168 = 0.185
- Probability of hitting bottleneck 3 = 35/168 = 0.208. Justin Lin and Yan Wang 2014

Fig 2: China-financed projects matched with bottlenecks in sub-Saharan Africa (2001–2010)

Source: Justin Lin and Yan Wang (2014), UNU-WIDER working paper 2014/046, Appendix I

‘One belt, one road’ vision

The concept of ‘one belt’ was first proposed by Chinese president Xi Jinping in a speech at Nazarbayev University in Kazakhstan in September 2013: “To forge closer economic ties, deepen co-operation and expand development in the Eurasian region, we should take an innovative approach and jointly build an ‘economic belt along the Silk Road’.”

The concept of ‘one road’ was introduced by a speech that Xi delivered at Indonesia’s parliament in October 2013: “China will strengthen maritime co-operation with Asean [Association of Southeast Asian Nations] countries to make good use of the China-Asean Maritime Co-operation Fund set up by the Chinese government and vigorously develop a maritime partnership in a joint effort to build the Twenty-first Century Maritime Silk Road.”

The ‘One belt, one road’ vision has been embraced by 57 countries, which expressed their willingness to support it by connecting it their own development plans, and striving for an ‘early harvest’. In November 2014, Xi announced the acceleration of the planning process for the ‘Economic Belt along the Silk Road’ and the ‘Twenty-first Century Maritime Silk Road’, and to strengthen co-operation with the countries involved. He also said China would set up a $40 billion Silk Road Fund, aimed at directly supporting the construction of ‘One belt, one road’.

“The AIIB [Asian Infrastructure Investment Bank] and the Silk Road Fund are complementary, rather than substitutive, to existing global and regional development banks,” Xi said in a speech at the eighth meeting of the Central Leading Group on Financial and Economic Affairs.[10]

The ‘One belt, one road’ vision reflects both the demand from relevant countries for releasing infrastructure bottlenecks and improving connectivity with large markets in Asia and Europe, as well as the need for China’s own development and security. Developing countries are constrained by inadequate capacity, knowledge and financing resources, while China is facing constraints in energy, arable land, skilled labour and the environment. Working together, all partners can complement each other and achieve win-win solutions.

The ‘One belt, one road’ plan also indicates China’s desire to share its own ideas and experiences regarding economic development. This includes the philosophy that ‘in order to get rich, you need to build roads first’ and that building infrastructure can act ‘as a countercyclical measure to boost aggregate demand and long-term productivity’.

China has used expansionary monetary, fiscal and investment policy to overcome contractionary pressure during two crises (the 1998 Asian financial crisis and the 2008–2009 global financial crisis). Now, after six 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 recommended by the International Monetary Fund (IMF 2014, WEO, chapter 3 on Infrastructure).

The ‘One belt, one road’ vision is also aimed at reflecting China’s view of ‘peaceful coexistence with differences’ and of commitments providing global public goods, peace and sustainability. Deeply rooted in China’s thousand-year history and civilization, there is a firm belief among the Chinese people that ‘one should not impose on others what he himself does not desire’.[11] This principle has been consistently adhered to when China has granted foreign aid in the last 50 years, and will be further modernised and strengthened by the current generation of leaders. There is a view that ‘the Pacific Ocean is large enough’ to allow the peaceful emergence of many developing nations, and that China’s rise is conducive to world development and peace.

Benefits to countries en route

The Yuxinou railway, now in operation, has opened up ‘cheaper and faster’ links between Kazakhstan and the European market, which is largely consumer-based. As of September 16, 2014, the rail service operates four departures per week from Duisburg (Germany) to China, Russia and Kazakhstan every Tuesday, Thursday, Friday and Saturday.

The proposed expansion of the Eurasian land bridge includes construction of a railway across Kazakhstan that is the same gauge as Chinese railways, linking India, Myanmar, Thailand and Malaysia. According to *Xinhua*, the expanded land-based ‘New Silk Road’ will begin in Xian in central China before stretching west through Lanzhou (Gansu province), Urumqi (Xinjiang) and Khorgos (Xinjiang bordering with Kazakhstan). The Silk Road then runs southwest from central Asia to northern Iran before swinging

CHINA’S ‘ONE BELT, ONE ROAD’ VISION: THE AIIB ANGLE

I am currently in charge of preparatory work on the Asia Infrastructure Investment Bank (AIIB), which, similar to the Brics New Development Bank, is aimed at promoting regional economic integration and co-operation. China would like to play a role in international economic stability, but some western friends have doubts and misunderstandings. I would like to make some clarifications.

First, China intends to work with established international organisations and multilateral development banks (MDBs). The Bretton Woods system, including the International Monetary Fund (IMF) and the World Bank, was set up in 1944, the Asian Development Bank (ADB) was established in the 1960s, and the European Bank for Reconstruction and Development (EBRD) in the 1990s. China would like to work with these multilateral organisations as well as bilateral government organisations when promoting regional integration and the ‘One belt, one road’ vision.

This vision by China’s leaders has been well received by many countries, but some nations have expressed their suspicions. ‘One belt, one road’ is the grand vision for a new international co-operation, which will benefit all relevant countries. It is not just a matter of creating more loan projects. ‘One belt, one road’ is aimed at producing regional economic co-operation and a new globalisation.

China has emerged as a strong new player in international development and co-operation, and we want to achieve joint development and ‘multiple wins’ with neighbouring countries. But it is not unusual for countries to have doubts and suspicions. Despite some parties wanting to see China take on more responsibilities, they sometimes doubt the country’s intentions.

Jin Liqun

This kind of attitude is normal. After World War II, the US emerged as the world leader, dominating the Bretton Woods system and playing an important role in the Asia-Pacific region. People soon got used to this pattern of geopolitical and economic governance.

But now China is emerging as a new influence in the region, and people are not used to it. There has to be a process (which takes time) to allow people to understand and realise that the country is playing a positive role in this region.

Listening to criticism

We need to understand this suspicion and be mindful when dealing with co-operation with all sides from the beginning. For example, if China provides loans to Association of Southeast Asian Nations (Asean) countries, the IMF will ask: “Will this increase the debt burden/ratios and affect debt sustainability?”

If we ignore the IMF’s concerns, our projects will meet with obstacles and the impact will be adverse. So we must co-ordinate and co-operate with established multilateral financial organisations. The IMF has a strong grasp of a country’s macroeconomic situation and debt sustainability, and seeking its advice makes sense. Should we ignore this advice and issue the loan, we may either not able to receive repayment of the loan and/or we will disturb the international financial order.

Inclusivity

The Bretton Woods system is quite inclusive. Almost all countries were included when it was established in 1944, although stringent conditions were put on the Soviet Union at that time. Now we need to use the same multilateralism to promote our proposed vision for international co-operation. For instance, for the ‘Maritime Silk Road’, we need to not only work with Asean countries, but also co-ordinate with India, Sri Lanka, ‘the central Asia five’ and Russia.

Connectivity is very challenging and complex – with different geocultural, socioeconomic and religious backgrounds in each country – so we need not only to promote physical connectivity, but also regulatory and policy connectivity.

I need to clarify a second misunderstanding in the media, which has reported that ‘China wants to export its excess capacity, and get access to natural resources’.

Indeed, we have to conduct structural change/transformation to get rid of excess capacity, but we cannot rely on exporting these capacities through trade and regional integration. The right way to deal with this problem is to adjust China’s own economic structure.

Aiming for mutual benefits

When we attempt to implement the ‘One belt, one road’ vision, it is challenging to find suitable projects that can benefit all sides involved. For instance, high-speed rail (HSR) is a good and relatively inexpensive technology, but it is difficult to find projects that can achieve viability and profitability. Some central Asian countries have vast landmasses, but scarce populations, so building an HSR line would not have sufficient traffic volume. Therefore, we must be pragmatic and patient, and gradually identify mutually beneficial projects.

We should also pay attention to three points:

- Interpret the vision correctly and comprehensively, reflecting that our vision must meet the needs for the countries involved.
- Co-operate with relevant countries closely and find mutually beneficial projects.
- Collaborate with established international organisations and co-ordinate with them closely.

We cannot develop the ‘One belt, one road’ policy without adhering to all three points.

AIIB development

During the process leading to establishing the AIIB from September 2013 to October 2014, 22 founding member countries participated at the signing ceremony. There were 26 founding members by the time of our meeting in Mumbai, India, on January 15-16, 2015.

This year, we have achieved a lot. The US’s attitude toward the AIIB has changed in a subtle way, becoming more positive and welcoming established international organisations to participate in the AIIB.

I put forward three principles for the AIIB – lean, clean and green:

- Lean: our institution should be efficient and highly capable. It should not become a big bureaucracy.
- Clean: we have zero tolerance for corruption in the AIIB, including in the process of international competitive bidding, procurement, etc.
- Green: we promote environmentally friendly economic development.

It should be pointed out that the AIIB is different from the ADB. A total of 40% of the ADB’s shares belong to the developed countries not located in Asia and only 38% belong to Asian countries. But Asian countries own 75% of the AIIB’s equity, while non-Asian countries hold the remaining 25%.

The AIIB is the first multilateral financial institution dominated by developing countries. China is able to provide 50% of funding for the AIIB, but we’re not seeking to control it or dominate it.

We’ll deny a project if most of our members reject it, although we have 50% shareholding. We are going to achieve the common goals of all stakeholders through negotiation and co-operation.

Future recruitment of the AIIB is open to global talent – we have already hired an American lawyer as general counsel. We hope this sends a strong signal that we are willing to work with partners from all over the world – and this will be proven by our actions.

Jin Liqun is secretary-general of the Multilateral Interim Secretariat for Establishing the AIIB

10 For news and discussions regarding the ‘One belt, one road’ vision, see *www.scio.gov.cn/ztk/wh/slxy/gcyl1/index.htm*

11 Translated as ‘What you do not wish for yourself, do not do to others’. Zi Gong (a disciple of Confucius) asked: “Is there any one word that could guide a person throughout life?” The Master replied: “How about ‘shu’ [reciprocity]: never impose on others what you would not choose for yourself?” – Confucius, Analects XV.24.

International trade, investment and co-operation

west through Iraq, Syria and Turkey. From Istanbul, the Silk Road crosses the Bosphorus Strait and heads northwest through Europe, including Bulgaria, Romania, the Czech Republic and Germany. Reaching Duisburg in Germany, it swings north to Rotterdam in the Netherlands. From Rotterdam, the path runs south to Venice, Italy – where it meets up with the equally ambitious Maritime Silk Road. The United Nations has proposed further expansion of the Eurasian land bridge, including the Trans-Asian Railway project.

A unprecedented opportunity is open to Kazakhstan to target the huge consumer market in Europe (35% of the world trade) and in Asia (33% of world trade) by joining the existing supply chains using the importing-to-export model. Kazakhstan can take this opportunity to export products that the EU market needs, if it can (jointly) produce with high quality and efficiency. China's interest in promoting manufacturing hubs in inland and western regions such as Sichuan and Xinjiang has provided a good opportunity for Kazakhstan and neighbouring central Asian countries for diversification, job creation and growth.

The port of Qingdao

The AIIB and the Silk Road Fund

The success of the 'One belt, one road' vision depends on successful financing that is open, inclusive and transparent. In fact, several leading officials have emphasised that openness and inclusiveness are the features of the proposed Asian Infrastructure Investment Bank (AIIB) and the Silk Road Fund, and their common objective is to achieve mutual benefit and shared prosperity.

The next decade will witness a significant structural transformation in global economics, as China and other emerging market economies (EMEs) play significant roles as large traders, manufacturers, investors, financiers and infrastructure builders. The 'One belt, one road' vision and its implementation will help address the bottlenecks in the Asia-Pacific region and beyond, and it could generate good returns for all stakeholders, as well as putting developmental results on the ground. However, to be effective, aid or development co-operation must be in the host country's own interest and demand-driven. Combining trade, aid and investment – a market-based approach – can ensure the alignment of incentives among equal partners, as shown by the successful experiences in many east Asian countries.

China needs to continue to learn, as in the last 35 years, to become a better development partner, by listening to the demands from partners and interacting with governments, non-governmental organisations and civil societies. China needs to be more open and transparent in providing accurate data on international development financing and activities. Political and economic dynamics must be taken into consideration when in discussion with the current government of the client country.

The established donors among Organisation for Economic Co-operation and Development countries also need to see if China's approach provides useful lessons to improve the effectiveness of the conventional North-South aid. A recent study by the World Bank in 2014 reviewed the approach of "resource for infrastructure [RFI] deals", finding this approach to be more effective in advancing the developmental impact "many years ahead of" the conventional North-South approaches. Many African leaders find China's approach (in RFI) more desirable, as it has led to 'inexpensive and tangible results' within three to four years, coinciding with the political cycle within a democracy.

In the post-2015 era, development financing will come less from ODA, but more and more from the other official flows (OOF), OOF-like loans, and OOF-like investment from development banks, sovereign wealth funds in emerging economies. In a multipolar world, the prospect of South-South development co-operation is likely to expand, as shown by the 'One belt, one road' vision and the establishment of the New Development Bank and the AIIB. However, established donors/partners need to be more inclusive to enhance the voice of emerging partners, and provide a place 'at the table' for these emerging nations.

Post-2015, the emergence of new multilateral or regional development banks and funds (such as the AIIB, the New Development Bank and the Silk Road Fund) are encouraging, bringing positive energy and momentum to the world's economic development arena. In a multipolar world, it seems inevitable to have multipolar development organisations and multilateral development banks and funds. There is reason to be cautiously optimistic that 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. n

THE VISION OF THE BRICS DEVELOPMENT BANK

2014 was a historic year for the Brics countries (Brazil, Russia, India, China and South Africa). On July 15 – witnessed by Chinese president Xi Jinping and other Brics leaders in Fortaleza, Brazil – finance ministers signed an agreement to establish the Brics Development Bank, later named the New Development Bank (NDB). This historic agreement marks the institutionalised co-operation among the Brics, and is intended to play a significant role in the five states' economic development and in the reform of global economic governance.

Starting from the leaders' discussion to the signing of the final agreement, it has taken less then two years to set up the bank, which highlights the co-operative spirit among the Brics.

Uniqueness

The five Brics countries are diverse in the geographic sense, spanning Asia, Europe, Latin America and Africa. They are emerging economies, representing rising forces in the global economic system. Each country has its own unique economic endowment as well as development pattern.

Although disparate, the five states share the common target of economic development, which has led to shared faith in cherishing unity, enhancing macroeconomic policy coordination and giving full play to respective superiority. It is this common faith that ties the Brics together in economic terms and drives forward their economic co-operation.

With this co-operative spirit, strategic consideration of tackling challenges and goals of building new financial mechanisms with Brics' characteristics, the countries reached consensus and signed the official agreement to set up the bank within a short time. Manifesting esprit de corps, this particularly predicts a bright prospect for the Brics' development.

Infrastructure development

The Brics' leaders unanimously hold the belief that the NDB's mission is to promote infrastructure development, create sustainable development and build consensus among the member states. Infrastructure, especially in the transportation and energy sectors, has been a bottleneck hindering economic growth in developing economies. And many advanced economies are now also facing the problem of ageing infrastructure.

Overwhelmed by the new challenges of the global economy's weak recovery and in order to promote global economic growth, improving infrastructure can be seen as a key measure. This is also the experience that China attained from its own development.

The country's old saying "To get rich, build roads first" is far from obsolete. The Brics should unswervingly implement the resolutions of the agreement and fix the mission and guidance for the bank to promote infrastructure construction in the five countries.

The Brics' bank demonstrates the principle of equality. It is a special version of a financial governance mechanism, particularly when the five founding countries hold equal shares. The authorised capital is $100 billion and the initial subscribed capital is $50 billion, which is also divided equally among the Brics, 20% each.

The structure behind this arrangement is innovative because the quota is evenly distributed, rather than based directly on each country's GDP weight. This innovation remains open to be verified in practice. The Brics reached a consensus that the governance structure of the bank should reflect equality. This is an attempt to democratise international relations in the area of international finance. Its success depends on the efforts of the Brics to maintain and promote the spirit of co-operation in its future practice under the bank.

Collaborative potential

We hope that, with collaborative efforts and with the goal of promoting sustainable economic development, the Brics can fully tap economic potential and unleash inner vitality, facilitating the nations' growth and reform of the governance structure within the global economy.

The NDB is a complement to and addition to the current global finance system, rather than a replacement. The current system is led by the International Monetary Fund and the World Bank. Coexisting with this system, the Brics attach great importance to economic development and infrastructure construction, support existing international financial institutions, striving for more say in them, assuming due responsibility especially in promoting infrastructure development, and coordinating with them on the best practices of new trends.

The NDB is willing to enhance co-operation with the IMF and the World Bank, such as co-financing programmes to contribute to global infrastructure as well as the economic governance system. Through this, the voice and representation of developing countries, especially the Brics, should be strengthened.

Downward pressure

Huge downward pressure now confronts the global economy, and the Brics nations undoubtedly also face their own challenges. The population in the Brics accounts for 40% of the global population and economic aggregate accounts for 20% of the global economy. But more importantly, the Brics represent an emerging force and a development trend. History will prove that the NDB will play a significant role in promoting the Brics' infrastructure development and reform of the global economic governance mechanism.

The NDB is located in Shanghai, China, which demonstrates other Brics countries' great trust in China and Shanghai. We must unswervingly follow President Xi's instructions on this mechanism, making every effort to put the bank into early operation.

The detailed preparation work has already started. Previously, the first interim board meeting was held in Istanbul, Turkey. The interim board members were unanimous that they were determined to implement the resolutions signed by Brics leaders, preparing one or two high-quality projects as soon as possible by each country to ensure these initial projects could be promptly launched when the bank is put into operation.

Through the joint efforts of our Brics members, we are anxious that the NDB can kick off by late 2015, and make great and effective contributions to infrastructure development and economic growth within the Brics nations as soon as possible.

Zhu Guangyao is vice-minister of finance.

Outbound investment developments, challenges

China has become a major overseas investor over the past few years, both in the public and private spheres. *Jin Liqun*, secretary-general, Multilateral Interim Secretariat for Establishing the Asian Infrastructure Investment Bank (AIIB), looks at the challenges and responsibilities that such investment entails

Statistics indicate that Chinese outbound overseas investment has been on the rise over the past few years, with China ranked as the world number three in 2012. Moreover, out of all the emerging market economies, Chinese overseas investment accounts for 77%. In 2013, the total outbound investment stood at $107.9 billion, up by 22.8% year on year. In the same year, foreign direct investment in China was $123.9 billion, just $16 billion more than the outbound figure. In 2014, China became a net capital exporter.

Some academics indicate that when the per-head income of a country reaches $4,750, the country becomes a net exporter of capital, rather than an importer. The number is too exact to be credible, but when income hits around $5,000 a head, the country might have to think about exporting capital for its investment. One way or another, China's economy is undertaking an important development towards outbound investment with a likely huge impact on the rest of the world. Chinese investment is now more widely distributed across the world, with investors most interested in leasing, commerce and other business services, finance, mining, retail, wholesale, and some manufacturing related to mining. If overseas investments continue to increase, more sectors will be covered.

Jin Liqun

M&A on the rise

The size of mergers and acquisitions (M&A) has increased. The acquisition by China National Offshore Oil Corporation (CNOOC) of Canadian oil and gas firm Nexen in 2014 via a $15.1 billion deal, was a significant event. Even though this kind of contract may not occur again in the near term, there is strong possibility that it could be repeated in the future. Overall, the size of the M&A can be expected to increase.

Another noticeable feature is that local companies, rather than central companies, have increased their investment overseas, and non-state-owned private companies are increasing their foreign investment.

Chinese investment has contributed substantially to the development of the host countries. The positive impact on local economies and local communities has been appreciated by more and more people. The geographical distribution can be rather misleading. Chinese investment in Asia seems to be decreasing proportionately during recent years, but this is not because Chinese investors are losing interest in Asia, it is more due to China's investment being expanded to cover other regions of the world.

Hong Kong's role

Another factor is the role of Hong Kong. Even though Hong Kong's role as China's gateway to the outside world is not as big as 20–30 years ago because China is now opening up widely, it is still very important now. Many companies like to have their subsidiaries set up in Hong Kong as stepping stone to reaching out to the rest of the world.

With regard to Europe, China has maintained very strong business ties with European countries, particularly at a time when eurozone countries experienced tremendous difficulties. Some European countries appreciated China's general support when they were in a very difficult situation. In general, European countries warmly embrace Chinese investment, but there are some concerns with regard to Chinese-European economic ties. Sometimes there are noises from countries that seem to be very good friends with China. This kind of political sentiment could create problems, particularly if the nations are major destinations for China's overseas investment. Why should China consider pouring money into a country that seems to be hostile to it? Even if this does not represent the mainstream sentiment, and does not represent the official position of the countries, it is a little bit worrying.

CNOOC acquired Canadian oil and gas firm Nexen in 2014 in a $15.1 billion deal

zhengzaishuru / Shutterstock

Post-2008 picture

Ever since the 2008 financial crisis, many Chinese companies have been keen to increase their investment in European countries. In 2010, direct investment in the EU was €6.1 billion. By 2012, China's direct investment increased to €27 billion. The difficulties experienced by European countries appeared to provide Chinese companies with a great opportunity. Chinese manufacturer Shandong Heavy Industry Group purchased 75% of the Italian shipbuilding company Ferretti, manufacturer Sany Heavy Industry purchased German machinery fabricator Putzmeister, and the Chinese state energy grid company purchased the Portuguese state grid. It would be advisable for European countries to take more proactive steps geared towards investment from China, which provides opportunities for both Chinese and European companies.

Discrimination against investment from China is not wise. (Preferential trade agreements and other multilateral trade negotiations that do not include China create global cross-border investment distortions.) For instance, there are some non-EU countries that have reached trade agreements or can carry out transactions with EU members so that their countries can enjoy the privilege of access to the market, approximating the status of EU members. In this regard, China seems to be a lonely outsider, with Russia in a similar position. The exclusion of China is, in fact, detrimental to the European countries themselves. China is made conspicuous as an outsider by its huge amount of capital flow to Europe. This should be acknowledged as abnormal.

Europe and the US

Some politicians – and even the general public – have an ambivalence towards Chinese investment, which has been fuelled by the media. The media try to make sensational news about Chinese investors, exaggerating the negative impact on the local economy to a certain degree that leads the public sentiment to be a bit unfriendly towards Chinese investors.

I was once interviewed by a correspondent from the German newspaper *Die Welt*, who asked me: "Mr Jin, do you think that China would buy out the whole of Europe?" I said: "Thank you very much for your compliment. It's impossible for us to do that."

And the rhetoric of the 'China threat' has been amplified for the general population, which is a huge problem. It is worrying that there are appeals in some European countries, where they should have a unified investment review policy, to censor investment applications from China.

China has traditionally chosen the US as its main investment destination and China Investment Corporation (CIC) has poured significant amount of capital into the US for many years. The US has usually been a trusted destination country, based on its adherence to the rule of law as well as its political and economic stability. Nowadays, we have more and more returns from Wall Street firms and some of the well-known big US companies. It is therefore natural that Chinese investment in the US would increase, given this win-win situation. However, China has been experiencing similar difficulties of discrimination in the US and always hopes that the Committee on Foreign Investment in the United States (CFIUS) will not create any excuses to block China's investment to the US.

Private investment and responsibility

Meanwhile, China's non-state, private-sector investors are increasing their investment in the rest of the world. When they do so, they should obey the laws and rules of the country they are investing in, be aware of and respect the religions and local customs, protect the environment and the interests of local people. When a major project occurs, the investor should also contribute to the local community in terms of development, charity, education and health. The investor should try to create a harmonious relationship with the local community, so that people in Africa, Asia and Latin America could start to sense that Chinese investors care, not only for their own profit, but also for the mutual benefits arising from their investments. n

"Chinese overseas investment has been on the rise over recent years, and carries more weight across the world"

Jin Liqun

Fine-tuning the new era of outbound investment

Li Keping, vice-chairman, president and chief investment officer of China Investment Corporation (CIC), pinpoints how the country can overcome the challenges of gaps in knowledge and experience, in order to create co-operative foreign investments that are mutually beneficial to China and the host countries

China's outbound investment has increased by 39% a year since 2002, pushing the country's stock of foreign investment to $600 billion, according to statistics released by the Ministry of Commerce, the National Bureau of Statistics and the State Administration of Foreign Exchange in September 2014. Although the overall stock of Chinese foreign direct investment is ranked eleventh in the world, China's aggregate investment in 2013 ranked third, according to official Chinese statistics. With the volume of inbound and outbound investment having converged, China is now entering an era that will see it become a net exporter of investment in the coming decade. So it is essential to plan for the next steps.

This is especially important because China's economy has become highly integrated with the global economy. As the world's largest trading nation, this has an important impact both on demand and supply, with a great many Chinese enterprises now dependent on the global market. So it is imperative to have a global focus. As a result, it is natural to integrate vertical and horizontal industrial markets through capital export. This is also necessary to maintain rapid economic growth. In fact, a lot of multinational companies have been through the same process. In their optimisation of the allocation of the world's resources, these companies have simultaneously upgraded their distribution of products and improved their value chain. The issue is not whether China needs globalisation, but rather whether China can harness it successfully.

Turning point

Studies have shown that once GDP per head reaches around $4,000, a country hits a turning point regarding imports versus exports. At the same time, China's population is ageing – raising fears that the country 'may grow old before it gets rich'. China's ageing demographic profile is similar to that of advanced countries, but its overall economy is still underdeveloped by comparison. More challenges and problems will arise from the ageing population, which will become more obvious in the next 10–20 years – meaning there is less time for China, compared with other countries, to work out solutions.

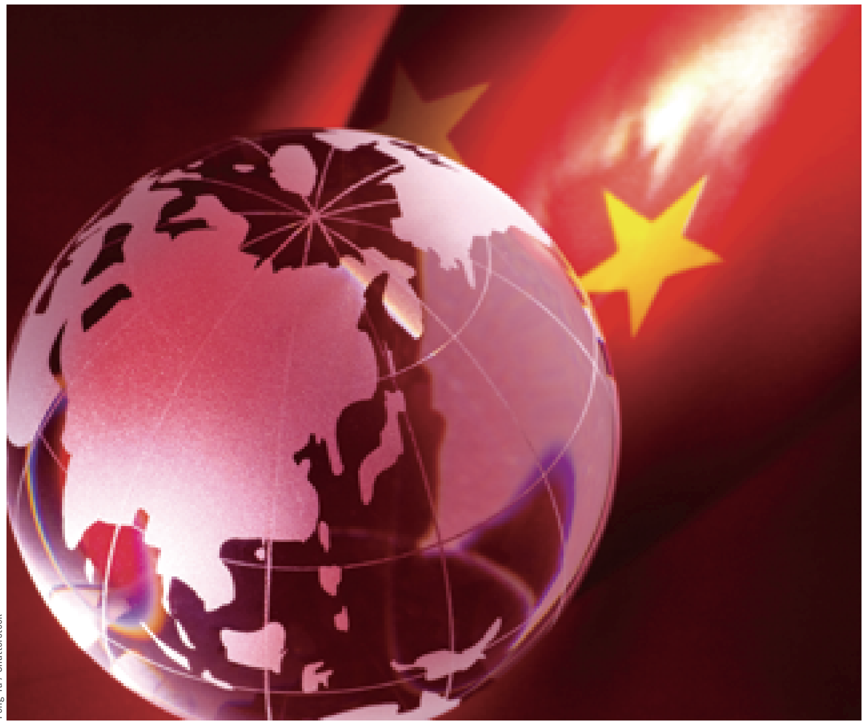
Another feature is that, although China has expanded its influence to more regions and industries, there is still a large gap in market knowledge, investment scale and economic development. An overseas investment project requires not only the right supply/demand environment, but also an overall level of development that determines the enterprise's appropriate standard of management and operation. China as a whole may not yet have achieved the capacity necessary for international management and global investment.

Management philosophy

The management philosophy of China's businesses is close-minded when compared with the rapid and internationalised growth of the real economy. Although enterprises import commodities and raw materials from the international market, and their products are delivered around the world, they lack an international view in terms of corporate management. The closed-minded management philosophy is, to some extent, determined by the stage of China's development. In addition, existing intricate rules and regulations for industries related to their responsibilities in areas such as the environment, ecology, sanitation and safety do not always protect the public from problems in these areas.

The whole of society is facing the pressures of these challenges. We have to admit that meeting strict rules and regulations have not been internalised as part of companies' management philosophy, but are treated only as measures that would add costs to their operations.

Li Keping



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As for the relationship between employees and employers, as a developing nation, China's state-owned enterprises have the most fair employment relationships, much better than those in private companies. In other words, from the perspective of this employment relationship, social welfare, social networks, managers and the overseas investment environment, there are a lot of inequalities preventing enterprises from realising the opportunities available to them.

In addition, there is a gap in attitudes towards overtime working between domestic and foreign businesses in terms of corporate culture and value. In China, employees work overtime automatically, and it is expected by employers. However, the same culture does not exist everywhere, and Chinese enterprises attract a lot of negative comments regarding this issue when they operate overseas.

Another challenge for China's economic development is the requirement for enterprises to have internationalised views, global strategic capacity and – most importantly – talented people. It calls for talent in the areas of international operations and international management.

Changing mindsets

Excepting structural challenges, some tangible issues such as behaviour and mindset have had a negative influence on China's overseas investment. For instance, if a Chinese enterprise does not have overseas investments, it can be viewed as less developed than its peers. But it is more important for China's enterprises to be prepared before following the rush into overseas investment. This will result in a higher likelihood of success.

Also, if we have a look at the research reports and conference materials on the topic, it is easy to find that people tend to attribute greater importance to the scale and speed of investment, rather than the quality and efficiency.

The focus on scale might sound good, but it blocks many of China's enterprises from making efficient and successful investment decisions. Another issue is that some enterprises focus on the process of investment, but neglect the management that follows in order to realise added value.

Companies are observed to lack the capability of achieving certain foreign investment goals. But foreign investment, as a strategy for development, can be made in the long term. It involves the extension and optimisation of companies' global industrial chains, not only helping to add value, but also the upgrading of business techniques and brands to help the overall structure.

Learning new business models through domestic and overseas economic integration is a very important element for enterprises to realise their goal of overseas investment.

However, this element has not gained enough attention within the process of investment. It is not the media's fault, but that of investors. Investors should have a global vision, and be clear about what they need and what they need to prepare to reach this goal, in order to improve themselves through the process of investment.

For overseas investment, the government should provide service and guidance while also, more importantly, making sure that enterprises share the fruit of economic globalisation. Businesses should focus on learning, accumulating and improving their capacity to engage in international operations and investment management, and establish talented teams of staff capable of such endeavours. At the same time, enterprises need to develop broad partnership networks, including peers in the same industry and in recipient countries. These partnerships are indispensable in terms of realising mutual benefits.

CIC, as a sovereign wealth fund, has been focusing on long-term investment, while providing services for domestic and overseas economic partners, and establishing a global investment platform and our own team. We have built a mutually beneficial platform to generate more profits and optimise global resource allocation to improve people's livelihoods. We have also developed co-operation with domestic and overseas partners.

Long-term co-operation

At present, we are discussing China's overseas investment from the perspective of an angel investor. But we will need bilateral agreements before investing in some developing countries' infrastructure projects. Investors have long-term capital, and would like to build mutually beneficial architecture through long-term investment. Recipients need to provide feasibility plans and the right legal environment to guarantee the social atmosphere for a stable and long-term investment. Success requires other conditions, too: bilateral co-operation on a longer-term basis and honesty. n

International trade, investment and co-operation

Overseas expansion of China's banking industry

The chairman of the Industrial and Commercial Bank of China (ICBC) , *Jiang Jianqing*, summarises the internationalisation history of China's financial and commercial institutions, and presents the lessons learned for the positive continuation of this global expansion

A historic turning point was reached in Chinese economic development in 2014, when the nation's direct foreign investments surpassed foreign countries' direct investments in China. As well-known scholar Deng Ning acknowledged, when a country's GDP exceeds $4,750 per head, direct foreign investments and foreign countries' direct investments will reach equilibrium. Once it reaches this level, outbound investments should exceed the inbound. He did not include China when carrying out this statistic analysis. But the country's GDP has now surpassed $6,000 per head, which could be a healthy sign.

However, China should better develop its direct foreign investment, rather than purchasing foreign countries' national debts via huge foreign-exchange reserves. Many entrepreneurs, including private enterprises, are increasingly adept at using the imbalance between global supply and demand to develop business. Accordingly, we see more Chinese enterprises carrying out overseas mergers and acquisitions than previously, while also establishing factories and stores abroad.

China is currently living through a truly great epoch. With many companies bringing more business to China's international banks, ICBC has now set up more than 330 branches in 40 countries, with total overseas assets of $250 billion and expected overseas profits of $3 billion this year. If we rank all big banks around the world, these overseas profits would rank around seventieth to eightieth, exceeding many big foreign banks' total profits.

As can be seen from this process, the development of global financial international banks has a very clear context. 100 years ago, its development was accompanied by the rise and development of capitalism and colonialism to a large extent.

After the First and Second World Wars, the global financial centre began to move to America. After the 1980s, Japan developed rapidly because of positive demographics and innovative reform. From the 1990s to the 2000s, Japan entered a phase of stagnation. Then US banks again developed quickly because of the growth of the technology sector and European banks because of the birth of the euro. After the 2007/2008 financial crisis, the European and US banking industry was affected on a large scale, but Chinese industry achieved rapid development through various drivers such as positive demographics, economic reform and foreign trade. China's major banks completed joint-stock system reform and rapidly improved their profitability and market competitiveness, becoming strong competitors on the global financial market.

Lessons to be learned

Several guidelines for banks' international management can be gathered from the past century's development.

First, transnational banks are usually closely connected to the domestic economy and coexist with the latter's own globalisation process. The size and strength of global major banks are always matched by their domestic economy. And their competitiveness in the international market is also compatible with their international influence.

Therefore, the Chinese banking industry's size within the global banking industry is huge at the moment, with an increasingly rapid pace of transnational management and stronger global competitiveness, which is completely consistent with the pace of Chinese economic development. Many Chinese companies' ventures abroad match this process, banks included. The first reason is demand, followed by capability – that is, when financial capability and managerial capability have developed to a certain stage. If China's internationalisation had been brought forward by 20 years, then there would have been many failures. So the current internationalisation just matches economic development exactly.

Jiang Jianqing

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Second, as can be seen from the process of banks' internationalisation, a diversified regional structure would improve risk-avoidance capabilities, as the economy is highly related to finance, and there is usually a convergence between economic performance and economic cycles. Regional diversified international management could, however, help deal with domestic economic fluctuations. Major commercial banks and multinational companies that have been active in the global financial markets for the past century have businesses in many countries and regions around the world that can help to insulate them against periodic fluctuations.

Third, a strategy of steady development is crucial, which Chinese banks and firms should acknowledge and value during the current fast pace of transnational management. Major multinational corporations and banks in the world all realised their development after going through tens or sometimes even hundreds of mergers. An economics Nobel laureate once said that there is no American giant company that did not develop and become strong via merger. Nevertheless, nearly no major company in China has developed in this way – most have undergone endogenous development. It is not until now that some companies have begun to carry out global mergers and acquisitions. Because of their lack of experience, Chinese companies should pay special attention regarding risk prevention, establishing various strategies adapted to the market environment and resource endowment, rather than slavishly imitating others and losing direction. Many banks have lost hugely during their international development, even becoming impoverished. Out of the 20 biggest banks in the world in 1913, there are only five banks today that have not been acquired and absorbed, or gone broke, with 75% of them having declared bankruptcy. This shows the importance of steady development.

Regulatory hurdles

There are some new conditions that banks need to be cognisant of regarding the international development process. As financial protectionism continues, strict regulatory controls have increased the difficulty of carrying out overseas mergers. Moreover, regulatory institutions apply different criteria on domestically funded institutions compared with foreign-funded institutions. There are also even stricter requirements on foreign-funded institutions with respect to market access, business practices, personnel structure, profitability requirements and consumer protection.

With differences in supervisory rules among various countries and managerial regulatory independence of financial institutions in different regions increasing, the operational difficulty of integration for commercial and international banks becomes even larger.

During the process of banks' internationalisation, conglomerates are facing a decentralisation trend – namely, every country has its own requirement to regulate branches independently, and that also promotes the decentralisation trend. These phenomena should be highly concerning. Positive as the overall situation of Chinese banks' international management is – 18 domestically funded banks set up 1,127 foreign-funded institutions overseas in 51 countries and regions, with more than $1.2 trillion of total assets up to the end of last year – Chinese banks still face countless challenges in international management.

> *"A strategy of steady development is crucial, which Chinese banks and firms should acknowledge and value"*
>
> *Jiang Jianqing*

The range of network topology remains small – management depth still needs to be expanded. Many institutions are inadequate in their service range, weak in their customer base, and their comprehensive service standards still need to be improved, which might have something to do with the parent commercial banks' insufficient international management.

Compliance risk and risk control are also challenges. With new international regulatory criteria made increasingly strict and the increase in the size, types and complexity of domestically funded banks across the world, banks can face even harsher regulations and challenges, such as country risks, legal risks and reputational risks. Some European banks have received huge fines in the US recently, which is a lesson we can draw from others' mistakes.

There are multidimensional obstacles in cultural integration: we should not only overcome the barrier of lowered operational efficiencies caused by language differences, but also be aware of apparent differences between Chinese and foreign ways of thinking. For instance, there are differences of opinion on subjects like a sense of hierarchy and working overtime between expatriates and local employees. Because there are large differences between Chinese and foreign employees regarding politics, culture, customs, religion, labour and law, we should pay a great deal of attention to cultural inclusiveness.

It is important to emphasise improvements in institutions and mechanisms. For example, with respect to operational systems, many institutions do not have sufficiently large scale in their offshore institutions. The first challenge is to improve service efficiency and standards to create economic scale. With respect to technological support, huge challenges remain for multinational companies managing their groups and for the global management of technological platforms.

Great expectations

Some of the expectations for the international development of China's banks include:

- First: always serve the globalisation of the Chinese economy. China's banks went global first, which has created a vital platform for domestically funded businesses to develop in the international markets. Many of these firms are not familiar with conditions like local laws and labour traditions when they first move into a new, foreign environment. However, their worries are lessened if they have a China-funded bank as a partner. Additionally, Chinese banks would get increased business if China-funded businesses ventured abroad more. Banks are enjoying rapid development in international business now, with tremendous business opportunities derived from the internationalisation of the renminbi. In our $250 billion of total overseas business assets, more than 20% of the assets and businesses and nearly 30% of the profits are from overseas renminbi business. For some overseas branches in particular, 60% of their profits come from overseas renminbi business. Consequently, with future overseas renminbi business growing in scale, renminbi internationalisation will increase, creating new opportunities for the internationalisation of China-funded banks.
- Second: localise business development. Setting up overseas branches is not the core of constructing multinational banks. Overseas banks should stick to the principle of equality, mutual benefit and win-win results, realising sustainable, localised and mainstream development. Meanwhile, they should actively participate in the economic construction of their host countries, promoting local economic development, and improve living standards and employment.
- Third: always strive to establish a world-class product line. When developing overseas, we cannot simply copy the product from China into other countries, as it doesn't usually fit internationally. ICBC is concentrating on some business fields and breaking new ground in markets, in order to form strong market service capabilities. For example, it is putting its efforts into – among other fields – the promotion of global cash management, trusteeship, capital management, precious metals, investment banking and leasing businesses. In several product lines like trade, capital-raising and gross settlement, we should form global product lines that will be hugely competitive.
- Fourth: corporation management and risk management should always be the priority. In the construction of transnational banks, we should strictly follow the regulatory requirements of the international banking industry, improve overseas corporation management according to law and rules, fully realise the political risks, compliance risks, market risks, credit risks, reputational risks in multinational management; and enhance the predictive capacity and scientific methods of risk prevention, to ensure capital security for banks.

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Integration is key

Last: always persist in constructing an integrated group managerial mechanism. China's transnational banks' overseas institutions must take advantage of their own strength in building an integrated mechanism for internal and external interactions and coordinated development. In addition, strengthen the training of global staff and reinforce the cohesion of global employees' groups.

This is a perfect time for China's development. With the country rapidly opening up, with transnational banks and companies helping each other forward, a bright future surely awaits us.

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International trade, investment and co-operation

Appendix: Major reforms in trade, investment and development co-operation

Date	Reform measures	Comments
October 2000	Forum on China-Africa Cooperation (FOCAC) founded	Beijing Declaration of the FOCAC proposed. Human Resources Development Fund for Africa founded.
May 2001	China became a member of the 'Bangkok Agreement'(the first agreement on trade negotiations among developing member countries of the Economic and Social Commission for Asia and the Pacific)	It included six official member countries. Tariff reductions were mutually achieved among member countries.
June 2001	The Shanghai Cooperation Organisation (SCO) founded	Includes six member countries with an aim to facilitate multilateral trade and investment co-operation among members.
December 2001	China became a member of World Trade Organization (WTO)	A series of reforms that facilitate free trade and free markets adopted.
February 2002	Regulations of the People's Republic of China (PRC) Governing Financial Institutions with Foreign Capital revised	Restrictions on foreign banks largely relaxed.
November 2002	Security investment category in capital account liberalisation moved forward	Qualified Foreign Institutional Investor (QFII) scheme formed and inward portfolio investment liberalised but controlled by quotas.
March 2003	Administration of Foreign-invested Venture Investment Enterprises Provisions established	Foreign venture capital inflow was permitted.
June 2003	Closer Economic Partnership Arrangement signed	The aim was to facilitate trade and investment between mainland China and Hong Kong.
October 2003	Forum for Economic and Trade Cooperation between China and the Portuguese-speaking Countries established in Macau	The aim was to enhance economic co-operation with Portuguese-speaking countries.
April 2004	Foreign Trade Law of The People's Republic of China revised	Trade operator needs registration for record rather than approval.
November 2004	Other investment category liberalisation in capital account moved forward	Renminbi deposit business of individuals permitted in Hong Kong. Individuals allowed to buy and transfer foreign exchange cross border under quota control.
February 2005	China-Caribbean Economic and Trade Cooperation Forum established	
September 2005	Security investment category liberalisation in capital account moved forward	International development organisations allowed to raise debt denominated in renminbi. Asian Development Bank issued 1 billion yuan worth of debt in China.
November 2005	China-Chile Free Trade Agreement signed	The tariff on most traded goods will gradually adopt a zero rate between the two countries.
April 2006	China-Pacific Island Countries Economic Development and Cooperation Forum established	Aimed at supporting the Pacific Plan and enhancing regional co-operation.
July 2006	Outward direct investment largely liberalised	Quotas on firms' investment in foreign currencies abroad were removed.
June 2007	Security investment category in capital account liberalisation moved forward	Qualified Domestic Institutional Investor (QDII) scheme formed. Outward portfolio investment liberalised but controlled by quotas.
June 2007	China-Africa Development Fund (CADFund) founded	China Development Bank is the main shareholder, with an aim to support Chinese firms investing in Africa.
July 2007	Security investment item liberalisation moved forward	Renminbi-denominated debt allowed to be issued in Hong Kong.
September 2007	China Investment Corporation (CIC) founded	CIC serves as a sovereign wealth fund. CIC invested in Blackstone and Morgan Stanley as of 2007.
January 2008	The Law of the PRC on Enterprise Income Tax enacted	Foreign firms are treated as equally as domestic firms in terms of tax rates.
April 2008	China-New Zealand Free Trade Agreement signed	The tariff on most goods traded will gradually adopt a zero-rate policy. Service trade areas are expanded beyond WTO agreement.
October 2008	China-Singapore Free Trade Agreement signed	The tariff on most goods traded was reduced to zero. Entry barriers of service trade became lower.
April 2009	China-Peru Free Trade Agreement signed	The tariff on most goods traded was reduced to zero. Selected categories in service trade were mutually opened up.
April 2009	Current account liberalisation moved forward	Trials for settling cross-border trade accounts in renminbi initiated.
January 2010	China and Association of Southeast Asian Nations (Asean) Free Trade Area established	Formed by China and 10 ASEAN countries with an aim to facilitate trade, investment and co-operation among member countries.

Appendix: Major reforms in trade, investment and development co-operation

Date	Reform measures	Comments
April 2010	China-Costa Rica Free Trade Agreement signed	The tariff on most goods traded was reduced to zero. Selected categories in service trade were mutually opened up.
April 2010	China-ASEAN Investment Cooperation Fund established	Mainly funded by China EximBank, with an aim to invest in the infrastructure and resource projects in ASEAN countries.
November 2010	Security investment category in capital account further relaxed	Foreign banks gain access to the domestic interbank bond market.
October 2011	Foreign direct investment (FDI) liberalisation moved forward	Outward FDI (OFDI) and FDI in renminbi permitted, but large-scale investment needs approval.
December 2011	Security investment category in capital account further relaxed	Renminbi Qualified Foreign Institutional Investor (RQFII) scheme introduced to allow qualified firms to invest offshore renminbi back into China, subject to an overall ceiling.
December 2012	Other investment category in capital account further liberalised	Cross-border renminbi loans experimented in Shenzhen.
September 2013	FDI liberalisation moved forward	Foreign investment in domestic financial institution in renminbi is permitted.
September 2013	China (Shanghai) Pilot Free Trade Zone founded	Negative listing scheme introduced for managing foreign investment. Restrictions on investment, capital account convertibility and firm entry largely relaxed within the zone.
July 2014	State Council's *White Paper on China's Foreign Aid* published	The white paper reviewed the achievements of foreign aid conducted by China under the South-South Development Cooperation (SSDC) framework during 2010–2012.
July 2014	The New Development Bank (formerly the Brics Development Bank) founded	Five member countries signed the agreement with an aim to support infrastructure investment in the Brics countries (Brazil, Russia, India, China and South Africa) and other developing countries.
October 2014	Asian Infrastructure Investment Bank (AIIB) founded in Beijing	There are 32 member countries so far, as of March 2015, with the aim of facilitating infrastructure investment in Asian developing countries.
November 2014	Security investment category in capital account further relaxed	Renminbi Qualified Domestic Institutional Investor (RQDII) scheme introduced to allow qualified firms to invest in offshore renminbi-denominated financial products.
November 2014	Shanghai-Hong Kong Stock Connect programme initiated	The stock market in Shanghai is opened to Hong Kong investors and the stock market in Hong Kong is also opened up to investors in China, both with restrictions. Only institutions with approval can engage in the programme. Investable stocks are limited and daily net purchases are restricted by ceilings.
November 2014	The Asia-Pacific Economic Co-operation (Apec) summit held, and the 'One belt, one road' vision was announced by Chinese president Xi Jinping	The Apec Connectivity Blueprint for 2015–2025 laid out. Negotiations regarding the China-Korea Free Trade Area saw crucial progress.
November 2014	The Silk Road Fund proposed, with initial investment of $40 billion from China	Mainly funded by the State Administration of Foreign Exchange (SAFE) and the central bank and open to other investors, with an aim of supporting the 'One belt, one road' strategy.
January 2015	New Zealand becomes a member of the AIIB	New Zealand become the twenty-fourth member of the AIIB
January 15-16, 2015	Meeting of the chief negotiators of the AIIB held in Mumbai	Four more countries have become the Provisionary Founding Members of AIIB, and articles of agreement (AoA) are being discussed, and expected to be completed in summer 2015.

THE RENMINBI AND THE INTERNATIONAL MONETARY SYSTEM

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The rising international role of the renminbi

The global reach of Chinese investment and the renminbi have expanded rapidly over the past few years. The currency's journey is seen by some as a reflection of China's global ambition and expansion

The international use of the renminbi has risen dramatically in the past five years. The renminbi is now the second most-used currency in trade finance and the fifth most-traded payment currency, according to Swift. The offshore renminbi market has also sprouted, with renminbi clearing centres emerging in Australia, Germany, Hong Kong, Singapore and the UK, among others, along with trillions of yuan of bilateral currency swap arrangements between the People's Bank of China (PBOC) and foreign central banks to provide liquidity support when needed. To observers, the growth of the renminbi's international role, along with China's global investment (see section 3, pp. 59–84), epitomises the country's expanding global ambition, against the backdrop of its fast economic expansion and the further integration of its economy into the global system.

The shortcomings and vulnerabilities of the current global financial system, the rising outreach of Chinese trade and investment, and the progress of China's financial and capital account reforms, have all shaped the renminbi's steady rise on the global stage.

A multi-pillar international monetary system with the renminbi as a reserve currency, supported by a more open capital account and a wider floating currency, will deliver benefits to both the global financial order and better growth domestically.

Shortcomings of the global monetary system

A global financial system that uses a single fiat money as its reserve currency faces an acute problem of discipline. The rest of the world relies on the reserve currency for transactional and savings purposes, generating huge demand for the designated reserve currency. This allows the reserve currency country to spend more than its export revenue allows, since its international debt does not face the pressure of a sell-off and squeeze by investors, as in the case of non-reserve currency countries. Such an "exorbitant privilege" – as Valéry Giscard d'Estaing, then the French minister of finance, noted in the 1960s – could give the reserve currency country an enormous advantage in its economic growth and management. In addition, the dominant role of the dollar means that the US effectively acts as a global central bank, and US monetary policy has great influence over international liquidity and economic conditions in other parts of the world.

The dollar's role in the international monetary system has been under continuous debate since it replaced sterling as the reserve currency more than 70 years ago. While the dollar has facilitated the liquidity of the global financial markets, providing anchors for countries during periods of macro stabilisation, the downside of the system has also been prominent at times. The US balance of payments crisis in the late 1960s resulted in the collapse of the Bretton Woods mechanism as the dollar de-pegged from gold. In the decade before the global financial crisis, US fiscal and external deficits rose substantially, leading to concerns about global balance of payments imbalances. However, the demand by foreign companies and governments for dollars helped to keep the US interest rate low, enabling it to fund large current account deficits while fuelling domestic asset bubbles (such as real estate). A report from the United Nations Conference on Trade and Development (UNCTAD) attributed the build-up of global imbalances and global financial crisis in 2008 to the inadequacy of the international monetary system, a view shared by Justin Lin (see "International monetary system: fixing the fault lines", pp. 98–99).[1]

An ultra-loose monetary policy in reserve currency countries since the global financial crisis, with the sole focus on domestic economic objectives, has depressed global interest rates while driving capital flows to emerging markets. For instance, a recent study by the Bank for International Settlements (BIS, 2014) finds that the unconventional US monetary policy spills over to Asia mainly through low domestic bond yields and rapid growth of domestic bank credit, by compromising national control over long-term rates that are key determinants of economic activity.[2] The expected reversal of this process in the coming year will likely imply a bumpy ride for the rest of the world.

As summarised by Kim Jun Il, deputy governor of the Bank of Korea, in his comments at the IFF AGM in 2014, under the system of a single reserve currency, the role of the reserve currency as a medium of exchange could come into conflict with its role as a store of value, as the demand for the former could reduce the incentive for keeping up with the latter. This subjects the world financial system to the whims of the monetary policy of the reserve currency country. A more diversified international monetary system, by introducing competition into the system, would likely help to ensure the store of value of reserves. Emerging market governments, therefore, are particularly keen to see this development – as net creditors in the

Table 1: Government and corporate debt levels in China, Japan and the US (2005–2014)

Country	Year	Government bonds turnover ($ billions)	Government bonds outstanding ($ billions)	Government bonds turnover ratio	Corporate bonds turnover ($ billions)	Corporate bonds outstanding ($ billions)	Corporate bonds turnover ratio
China	2005	213.82	798.70	0.27	40.04	54.92	0.73
	2006	272.73	1,049.62	0.26	77.34	99.45	0.78
	2007	621.16	1,453.81	0.43	113.69	143.21	0.79
	2008	1,519.63	1,931.96	0.79	212.91	234.54	0.91
	2009	1,170.23	2,063.94	0.57	477.91	427.14	1.12
	2010	2,298.36	2,387.55	0.96	775.69	627.79	1.24
	2011	1,578.61	2,507.38	0.63	1,001.73	812.26	1.23
	2012	2,055.24	2,729.67	0.75	1,156.15	1,177.76	0.98
	2013	495.39	2,979.47	0.17	262.26	1,428.77	0.18
	2014	1,053.63	3,345.31	0.31	306.36	1,544.90	0.20
US	2005	143,994.56	7,185.16	20.04	4,172.62	5,120.91	0.81
	2006	138,057.95	7,512.19	18.38	4,255.70	5,503.54	0.77
	2007	150,037.83	7,941.48	18.89	4,129.47	6,118.48	0.67
	2008	144,252.01	9,291.36	15.53	3,609.37	6,390.69	0.56
	2009	105,932.89	10,922.27	9.70	5,025.94	7,089.16	0.71
	2010	136,451.02	12,625.17	10.81	5,153.63	6,543.80	0.79
	2011	145,933.53	13,647.81	10.69	3,931.20	6,618.10	0.59
	2012	133,611.86	14,760.52	9.05	4,214.10	7,050.50	0.60
	2013	140,252.77	15,525.66	9.03	4,551.22	7,457.90	0.61
	2014	129,847.08	16,157.16	8.04	5,008.50	7,840.30	0.64
Japan	2005	7,322.13	6,162.55	1.19	128.58	734.70	0.18
	2006	10,276.43	6,450.32	1.59	70.25	716.09	0.10
	2007	14,735.05	6,963.60	2.12	87.91	783.24	0.11
	2008	12,793.06	8,137.43	1.57	108.43	918.83	0.12
	2009	11,327.24	9,023.21	1.26	56.64	1,014.24	0.06
	2010	11,800.55	10,241.15	1.15	73.79	1,081.14	0.07
	2011	13,232.75	11,432.28	1.16	90.74	1,147.23	0.08
	2012	12,263.31	11,229.04	1.09	89.23	1,048.79	0.09
	2013	11,340.94	9,444.31	1.20	63.71	811.60	0.08
	2014	11,048.75	8,414.56	1.31	55.01	692.62	0.08
	2014	11,048.75	8,414.56	1.31	55.01	692.62	0.08

Source: iFinD, CEIC, Asian Development Bank

1 *unctad.org/en/Docs/tdr2009_en.pdf*

2 *www.bis.org/publ/work478.pdf*

global financial system, they have a proportionally larger share of US government debt and are vulnerable to big valuation losses on these holdings. The current global financial governance is in need of substantial reforms (see interview with Zhu Guangyao, vice-minister of finance, pp. 92–93).

The issue of a new global reserve system has attracted much attention in recent years, and different options have been proposed. One approach is to use a notional currency, such as by extending the special drawing rights (SDR) of the International Monetary Fund (IMF). The SDR is an international reserve asset, created by the IMF in 1969 to supplement its member countries' official reserves under the Bretton Woods system. At present, the SDR comprises a basket of four currencies of developed nations: the dollar, euro, sterling and yen. Such a composition does not match the shift in global trade and investment in recent years where the importance of emerging markets is rising rapidly.

In 2009, PBOC governor Zhou Xiaochuan proposed that the currency basket of the SDR should be expanded to include emerging market currencies such as the renminbi, to make its currency composition more representative of the reality of global economic power. This year, the IMF will undertake its five-yearly SDR review, where the possibility of including the renminbi will be assessed. A positive assessment would be a strong vote for and powerful sign of the renminbi's international status, but the outcome remains highly uncertain, given the IMF criterion of the "freedom of use" of currency.

It is not the case, however, that a notional SDR – even if expanded – would be ready to replace the dollar as the international reserve currency. By design, the SDR does not have the backing of taxation and/or commodities of national currencies. According to the IMF, "the SDR is neither a currency, nor a claim on the IMF. Rather, it's a potential claim on the freely usable currencies of IMF members". In addition, it does not have enough liquidity. The SDR – despite its long history – has remained a small share of global reserve assets (around 4%), with its use mostly confined to the official sector. There remain very limited private market activities in SDR. Moreover, the creation of a global currency such as the SDR will likely meet strong resistance from current reserve currency countries such as the US.

Is the renminbi suitable as the third reserve currency?

An alternative approach where an international financial system comprises multiple reserve currencies is likely to be more promising. Each of these reserve currencies would be backed by its respective national economy, and the coexistence of multiple currencies would introduce competition and some discipline into the international monetary system.

CHINA'S PLAN TO MAKE THE RENMINBI MORE FREELY USABLE – ZHOU XIAOCHUAN, GOVERNOR OF THE PEOPLE'S BANK OF CHINA

This year, the International Monetary Fund (IMF) will conduct its quinquennial special drawing rights (SDR) review. One important issue in the review will be whether the renminbi will be included in the SDR currency basket. One of the criteria for an SDR currency is that the currency must be 'freely usable', which requires a certain degree of capital account convertibility.

The goal of achieving capital account convertibility was first put forward in the early 1990s by China, and was reiterated in the Twelfth Five-Year Plan and at the Third Plenum of the Eighteenth Central Committee of the Communist Party of China (CPC).

Over the last two decades, China has been making steady progress towards achieving this goal, despite the adverse impact of the Asian financial crisis and the global financial crisis. As well as being the time for the SDR review, 2015 is also the final year of the Twelfth Five-Year Plan. China is prepared to take a series of targeted reforms to further increase the renminbi's capital account convertibility.

Capital account convertibility

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, the country achieved current account convertibility and announced it would seek to achieve capital account convertibility.

However, this process was delayed by the Asian financial crisis that erupted soon after. At the Third Plenum of the Sixteenth CPC Central Committee in October 2003, China once again made it clear that it would "gradually achieve renminbi capital account convertibility".

From then on, much progress has been made in streamlining foreign exchange management and promoting capital account convertibility:

- the renminbi has largely become convertible for foreign direct investment (FDI) and outward direct investment (ODI);
- registration-based management has been adopted for trade credit and trade-related claims on nonresidents, and only external debt remains subject to quota management;
- and the Qualified Foreign Institutional Investors (QFII) and Qualified Domestic Institutional Investors (QDII) programmes have been introduced and improved.

Zhou Xiaochuan

The process of renminbi capital account convertibility was interrupted again by the global financial crisis in 2008. At the same time, because of the shortage of hard currencies and increased volatility among major currencies, the demand for the renminbi in many countries has increased.

In response, China began to facilitate the use of the renminbi in cross-border trade, and direct investment expanded renminbi cross-border financial investment in several ways, including: allowing foreign institutions to invest in the domestic interbank market, and launching the Renminbi Qualified Foreign Institutional Investor (RQFII) programme; continuously deepening bilateral monetary co-operations, with 28 bilateral local currency swap agreements signed; promoting the steady development of offshore renminbi markets; and establishing renminbi clearing banks in 14 countries/regions.

These steps have not only supported the fast development of renminbi internationalisation, but also further strengthened renminbi capital account convertibility.

In 2011, the goal of "gradually achieving renminbi capital account convertibility" was reiterated in the Twelfth Five-Year Plan. At the Third

The new system would be a departure from the current dollar-centric international monetary system. At present, the dollar remains a dominant reserve currency. Although its share has declined somewhat since the introduction of the euro, the dollar still accounts for about 62% of global reserves (compared with more than 70% in the early 2000s), 87% of global foreign exchange transactions, and 81% of international trade settlement.

Although the use of the euro has become more prominent since the adoption of the common currency (accounting for 23% of global reserves, compared with less than 15% before the adoption), its further expansion on the global stage could be challenged by two factors. First, the government debt market in Europe is segmented and the respective national government debt markets are shallow. Since there is not a single euro government debt market, none of the individual government debt markets come close to the size of the US Treasury market.

Second, the recent crisis may have thrown the currency's prospects into uncertainty. The eurozone economy is still struggling with a prolonged recession. Both the corporate sector and the financial sectors are still going through restructuring since the global financial crisis. Several euro area countries now have very large deficits and debts, raising questions about the sustainability of their public finances. In addition, debt crises in individual countries – in particular, Greece – have raised concerns about the very survival of the currency. The prospect of the euro playing a significantly larger international role in the coming decade is likely to be constrained by the uncertainty associated with these debates.

Could the renminbi be a suitable candidate for the third major reserve currency? Historically, countries with a large economy and trade combined with a stable macro environment tend to see a comparable rise in the global role of their currencies. In the view of Barry Eichengreen, professor of economics at University of California, the world needs to be prepared for a system where the dollar, euro and renminbi will all be consequential international and reserve currencies. The multi-polar international monetary system is needed to reflect a more multi-polar world economy. In his view, after World War II, when the US accounted for the majority of industrial production of the non-Soviet world, it made sense that the dollar was the principal unit in which exporters and importers invoiced and settled their trade, in which international loans were extended, and in which central banks held their reserves. But this situation makes less sense today, as the US accounts for just 20% of the combined output of countries engaged in international transactions (Eichengreen, 2010).[3]

Indeed, ever since the relaxation in 2009 of the self-imposed constraints on the use of the renminbi in trade settlement, the

Plenum of the Eighteenth CPC Central Committee in 2013, it was announced that China would seek to "speed up the process toward renminbi capital account convertibility". The China (Shanghai) Pilot Free Trade Zone was established in 2013. In the second half of 2014, the Shanghai-Hong Kong Stock Connect programme was successfully launched, representing an important step in the liberalisation of the capital market.

At present, there are only a few capital account items that are completely inconvertible.

According to the IMF's classification of capital account transactions, 35 out of the 40 items are fully or partly convertible in China, and only five items remain inconvertible.

These five items mainly involve individual cross-border investment and the issuance of shares and other financial instruments by nonresidents on domestic markets. Therefore, China is not far from achieving its goal of renminbi capital account convertibility.

A more freely usable currency

In 2015, China will launch a series of reforms targeting currently inconvertible items under the capital account, with the aim of further promoting renminbi liberalisation and making it a more freely usable currency.

First, the country will create channels for cross-border investments by individual investors, including the launch of the pilot Qualified Domestic Individual Investor (QDII2) programme.

Second, China will introduce the Shenzhen-Hong Kong Stock Connect programme, and nonresidents will be allowed to issue financial products on the domestic markets (with the exception of derivatives).

Third, foreign exchange regulations will be revised to remove requirements for *ex ante* approvals in most cases, and an effective system will be built for *ex post* monitoring and macro-prudential management.

Fourth, measures will be taken to further facilitate access to the Chinese capital markets by overseas institutional investors.

Fifth, efforts will be made to further facilitate the international use of the renminbi by removing unnecessary policy barriers and providing the necessary infrastructure.

Sixth, steps will be taken to ensure sound risk prevention.

It is worth noting that the concept of capital account convertibility has changed since the global financial crisis.

The capital account convertibility that China seeks to achieve is not based on the traditional concept of being fully or freely convertible. Instead, drawing lessons from the global financial crisis, it will adopt a concept of managed convertibility. After achieving renminbi capital account convertibility, the country will continue to manage capital account transactions, but in a largely transformed manner, including using macro-prudential measures to limit risks from cross-border capital flows and to maintain the stable value of the currency and a safe financial environment.

China will retain capital account management in four cases.

First, cross-border financial transactions that involve money laundering, financing of terrorism, as well as those that overly exploit tax havens will be subject to monitoring and analysis. This is a practice widely adopted by most countries.

Second, macro-prudential management of external debt remains necessary in emerging market economies. Excessive foreign debt in the private sector and significant currency mismatches were the origins of the Asian financial crisis. Countries need to learn the lesson from the crisis, and macro-prudential measures could be used to manage their external debt when necessary.

Third, short-term speculative capital flows will be managed when appropriate, while lifting controls on the medium- and long-term capital flows that support the real economy. This is also a recommendation by the IMF.

Fourth, balance of payments statistics and monitoring will be strengthened. As suggested by the IMF after the global financial crisis, countries may adopt temporary capital control measures when there are abnormal fluctuations in the international markets, or there are balance of payments problems.

This text is an excerpt of a speech made by Zhou Xiaochuan at the IMF World Bank Spring Meeting in April 2015.

3 *eml.berkeley.edu/~eichengr/managing_multiple_res_curr_world.pdf*

share of China's currency in global trade has rapidly grown, driven by the real needs of merchants to manage exchange rate risks in trade transactions.[4] While the initial policy focus was to encourage the denomination and settlement of bilateral trade transactions in renminbi, the government started to actively promote the use of the renminbi in investment transactions to spearhead capital account reforms. The latter includes the recent expansion of renminbi-denominated cross-border portfolio investment, the increase of renminbi-denominated bonds in the offshore market and the rise of outward direct investment in renminbi.

To support the international use of the renminbi, the government has also developed related financial infrastructure and expanded currency swap arrangements with central banks across the globe to provide liquidity support in offshore renminbi markets. The private sector has embraced these liberalisation measures, and transaction volumes have increased strongly from a low base.

Conditions for internationalisation shaping up

There are still several important shortcomings inhibiting the renminbi's global status.

First, as the Chinese financial system remains bank-dominant, the bond market is still comparatively small. The size and liquidity of China's debt market currently lags behind those of existing reserve currency economies.

In particular, the total debt outstanding in China stands at around $5 trillion (versus $25 trillion for the US and $9 trillion of Japanese bonds). The Chinese government's bond debt is around $3.3 trillion, compared with more than $12 trillion of US government debt. The turnover ratio is relatively low, as well. In China, the turnover ratio is about 1, compared with 14.2 in the US, pointing to low liquidity in the market (Prasad, 2014). A global reserve currency will need to be supported by a large and liquid bond market so that global investors can invest and maintain the value of their assets.

Second, the exchange rate exhibits limited flexibility under the managed float regime. Both the daily central parity rate of the renminbi against the US dollar and the daily trading range around the central parity are controlled by the government.

And third, cross-border capital flows still face various restrictions. It should be noted, however, that the *de jure* measure of capital account openness likely significantly overstates the restrictiveness of the system, as incremental reforms over the years have greatly increased the mobility of the cross-border flows. Cross-border bank flows are particularly large, with their size (relative to Chinese GDP) on par with open economies such as Australia, according to the IMF. Current account transactions – including trade and services – have also been used as channels for disguised capital flows at times.

> *"The growth of the renminbi's international role, along with China's global investment, epitomises the country's expanding global ambition"*

Despite these challenges, recent incremental efforts to liberalise the Chinese currency have resulted in the rapid increase in its use as an international currency.

First, the bond market has grown rapidly to become the third largest in the world. The development of the bond market also suits domestic objectives, as it reduces the reliance on the banking system for financial intermediation, while improving the role of direct financing, to better manage the system risks. The gradual opening-up of the domestic bond market to foreign investors could see liquidity rise.

Second, the exchange rate regime has also seen steady reforms. The government widened the daily trading band twice in the past two years, expanding the permitted daily range from +/-0.5% to +/-2% around central parity. As US interest rates start to rise and the dollar strengthens, upward pressure on the renminbi has receded, with the currency coming under some downward pressure against the dollar. The two-way flexibility is welcome – and indeed essential for the currency to move towards its reserve currency status.

Finally, incremental steps have continued to be taken to liberalise cross-border capital flows. In the last few years, the government has relaxed cross-border security investment, including by expanding the existing channels of institutional investors through the Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) schemes, and introducing new channels of renminbi-QFII. Renminbi-denominated bonds have been issued in more offshore centres, including recently in the UK.

The government also established the Shanghai Free Trade Zone (SHFTZ), where more liberal policies on financial flows have been introduced, in the hope of replicating the policies at a later stage in the rest of the country. In February 2015, the PBOC allowed more freedom for companies in the SHFTZ to borrow from abroad. The recent launch of the Shanghai-Hong Kong Connect programme, which permits direct equity trading between the Shanghai and Hong Kong stock exchanges, has also set the stage for broader liberalisation of portfolio flows for individual investors (see appendix).

Capital account reforms

Capital account reforms have gathered momentum under the new leadership in China, and the party's Third Plenary in November 2014 pledged to "accelerate the pace of capital account reforms towards full currency convertibility". There are a few compelling arguments in favour of capital account reforms over time. First, capital account liberalisation is likely to help improve allocative efficiency and is in line with the government's view that the market should play a decisive role in the economy. Although China does not rely on global funding for growth (unlike other emerging market countries, where the funding gap was the primary reason for opening up internationally), high domestic savings are largely

4 www.hkma.gov.hk/media/eng/publication-and-research/research/china-economic-issues/cei_200902.pdf

concentrated in domestic assets (deposits and real estate) with limited diversification. Second, operationally, as trade size grows, it is difficult to maintain watertight controls on capital flows. And third, from the governmental perspective, the liberalisation of capital flows could also be used as a catalyst for institutional reforms, mirroring the success of trade liberalisation two decades ago.

There are, however, active debates on how renminbi internationalisation and the associated liberalisation of capital flows should be positioned in the financial reform agenda (it should be emphasised that the debate is largely on how, rather than whether, to liberalise).

China's approach has been unorthodox, as the Chinese government pushed capital account reforms and domestic financial reforms iteratively and simultaneously, in contrast to the textbook advice of completing domestic financial restructuring before liberalising capital flows.

The main question facing Chinese officials is whether the speed of the external opening-up is too fast compared with domestic reforms. The standard dilemma is the "impossible trinity", where an open capital account, coupled with the limited flexibility of the currency, makes it difficult to control domestic monetary policy independence. To some observers, domestic reforms such as bank restructuring and state-owned enterprise reforms should precede capital account opening-up, so that the system is sufficiently resilient to deal with volatile international capital flows that have caused crises in other emerging markets (Yu Yongding). Others, however, believe that it is feasible that reforms be conducted iteratively without the pitfalls suffered by other emerging market peers because: the Chinese economy is large, and is not just a price taker in international finance; and there remain many policy tools through macro-prudence to reduce the vulnerability of its domestic institutions.

There are practical considerations in favour of accelerating the pace of reforms, as well.

First, capital controls have become quite porous, making capital account opening-up a *de facto* choice. For instance, despite controls in portfolio (equity and debt) flows, banks intermediated flows are high and volatile. In fact, as a share of GDP, gross bank intermediated flows are on a par with more open economies such as Australia and the US (IMF). In addition, trade flows are often used as a disguised vehicle for cross-border capital transactions.

Second, the strength of the external balance sheet and recovery in the global economy/US rates make for an opportune time for faster liberalisation. The current account surplus and large foreign-exchange reserves provide cushions for larger-than-expected capital outflows. And a pick-up in global rates and recovery in the developed markets should allow capital inflow pressures to diminish in coming years, reducing the pressure of one-way capital flows on domestic interest rates and monetary conditions.

In a recent speech (see box, pp. 88–89), PBOC governor Zhou indicated that capital account liberalisation will accelerate this year, making the renminbi more freely usable (thereby paving the way for the renminbi to be part of the SDR). He emphasised that, in light of the experiences after the global financial crisis, China's capital account reforms will adopt an approach of "liberalisation with management", whereby macro-prudential measures will be used to ensure financial stability after the capital account becomes convertible.

Recent progress

Owing to these liberalisation measures, the international use of the renminbi has steadily risen, as can be seen from several key developments:

- The amount of cross-border renminbi settlements in the first nine months of 2014 reached 4.8 trillion yuan, an increase from the 4.6 trillion yuan total in 2013. According to the Bank of China's global survey, about 87% of domestic firms and 69% of offshore firms plan to use the renminbi in their future cross-border trade settlements.
- The third-party use of the currency for payment purposes – an important measure of the international role of the currency – has increased from a low base. According to a survey by the Bank of China of 3,000 domestic enterprises conducting cross-border renminbi business, 41% of their overseas subsidiaries conducted renminbi transactions with third parties in 2014, compared with 10% in 2013.
- The offshore issuance of renminbi bonds by Chinese banks and corporations has been strong. The first offshore renminbi bond was issued in 2007. In 2014, gross issuance of offshore renminbi bonds and certificates of deposits hit a record high of 564 billion yuan (rising by 47% from the previous year). In October 2014, the British government issued renminbi-denominated debt – the first foreign government bonds denominated in renminbi.
- The offshore renminbi market has expanded. At the end of 2014, offshore renminbi assets exceeded 2.7 trillion yuan, which included 1.8 trillion yuan worth of deposits, 272 billion yuan of certificates of deposit and 672 billion yuan of bonds, according to Standard Chartered Bank. Notably, offshore renminbi loan growth is expected to accelerate as more cross-border loan programmes start, paving the way for more rapid offshore banking and monetary expansion through the multiplier effect.

While the initial momentum of the renminbi's international rise is reflected in its strong trade links, further growth of the international renminbi market will likely be bolstered by increasing cross-border capital flows, and in particular outward investment by Chinese corporations and the country's government.

Such investment allows enterprises to benefit from the lower cost of production in neighbouring countries (particularly in South-east Asia). For the government, such investment – for instance, through the recently launched 'One belt, one road' initiative – helps to strengthen the regional trade and economic links. See "Fine-tuning the new era of outbound investment", by Li Keping, vice chairman, president and CEO of China Investment Corporation, pp. 76–77.

The steady progress of capital account liberalisation and further renminbi internationalisation, as we expect, will have a profound impact on the landscape of the global financial markets. According to estimates by US financial institution Goldman Sachs, assuming China reaches full convertibility by 2020, portfolio inflows and outflows could reach 5–7% of GDP each way, compared with less than 1% of GDP at present. Total portfolio flows could rise to between $1.5 trillion and $2 trillion in the next five years. The annual renminbi cross-border trade could increase to between $2 trillion and $3 trillion in the next few years, or 10–15% of global trade. The renminbi bond market could rise to $20 trillion (15% of the world bond market) with liberalisation in the coming decade. n

The internationalisation of the renminbi

Interview: Zhu Guangyao

What is your assessment of the global economy?

Six years have passed since the bankruptcy of Lehman Brothers, yet the world has not fully stepped out of the shadow of the global financial crisis. For instance, the International Monetary Fund (IMF) downgraded its global economic forecast three times in 2014 (its latest expectation was for an annual global economic growth rate of 3.3%). The World Trade Organization (WTO) also lowered the expected global trade growth rate to 3.1%, compared with 5.2% in the past 20 years. This means that the growth rate is slowing, and that growth in trade is lower than expected. At present, the global economy is experiencing instability, uncertainty, imbalance and vulnerability.

Are the dynamics uneven, even polarised?

Last year, the imbalance of the global economy was demonstrated by the polarisation of emerging market countries. After the breakout of the crisis, the strong performance of the emerging market economies facilitated global economic growth. But in 2014, the growth rates of Russia and Brazil – both members of the Brics nations (with the group also comprising India, China and South Africa) – were only 0.2% and 0.3% respectively. Compared with these two countries, China and the US still enjoyed strong economic growth. The IMF maintained its optimistic prediction of China's 7.4% economic growth rate in 2014, and has not adjusted its prediction for the country's 2015 figure (7.1%). Meanwhile, the fund adjusted the economic growth rate of the US from 1.7% to 2.2% in 2014. China and the US will clearly be major contributors to growth in the global economy.

Zhu Guangyao

On the other hand, Europe still faces challenges. The IMF said economic growth in the eurozone is 0.8%. Meanwhile, the unemployment rate in Europe remains relatively high. Europe's two major economies, Germany and France, were expected to grow at a rate of 1.4% and 0.4% respectively. The market's concerns are obvious. Among the Asian economies, the IMF expected Japan's economic growth to be 0.9% in 2014. But after the adjustment for the introduction of a rise in domestic consumption tax, a 7% decrease occurred during the second quarter of 2014. By the end of October, the governor of the Bank of Japan lowered the central bank's economic growth prediction to 0.5% – 40 basis points lower than the IMF's prediction. This is not good news for either Japan's economy or for global economic growth. Structural adjustment – the 'third arrow' of prime minister Shinzo Abe's administration – seems to be facing great challenges.

Are you concerned about deflation and divergent monetary policies?

The risk of deflation is currently driving the co-ordination of monetary policy among G20 countries. The solution to global deflation lies in financial policy. Today, world interest rates are at their lowest levels compared with any other period of business cycle recovery since the Second Word War. On the one hand, it reflects that the process of recovery is relatively slow. On the other, it implies there is a risk of deflation. Deflation has long been apparent in Japan, but recently the annual rate of inflation rate in the Europe was as low as 0.3–0.4%. The president of the European Central Bank (ECB), Mario Draghi, admitted in August that Europe was facing the risk of deflation, and said the ECB would not raise its interest rate before the middle of 2017. Therefore, the risk of deflation to the European economy will be great.

No major developed country can maintain its goal of a 2% inflation rate, which explains why the Bank of Japan has increased the Japanese money supply by ¥80 trillion per year. The Federal Reserve has started to end its quantitative easing (QE) policy, following three rounds of QE, amounting to around $3 trillion. While the overall benefits of QE are disputable, the programme did stabilise the US economy at the beginning of the crisis. Of course, the large amount of money printed also had an impact on the financial markets, which requires further study.

The key issue currently is whether the Fed will start the process of normalising interest rates because of improvements in the US economy. Fed chair Janet Yellen has clearly signalled that the first interest rate rise would be cautious – probably just 25 basis points. But the history of Fed actions shows that in all economic cycles, once the Fed has started the process of interest rate normalisation, the range of increase is more than just 25 basis points. Instead, it has raised rates steadily over a period of time, which has led to a stronger US dollar. Since the ECB has said it will not raise interest rates before the middle of 2017, the gap in interest rates between the US and Europe will probably widen during this period of time.

Looking at the monetary policies of the Fed, the ECB and the Bank of Japan, we can see the level of interest rates varies in major advanced economies based on their own economic circumstances. Changes in trade set-up, direct investment and the price of bulk commodities have a direct impact on interest rates. These three factors are all independent, but they also interact with one another directly. The overly slow global economic recovery has also added uncertainty to these factors.

How do you assess domestic financial reforms in the context of globalisation?

Over the past few years, the internationalisation of renminbi has been accelerated. In August 2014, the UK chancellor of the exchequer, George Osborne, told G20 finance ministers and governors of central banks in Washington DC that the British government planned to issue sovereign bonds in renminbi – with the proceeds from the issuance added to foreign reserves, instead of offsetting the UK's trade deficit. This was the first time a western country had issued national debt denominated in renminbi and the planned issue of 2 billion yuan was increased to 3 billion yuan because of the positive market reaction. An as industrialised country, Britain holds only a relatively small amount of foreign reserves. But it was a symbolic step that this was done by a G7 country, and is an important step for the internationalisation of the renminbi. At the same time, the People's Bank of China (PBOC) has initiated currency swaps and other activities with the ECB, the Bank of England and the Banque de France, which promotes the use of the renminbi in international financial markets.

China's financial reform will continue, notably in the capital account. But with the process of China's financial reform still under way, the IMF has urged a cautious opening of the capital account to minimise the risk of systematic failure. In fact, the PBOC had expected the speed of opening to be faster than present. But the international community is relatively cautious regarding this policy initiative, which shows that China's financial reform is important to not only Chinese structural adjustment, but also to the stability of the international financial markets.

There are several aspects of reform that require attention. The basic principles of supervising shadow banking is to cope with the relationship between moral hazard and the prevention of systematic and regional risk. The support of small and micro-businesses requires further reform of the financial system, which can be realised by the establishment of small private banks. China approved the establishment of five private banks in 2014, but this process still needs to be pushed forward. A deposit insurance system was clearly put forward in the Eighteenth National Congress of the Communist Party of China at the Third Plenary Session, and the next step is the full implementation of the policy.

> *"Global economic governance requires the strengthening of policy co-ordination and an increase in compromise and trust"*

What roles should China play in global financial governance?

The international financial set-up is moving into a new phase, and China is making contribution to and making use of the improvements of international finance. The country took an active part in the G20 process, particularly the work of the Financial Stability Board (FSB). This year, the FSB set three key policy goals to address related to: 'too big to fail', cross-border derivatives trading and shadow banking. China participated in the policy-making process of all these three issues.

In addition to the policy discussion, the practice of China's financial reform itself helped the development of the FSB. Bank of China was among the first round of participants as a global systemically important bank, with Industrial and Commercial Bank of China (ICBC) and ABC (Agricultural Bank of China) subsequently joining it. In terms of international financial governance, especially the governance structure of commercial banks, China's voice and representativeness are rapidly improving.

In addition to policy discussions at the FSB, China also suggested distinguishing the rate of progress of developed countries from that of developing countries. The international governance system, especially in the governance of some big banks, requires some time.

In terms of the regulation of cross-border derivatives, the standardisation of accounting systems has an important global impact, and remains an urgent issue that needs to be addressed. Some differences still exist in accounting practices, and the US is unwilling to compromise. Although this issue has been on the agenda for a long time, the co-ordination of accounting policy has not yet been achieved. To facilitate agreement, joint efforts by Europe, the US and Japan are required, with compromises required. Global economic governance requires the strengthening of policy co-ordination and an increase in compromise and trust.

IMF reform

As a major developing country, China has its own voice, and has played its own part in international co-ordination – and its influence is increasing. But the key issue related to international economic governance is the position of the US. As the biggest economy in the world and the nation that dominates the international monetary system, the US needs to show wisdom and a sense of responsibility.

The US was the leader in constructing the international political, economic and financial systems in the post-war period. The system as a whole still faces many challenges – for example, how to operate in an effective and sustainable manner, and restore the credibility of the financial system after the 2008 financial crisis. One of the major challenges is reforming the shareholdings of the IMF. As a direct participant in the 2010 reforms, the US made a resolution on voting share reform that was approved by the G20 summit. But the plan has not been fulfilled because of its failure to secure approval in the US Congress. The 2010 IMF reform plan should be enforced immediately, as it is a requirement of all G20 members and other nations around the world. The US has been asked to shoulder its responsibility, and since it involves its own national interest, the US should have the wisdom to address the problem.

Since global economic growth is unstable, uncertainty is increasing and growth imbalances are significant, the current international financial system has a part to play and therefore consolidate its own position. The process of reforming the international financial governance structure has to be pushed forward, and this is the important policy and organisational basis for the current international financial system to work effectively. n

Zhu Guangyao is China's vice-minister of finance.

Renminbi evolution

Dai Xianglong, former chairman of China's National Social Security Fund (NSSF) and former president of IFF, backs the idea of the internationalisation of the renminbi and the benefits it could bring – not just for China, but for the rest of the world

The concept of the internationalisation of the renminbi was put forward only very recently. Former Chinese president Hu Jintao first proposed that improvements were needed in the international currency system at the G20 Summit held in Washington DC in November 2008. Even at that time, the concept of the internationalisation of the renminbi had yet to fully emerge.

Although the advent of the euro had already offered one potential diversification of international currency, China had always been very cautious about the concept of the internationalisation of the renminbi – it had never been mentioned in any official documents or speeches of state leaders. The only reference was achieving the free convertibility of the Chinese currency. So it is odd that foreign media coverage often appears to interpret renminbi internationalisation as a challenge to the dollar, but that distorts our original meaning.

The internationalisation of the currency is actually an objective need for a highly open real economy of China. The country has such a large trade volume and enormous investment that using a third currency in settlement, versus the two currencies of the nations involved in the trade, pushes up costs significantly. In addition, foreign currency held by China will depreciate a lot because we can only use other currencies in transactions. The fact that the renminbi could not be used for settlement restricts the trade development of the country – one of the reasons why China now promotes its international use. There is a focus on the goal of realising the widespread cross-border use of the renminbi and its use in foreign exchange reserves. This is a long-term goal, which may not necessarily be achieved in three to five years.

Dai Xianglong

International system reform

China has clear ideas regarding the reform of the international monetary system. The dollar has long been the main international reserve currency and most of the foreign exchange reserves of China are in dollars.

We have never denied the role of the dollar in foreign exchange reserves, although the US itself should reduce its fiscal deficits and, despite some arguing the euro might collapse sooner or later, we still advocate the steady development of a common European currency.

On the issue of renminbi internationalisation, some financial institutions in the US share the same opinion as the Federal Reserve. I once asked a former New York Fed president about the subject, and he told me that to realise the internationalisation of the Chinese currency, the first step is to develop the renminbi bond market, not necessarily the stock market. When I discussed this issue with former US Fed chairman Alan Greenspan, he said that the internationalisation of China's currency relies on our confidence. That China's economic aggregates have reached that of its major international levels does not necessarily guarantee the international use of its currency. Moreover, the policy of the central bank should also be more transparent.

Originally we did not intend to attempt to improve the international monetary system, but the internationalisation of our currency could well promote the improvement of the global system because it could make currencies more stable in more and more countries, which is beneficial for the free convertibility of the renminbi.

But there is no such a thing as a timetable for the internationalisation of the Chinese currency. Foreigners often ask me when we will realise full convertibility of the renminbi, but we don't have a specific schedule – neither hypothetical nor confidential. China will promote and speed up the internationalisation of its currency step by step, according to its economic conditions and financial status.

At this stage, renminbi internationalisation is neither challenging the role of the US dollar nor changing the world monetary system. People are divided on the subject, but it is hoped that we can reach consensus through discussion. n

RMB internationalisation: from strength to strength

The renminbi now ranks second in the world's most-used currencies in trade finance, and its internationalisation has gone from strength to strength, as described by *Tian Guoli*, chairman of the Bank of China

World finance did not perform well in 2014, especially the European Union and the US economies, which have recovered slowly from the crisis. China's GDP growth started to slow down. Banks were concerned about their bad assets, after they developed their overseas business too rapidly. Gross profit ratio in Hong Kong and the whole offshore business had increased by at least 30%, which benefited from renminbi internationalisation to a large extent.

Current status

The internationalisation of the renminbi increased gradually in 2014. The amount of cross-border renminbi settlement in the first nine months of 2014 reached 4.8 trillion yuan, exceeding the year of 2013 at 4.6 trillion yuan. The range and size of actual receipts and payments in renminbi from third parties other than mainland China grew dramatically. Specifically, the levels of cross-border renminbi settlements between Germany, the UK and mainland China during the first seven months in the year of 2014 exceeded 140 billion yuan, with 100 billion yuan in Australia and the US.

Tian Guoli

The growth is significant. The Bank of China (BOC) surveyed more than 3,000 domestic and foreign enterprises on their international renminbi business. According to the results, 41% of overseas enterprises carried out cross-border renminbi settlements with third parties outside of mainland China in 2014, exceeding 2013 by 31 percentage points. It is also reflected that settlements in renminbi were made by 8% of the surveyed overseas enterprises from Asean countries, Japan and Korea, 4% from Europe, and 2% from the US.

It is clear from the markets that global investors possess increasing confidence in holding renminbi. During the first 10 months of 2014, outstanding bond balance of offshore renminbi (CNH) reached 775.9 billion yuan, of which newly issued renminbi-denominated bonds amounted to 179.6 billion yuan. The BOC has successively issued renminbi-denominated bonds in Australia, France and Luxembourg. International investors oversubscribed eagerly, proving that the market pays a great deal of attention to renminbi business. In particular, the British government issued 3 billion yuan treasury bonds in October 2014 – the first time a foreign government has issued national debt in renminbi. The BOC participated as a lead arranger, and the issue achieved a high rate of oversubscription. The UK government has therefore taken the lead in using renminbi as a foreign exchange reserve.

Driven by reform

As China comprehensively reforms and adjusts its economic structure, future economic transitions will provide a lot of room for renminbi internationalisation. In the next five years, China is expected to import $1 trillion of goods, with foreign investment at more than $500 billion. This $500 billion is almost the size of total investments by China over the past 30 years, and will definitely be a strong impetus for renminbi internationalisation. China's total investment abroad now is approximately $650 billion.

China's 'One belt, one road' initiative will unlock new models for regional corporations. As shown in the global customer survey by the BOC, around 87% of domestic enterprises and 69% of overseas enterprises plan to either use the renminbi in cross-border transactions or further increase the renminbi's settlement ratio in receipt and payment uses. These two figures have grown by 10% and 8% respectively compared with 2013.

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Of the surveyed foreign firms, 41% acknowledged the renminbi becoming a vital global currency, similar to the US dollar and euro in status and function, an increase of 10 percentage points compared with 2013. After five years of prosperity, an increasing number of businesses have greater optimism regarding the renminbi's prospects and status as an international currency.

Benefits of internationalisation

With regard to cost savings, investment facility and capital allocation, the renminbi has become a new, superior choice for financial markets around the globe.

Firstly, cross-border financing facilities could effectively reduce the business costs for enterprises. Due to the cost differences between domestic and overseas productive factors, commercial banks can raise low-cost renminbi capital from overseas markets through the issuance of bonds, commercial paper, overseas loans under domestic guarantee and other bank loans.

In September 2013, a large international energy company needed financing for its programme in Zhuhai. The Bank of China's London branch co-led this company to issue a 1.2 billion yuan, five-year loan overseas and completed the examination and approval report procedures with the State Administration of Foreign Exchange for its domestic branches. The company then injected 1.2 billion yuan into its Zhuhai branch's account, taking only one month to issue the bonds from start to finish. The cross-border speed of renminbi flows has increased tremendously, and the programme saved the company about 123 million yuan over five years.

Second, investment facilitation has been boosting firms' global operations. Renminbi internationalisation has produced various investment facilities for companies, accelerating their global investments. This not only offers a good chance for domestic enterprises to expand overseas, but also provides a genuine opportunity for overseas companies to invest in the Chinese market. Commercial banks use numerous renminbi cross-border products to boost the development of foreign companies in China.

The Bank of China's Seoul branch collaborated with the Sichuan branch, releasing 200 million yuan in overseas direct loans for a Korean company's car factory programme in China, supporting the Korean company's cross-border investment programme in China, by meeting both the company's financing demands and lowering remittance risk.

Third, a two-way flow of renminbi across a border enables companies to freely transfer capital. The Shanghai Free-Trade Zone (SHFTZ) has eased policy restrictions on the pool of renminbi and foreign currency for its business customers. Transnational enterprises that are members of the zone can carry out two-way cash business between enterprise members both domestic and abroad. Capital in the pool can be transferred freely among its members. Since December 5, 2013 – when the BOC started up the first cross-border renminbi bidirectional capital pool business in the SHFTZ – it has engaged over 10 members, amounting to 10.5 billion yuan.

Renminbi internationalisation is rooted in international trade, and has benefited diversification – this internationalisation has already begun, for which the offshore construction market is an extremely important driving force. The BOC predicts that the renminbi capital pool overseas will increase from 2.5 trillion yuan to 3.0 trillion yuan in 2015 – part of which comprises an offshore market based mainly in Hong Kong with the possibility of exceeding 1.5 trillion yuan. With the gradual construction of a renminbi settlement system in other countries, the renminbi settlement ratio of China's exports and imports will increase further. Renminbi capital pools are steadily growing at home and abroad. In the case of the offshore renminbi bond market, the size of issued bonds in 2014 is set to surpass 200 billion yuan. The EU and US low-interest-rate environment will not change fundamentally, which should help maintain the issuing and trading vitality of global bond markets. And newly issued renminbi bonds are expected to rise to 300 billion yuan. Undoubtedly, the future evolution of renminbi internationalisation is closely connected with the currency's offshore development.

> *"As China comprehensively reforms and adjusts its economic structure, future economic transitions will provide a lot of room for renminbi internationalisation"*
>
> *Tian Guoli*

Further tapping potential and better meeting overseas demand, while expanding and deepening the renminbi's offshore market business, have become vital issues for the currency's internationalisation development.

Features of internationalisation

There are several major features of the renminbi's internationalisation that must be built upon.

First, the currency's offshore market has been further deepened. With an increasing number of Chinese companies venturing abroad, pushing forward the pace of building overseas industrial parks and launching projects such as foreign infrastructure construction, technical contracting and energy development, the industrial chain will be taken further abroad.

This expands the overseas use of the currency, making foreign renminbi product transactions even more active, while simultaneously helping the currency to remain and circulate abroad.

Second, the renminbi is in full swing in many offshore markets, and increasing with a larger number of products and transactions available. Offshore markets with an open and inclusive perspective continuously consolidate their financial centres' status, and are expected to remain leaders in renminbi offshore markets because of their promotion of trading facilities and systems, as well as by their taking advantage of new elements of the renminbi's internationalisation. With the currency's internationalisation bringing in tremendous profits to offshore centres, Europe, North America, South Korea and parts of South-east Asia are showing interest and actively seeking to develop offshore renminbi markets.

Third, the global service capacity of Chinese-funded financial institutions is a boost for constructing renminbi offshore markets.

From a global perspective, the internationalisation of financial institutions is an essential support for domestic currency internationalisation, and a crucial participant in offshore markets. Chinese financial institutions are more familiar with businesses and individuals that invest outside China.

Large financial institutions, in particular, can offer more competitive pricing by interacting with both domestic and overseas institutions, in order to provide renminbi-related services such as cross-border renminbi settlement, trans-boundary financing and capital transactions – thereby better expanding and deepening transactions of all types of overseas renminbi products.

Fourth, improving the co-ordination of cross-border capital will be a vital prerequisite for a sustainable offshore market.

To develop offshore markets, flows of cross-border capital must be more frequent.

Free cross-border capital flows plus improved financial resource allocation efficiency would naturally extend arbitrage behaviour, and could even form an asset price bubble.

We can only create a beneficial market for renminbi internationalisation by preventing it from breaking away from the real economy's demands, preventing overstretching by efficiently managing cross-border renminbi-related risks, improving the international co-ordination of financial policies and the ability to cope with all kinds of external economic shocks. Renminbi internationalisation is an important mark of China's deepening reform and expanding opening-up process.

History has shown that reviving Chinese and world economic development will bring positive results for the reform of the international currency system.

All in all, the future for renminbi internationalisation has just got started. Carrying tremendous potential, the renminbi now ranks second in the world's most-used currencies in trade finance. Low as it may be on application in the global market, the development potential of the renminbi remains huge. n

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The internationalisation of the renminbi

International monetary system: fixing the fault lines

Justin Lin, honorary dean of the National School of Development at Peking University and former chief economist at the World Bank, explains why US, not Asian, policies caused the financial crisis and recommends how to fix endemic global imbalances

Justin Lin

The hypothesis most frequently cited as the cause of the global crisis centres on imbalances in the global economic and monetary system. In particular, large surplus countries caused tectonic market distortions by using their foreign reserves to purchase US Treasury bills. These purchases of government securities depressed interest rates in the US, which in turn sparked a debt-fuelled spending spree by the country's consumers that ultimately resulted in housing and other bubbles in the US. Once the bubble finally burst, the US faced a major financial crisis that resulted in an economic crisis that rippled across the world. Potentially, this hypothesis is plausible. But what caused the large surpluses in China and other Asian countries? There are three commonly accepted theories.

The first one was the east Asian economies adopted an export-orientated strategy and, as a result of their exports, acquired large trade surpluses. The second common hypothesis is that east Asian economies learned a lesson in the 1998 crisis. They understood that if they did not have large enough foreign exchange reserves, their countries could once more be subject to speculative attacks. So for self-insurance, they started to accumulate reserves by exporting more. The third, and most widely accepted, hypothesis is that imbalances were the result of east Asian economies – and China, in particular – manipulating their foreign exchange rates.

Again, these hypotheses appear plausible, but do they stand up to an examination of the facts? Looking at the export-driven development hypothesis, we know that east Asian economies had adopted export-driven growth strategies since the 1950s and 1960s. For China, it started later, in the 1970s. Yet we know that before 2000, trade was basically balanced in east Asian economies, and some economies – such as South Korea – actually ran a trade deficit. So this kind of export-orientated strategy does not necessarily lead to huge surpluses and most east Asian economies did not have large trade surpluses until about 2000. It seems illogical to attribute a strategy that has been in use for more than half a century to explain what happened in just the last 10 years.

In the second hypothesis, all the east Asian economies increased their trade surpluses a lot and ramped up their reserves. But we also observed some other countries, such as Japan and Germany, substantially increasing their trade surpluses during the same period of time. But they did not have any particular motivation for accumulating reserves as a means for self-insurance. Since the yen is an officially sanctioned reserve currency, Japan would not need to stockpile foreign reserves against some form of speculative attack, yet its foreign reserves also grew.

The final hypothesis, that east Asian economies manipulated their exchange rates to increase their exports, also looks inconsistent. That's because the trade surpluses of other competing economies should have been reduced. But the fact is that almost all other countries competing with east Asian economies also increased their trade surpluses and reserves. So there is an inconsistency.

The value of Chinese currency, in particular, has been the target of discussion in the past decade as the cause of global imbalances. This issue was first raised in 2002. The accusation was that China was manipulating its currency to increase its export competitiveness. But the fact remains that in 2003, China's trade surplus was smaller than its surpluses in 1997 and 1998. In 1997 and 1998, during the east Asian financial crisis, China did not devalue its currency despite the devaluations of currencies of many of its neighbours – indeed, at that time, everyone said the Chinese currency was overvalued.

If in 1997–1998, China's currency was overvalued, then its trade surplus should have been smaller than in 2003–2004. But actually, in 2003-2004, the trade surplus in China was smaller than in 1997–1998. So it seems impossible for the Chinese currency to have been undervalued in 2003 and 2004. Moreover, the Chinese trade surplus did not become particularly large until 2005. And between 2005 and 2006, the renminbi appreciated by about 20% against the dollar. However, even this appreciation did not result in a decrease in China's trade surplus with the US. At the same time, many developing countries were competing with China, but their trade surpluses did not decline – and again their accumulation of reserve also continued to increase.

All the hypotheses point to east Asian economies as the cause of global imbalances and the global crisis. However, the issue of global imbalance also manifests itself in the trade deficit in the US. But this deficit has been falling. The US trade deficit with east Asian economies as a percentage of its total trade deficit declined from 51% in the 1990s down to about 38% in 2007. This implies that the east Asian contribution to global imbalances declined instead of increased. Therefore, some kind of alternative hypothesis is in need to explain the trade deficit in the US.

A principal reason for the growth in China's trade surplus with the US was the relocation of production from east Asian economies to China and the transfer of the trade surpluses from other east Asia economies to China. In 2001, China ran a huge trade deficit with other east Asian economies. So we need to have a new hypothesis that can be consistent with the evidence. And I believe the only hypothesis that can be consistent with evidence is that global imbalances and the global crisis were triggered by the current international monetary system that uses the dollar as a global reserve combined with some policy mistakes in the US.

We know that in the 1980s there was a trend towards financial deregulation in the US that allowed financial institutions to operate with high levels of leverage that resulted in an increase in liquidity. Secondly, in 2001, when the US was hit by the burst of the dotcom bubble, the US Federal Reserve deployed very loose monetary policy to help the financial system to recover. The combination of low interest rates and high leverage created excessive liquidity in the US monetary system. This excessive liquidity first aided a bubble to form in the housing market and equity market in the US. It also created huge wealth effects that fuelled household consumption. The US became a huge consumer and saved less.

At the same time, the US government, because of the Afghanistan and Iraq wars, also ran a deficit. By that time, China produced many of the goods exported to the US market, resulting in China running a large trade surplus with the US because of the high levels of consumption by the latter country. This excess of liquidity and low interest rates also encouraged speculative outflow. So in 2000, total capital outflow from the US to developing countries was $200 billion, but this figure swelled to $1.2 trillion by 2007. Large capital inflows to developing countries certainly supported the housing bubbles and investment booms in developing countries, which caused overheating in some economies.

With high levels of liquidity supporting investment, the demand for capital goods increased a lot. That contributed to capital-goods-exporting countries, such as Japan and Germany, also running large trade surpluses. Because of the boom in demand in both developing countries and some high-income countries, the demand for commodities increased, causing a commodity price boom after 2000. All the countries, except for the US, accumulated reserves because of trade surpluses and capital inflows, which they used to purchase assets in the US to earn a return for their reserves.

The hypothesis stated at the start of this article only characterises the reserve flows from the acquisitive countries back to the US. In fact, those reserves were first created in the US. So how can we prevent a similar crisis again? From my analysis, the situation only occurs because the dollar is the world's dominant reserve currency – otherwise it would be impossible for the US to run a large current account deficit for such a long time. It was the dollar's reserve currency status combined with financial deregulation in the 1980s and 1990s, plus the Federal Reserve's low interest rate policy in the 2000s, that caused the bubble and trade deficit in the US.

If we want to prevent a similar situation recurring, we need to address the conflict of interests associated with using a national currency as a global reserve currency. Many parties believe the International Monetary Fund's special drawing rights (SDR) can be a reserve or can be a way to solve the issue. But the SDR is a basket of national currencies, so it will not address the root cause of the crisis – that is, the conflict between national interest and global interest. For this reason, I propose an alternative: to have a supra-national reserve currency, which I call 'paper gold', which could avoid this conflict of interest.

P-gold would have the advantage of gold, but as it would be fiat money there could also be an increase in the supply of this reserve according to certain fixed rules, such as the k-percent or Taylor rules. To me, the needs are growth in the global economy and international trade. It would also avoid the trouble observed in the southern European countries, as every nation would use paper gold as its reserve currency while also issuing its own national currency. In the case of crisis, reserve currency appreciation can be used as a way to create a scope for structural reform.

> *"We need to address the conflict of interests associated with using a national currency as a global reserve currency"*
>
> *Justin Lin*

Could people accept it? That depends on many factors. But if we opt for multiple reserve currencies, and if all the multiple reserve currency countries have certain kinds of structural problems domestically, the system is likely to remain unstable, which is a lose-lose situation for reserve currency and non-reserve currency countries. n

Appendix: Capital account & exchange rate reforms, renminbi internationalisation

CAPITAL ACCOUNT REFORMS		
Date	**Reform measures**	**Comments**
February 2002	Revised regulations of the People's Republic of China Governing Financial Institutions with Foreign Capital	Restrictions on foreign banks were largely relaxed.
November 2002	Relaxation of restrictions on cross-border security investment	Qualified Foreign Institutional Investor (QFII) scheme was formed and inward portfolio investment was liberalised, but controlled by quotas.
March 2003	Rules relaxed on foreign venture capital inflows and establishing relevant regulations	Foreign venture capital inflow was permitted.
November 2004	Easing of restrictions on cross-border other investment	Renminbi deposit business of individuals is permitted in Hong Kong. Individuals are allowed to buy and transfer via foreign exchanges cross-border under quota controls.
July 2006	Relaxation of restrictions on outward direct investment (ODI)	Quotas removed on firms' investment in foreign currencies abroad.
June 2007	Restrictions relaxed on cross-border security investment	Qualified Domestic Institutional Investor (QDII) scheme was formed. Outward portfolio investment was liberalised, but controlled by quotas.
November 2010	Relaxation of restrictions on cross-border security investment	Foreign banks gained access to the domestic interbank bond market.
September 2013	China (Shanghai) Pilot Free Trade Zone founded	Negative listing scheme was introduced in managing foreign investment. Restrictions on investment, capital account convertibility and firm entry were largely relaxed within the zone.
November 2014	Shanghai-Hong Kong Stock Connect programme initiated	The stock market in Shanghai was opened to Hong Kong investors and the stock market in Hong Kong was also opened up to investors in China, both with restrictions. Only institutions with approval can engage in the programme. Investable stocks are limited and daily net purchases were restricted by ceilings.
RENMINBI INTERNATIONALISATION		
Date	**Reform measures**	**Comments**
February 2004	Renminbi banking business initiated in Hong Kong	Business lines of retail banking and settlement in renminbi started in Hong Kong.
September 2005	Offshore renminbi-denominated debt issued by international development organisation	International development organisations are allowed to raise debt denominated in renminbi. The Asian Development Bank (ADB) issued 1 billion yuan worth of debt in China.
July 2007	Relaxation of restrictions on offshore renminbi-denominated debt	Renminbi-denominated debt was allowed to be issued in Hong Kong.
December 2008	Establishment of bilateral currency swaps with South Korea	The People's Bank of China (PBOC) established 180 billion yuan bilateral currency swap agreement with South Korea.
April 2009	Restrictions relaxed on cross-border renminbi settlement	Trials for settling cross-border trade accounts in renminbi with Hong Kong partners were initiated in five cities.
2009	Bilateral currency swap agreements signed with five countries	The PBOC established bilateral currency swaps with Hong Kong, Malaysia, Belarus, Indonesia and Argentina.
2010	Bilateral currency swap agreements signed with two countries	The PBOC established bilateral currency swaps with Iceland and Singapore.
April 2011	The first offshore renminbi-denominated initial public offering (IPO) in Hong Kong	Hui Xian REIT went public on Hong Kong Stock Exchange and raised over 10 billion yuan.
October 2011	Restrictions relaxed on cross-border renminbi-denominated direct investment	Outward foreign direct investment (OFDI) and FDI in renminbi were permitted, but large-scale investment required approval.
December 2011	Relaxing restrictions on cross-border renminbi-denominated security investment	Renminbi Qualified Foreign Institutional Investor (RQFII) scheme was introduced to allow qualified firms to invest offshore renminbi back into China, subject to an overall ceiling.
2011	Bilateral currency swap agreements signed with six countries	The PBOC established bilateral currency swap agreements with New Zealand, Uzbekistan, Mongolia, Kazakhstan, Thailand and Pakistan.
April 2012	Renminbi-denominated debt issued in London	HSBC issued 2 billion yuan worth of debt in London. Centre for renminbi business in London was founded.
December 2012	Restrictions relaxed on cross-border renminbi-denominated other investment	Cross-border renminbi loans were trialled in Shenzhen.

Appendix: Capital account & exchange rate reforms, renminbi internationalisation

RENMINBI INTERNATIONALISATION		
Date	**Reform measures**	**Comments**
2012	Bilateral currency swap agreement signed with three countries	PBOC established bilateral currency swaps with the United Arab Emirates (UAE), Ukraine and Australia
June 2013	Introduction of the China Interbank Offered Rate (Chibor)	Hong Kong launched Chibor, marking a crucial step in the development of the offshore renminbi market.
September 2013	Restrictions relaxed on cross-border renminbi direct investment	Foreign investment was permitted in domestic financial institutions in renminbi.
2013	Establishing bilateral currency swap agreements signed with three countries/areas	PBOC established bilateral currency swaps with the UK, eurozone and Brazil.
October 2014	Renminbi-denominated sovereign bonds issued by the UK	The UK Treasury successfully issued renminbi-denominated sovereign bonds for 3 billion yuan ($482.7 million) and a maturity period of three years.
November 2014	Restrictions relaxed on security investment category	Renminbi Qualified Domestic Institutional Investor (RQDII) scheme was introduced to allow qualified firms to invest in offshore renminbi-denominated financial products.
2014	Establishment of bilateral currency swap agreements with five countries	The PBOC established bilateral currency swap agreements with Switzerland, Sri Lanka, Russia, Qatar and Canada.
EXCHANGE RATE REFORMS		
Date	**Reform measures**	**Comments**
July 2005	Adopted managed floating exchange rate regime	The PBOC officially announced a market-based managed floating exchange rate regime with reference to a basket of currencies.
January 2006	Modified the pricing mechanism for the middle price of the renminbi exchange rate	A market-maker system with inquiry scheme was introduced by the PBOC to determine the middle price of the renminbi exchange rate.
May 2007	Increased flexibility of the renminbi exchange rate	The PBOC widened the daily trading band of the renminbi against the dollar in the interbank market from ±0.3% to ±0.5%
April 2012	Increased flexibility of renminbi exchange rate	The PBOC widened the daily trading band of the renminbi against the dollar in the interbank market from ±0.5% to ±1%
March 2014	Increased flexibility of renminbi exchange rate	The PBOC widened the daily trading band of the renminbi against the dollar in the interbank market from ±1% to ±2%.

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Venue: Christ's College, Cambridge, UK

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For more information

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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 a large number of financial institutions and financial leaders. As a standing high-level dialogue holder, 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 G-20, the IFF has, therefore, been reviewed as the world's "F-20".

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