

# China's Approach to Reform

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**Rapid economic development is based on long-term goals that aim for stability**

SOME amazing things are going on in China right now. Cities are changing beyond recognition in just a few years, or even in a few months. Rapid industrialization is attracting hundreds of millions of peasants to the cities seeking employment—around the traditional Lunar New Year Festival, they pack train and bus stations to head home to see their relatives. And China is integrating rapidly with the rest of the world. For example, hundreds of thousands of enterprises, many backed by foreign investment, have sprung up in the cities of eastern China to make garments, footwear, headgear, electronic devices, toys, and other items for export across the globe.

With rapid industrialization, the country of 1.3 billion people has enjoyed an average annual GDP growth rate of 9 percent over the past three decades, turning China into an important engine of world economic growth. In fact, according to the World Bank, of the 3.9 percent of global economic growth in 2006, China contributed 0.5 percentage points of it. China's living standards have risen considerably, and as many as 400 million Chinese have shaken off the shackles of poverty.

Because of China's industrialization, urbanization, and globalization, the rest of the world is naturally paying considerable attention to how China grapples with the challenges of ensuring sustained and steady development and of dealing with issues such as unemployment, an expanding income gap, the imbalance between investment and consumption, environmental protection, and social security. The Chinese government has drawn up a development policy—taking into account the experiences of other countries and adapting lessons from elsewhere to its own circumstances—and

is constantly tracking how development across the country is proceeding.

## **Sustainable development a top priority**

For China, the top economic policy priority is promoting sustainable development—which is the key to improving people's livelihood and achieving broad-based prosperity. With that in mind, the government has continuously tried to strengthen macroeconomic management in recent years. And as a result, economic volatility has been greatly reduced.

During 2001–06, on average, China's GDP grew at an annual rate of 9.8 percent, fiscal revenues increased at 18 percent, per capita disposable income of urban residents grew at 10 percent, and net per capita income of rural residents increased at 6 percent. In urban areas, 56 million new jobs were created. At the same time, the government increased spending on agriculture, education, health care, and social security.

China's central bank has supported the economic development goal through its pursuit of currency stability, which is its monetary policy objective. Confronted with an overly rapid expansion of investment and credit, the central bank has taken a series of measures over the past year to tighten credit conditions by issuing central bank bills and raising both the reserve requirement ratio and the benchmark lending and deposit rates. Since 2006, it has raised the reserve requirement ratio on nine occasions, the benchmark lending rate on five occasions, and the benchmark deposit rate on four occasions. Frequent fine-tuning of monetary policy has curbed the overexpansion of credit growth and avoided the undue contraction impact of an overly fast withdrawal of liquidity.

## Better market-based institutions

China initiated the process of reform and opening up in the late 1970s, and since then, the government has consistently carried out reforms in a number of fields. But, over the past two years, China's external imbalances, particularly its current account surplus, have increased. Why has this occurred? The problem is attributable to many factors. The domestic national saving rate is high because of China's inadequate social security network, as well as insufficient medical care, education, and housing systems; the rapid increase in fixed capital investment over the past few years and the consequent expansion of manufacturing capacities have contributed to the incentive for enterprises to increase their exports while domestic demand remains sluggish.

Globally, as a result of China's opening to the rest of the world, foreign direct investment has been pouring into the country for many years, turning China, in many respects, into an important processing export base for multinational corporations. In 2006, the volume of exports and imports by foreign-funded enterprises accounted for 58.9 percent of China's total foreign trade and 51.4 percent of the trade surplus. In addition, the economic

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structure of leading advanced countries, characterized by a chronic low saving rate, high growth, high consumption, and high indebtedness, has also driven demand for Chinese exports. These factors are mainly long term and structural; they need to be addressed gradually by deepening reforms and implementing structural adjustment.

In this regard, the central bank has taken steps in the following three areas. First, *the positive role of financial activities in promoting consumption has been further enhanced* through efforts to develop consumer credit, improve access to financing, and provide more financial products. Consumer credit recorded an average annual growth of 28 percent during 2001–06.

Second, *the reform of the renminbi (RMB) exchange rate regime has moved ahead in a proactive, controllable, and gradual way to increase the role of the market in establishing the RMB exchange rate*. On July 21, 2005, China moved to a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. Over the past two years, the RMB has appreciated by 9.4 percent against the U.S. dollar, and the real effective exchange rate of the RMB has appreciated by 6.3 percent, according to the Bank for International Settlements.

A number of reforms have been initiated to give the market a bigger role in determining the RMB exchange rate. These measures include introducing a market-maker system and over-the-counter transactions in the interbank foreign exchange market; increasing the variety of foreign exchange

products by introducing forward and swap transactions; and widening the daily floating band of the RMB against the U.S. dollar in the interbank spot foreign exchange market from 0.3 percent to 0.5 percent.

Third, *reform of the foreign exchange management system has been accelerated with a view to gradually promoting RMB convertibility under the capital account*. Steps have been taken to facilitate the holding and use of foreign exchange by enterprises and individuals. A system of qualified institutional investors has been established, and efforts have been made to liberalize domestic financial and capital markets in an orderly way. Various means have been explored to facilitate capital outflows, and enterprises have been encouraged to invest abroad. The monitoring of cross-border capital flows has been strengthened to pave the way for further opening up.

## Approach emphasizes stability

In implementing economic policy, China has adopted an orderly and gradual approach with an emphasis on stability, reflecting the fact that it takes time to improve the infrastructure of the market-based system, including the legal and regulatory framework, banking system, accounting standards, professional expertise, and institutional capacity.

Take the introduction of a market-based interest rate structure. The overall reform strategy was set at the very beginning: interest rates in the money and bond markets would be liberalized first, followed by gradual liberalization of interest rates on loans and deposits; in liberalizing the lending and deposit rates, reform measures would be introduced on foreign currencies ahead of domestic currency, on loans ahead of deposits, and on long-term and large-value loans and deposits ahead of short-term and small-value instruments.

Since 1996, the interbank market rate, the bond market rate, and the issuing rate on government bonds and policy financial bonds have been liberalized, the interest rate on foreign currency loans and large-value foreign currency deposits has been deregulated, and the floating band of the RMB lending rate has gradually been enlarged. In 2004, we introduced a floating central bank lending rate system, and removed the ceilings of the lending rate and floor of the deposit rate of commercial banks. Early this year, we launched the Shanghai Interbank Offered Rate (SHIBOR) with a view to creating a benchmark rate for the money market.

Thus, the interest rate liberalization reform has moved ahead in an orderly and gradual manner in line with the central bank's goal of improving macroeconomic management capacity, reforming financial institutions, and developing financial markets. This approach has helped safeguard the stability of the financial system and helped create a favorable environment for advancing and deepening financial sector reform.

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In sum, China will continue improving its development strategy by drawing lessons from its experience with reforms and opening up its economy. And consistent efforts will be made to deepen reforms and further open up to the outside world so as to maintain sustained, rapid, and healthy economic development. ■