

# Advancing Enterprise 2005

4 February 2005

## **Speech by Governor Zhou Xiaochuan, Governor, People's Bank of China at Advancing Enterprise 2005.**

Ladies and Gentlemen, good morning. It's my pleasure to have a chance to talk about the Chinese economy in front of such a distinguished audience and, perhaps make some comparisons between China and India. First of all let me take a few minutes to review the major economic indicators of last year.

In 2004, the Chinese economic growth rate was 9.5%. The consumer price index increased by 3.9%, higher than we expected, but still manageable. Last year China created 9.5 million new jobs. This is quite a huge number but for a population of 1.3 billion, we still need to go further to solve the unemployment problem. Last year, the total import/export turnover was \$1.1 trillion with a trade surplus of \$32 billion in goods. However we had a service trade deficit of around \$12 billion. So, altogether the current account balance is something like \$20 billion in surplus.

In China we have a relatively strong manufacturing industry. The manufacturing industry takes 53% of our GDP while agriculture takes 15%. Unfortunately, we have to say that the service sector is relatively weak at only 32% of our GDP. It's probably the lowest ratio in the world. Listening to Minister Chidambaram of India, we understand that although India is also a developing country, its service sector is over 50% of their GDP. I think this is the difference between China and India, and it leaves great room for China to develop our service sector.

Another difference is that the Chinese economy depends very much on investment, which accounts for around 45% of GDP. Certainly, this is related to high savings rate. We have to turn the high savings in China into investment, but we also have to consider the investment return and the investment efficiency. India invests around 25% of its GDP to reach 8.5% of growth rate, while China used 45% investment ratio to reach 9.5% of growth rate. This is something for us to consider.

One of the outstanding developments in China is that we have made very important progress in the infrastructure. Many years ago, China was very poor in roads, railways, power, ports, airports, etc; there have been substantial changes. Improvements in infrastructure facilitate export, manufacturing and the development of trade.

In China the labour market is highly flexible - although in the urban area we also have some rigidity in the labour market, half the population live in the countryside and this part of labour is very flexible in market. In general the labour market's flexibility is advantageous for China to develop manufacturing and export sectors.

When we talk about the Chinese economic characteristics, one thing we have to bear in mind is that the Chinese economy as a large economy is a very open economy now. For other large economies like the US, Brazil, Russia and India, usually the external trade is only 10-20% of GDP, in China \$1.1 trillion of import/export already takes 70% of our GDP, which shows that the Chinese

## Advancing Enterprise 2005

economy now is already very open. As I said, we have a trade surplus of \$32 billion in goods and a \$12 billion trade deficit in services, so the total trading surplus is only 2% of our external trade volumes, and lower than 2% of our GDP. Our policy is to reach a balance in our international payments. We are going to reduce the tariff rate further. After China's accession to the WTO, each year we reduce the tariff rate by an average of half percent. Now the average tariff rate is around 9.9%. We are going to reduce it further.

In China, the development of the manufacturing industry increased the demand for imports. We notice that per capita income has been increasing by 10% each year, and labour costs have been increasing very fast. We can anticipate that the manufacturing costs will increase sharply. Along with China's economic development and structural adjustment, we are going to reduce the dependence on the manufacturing sectors and on export. We find that the quality of our labour, especially our skilled labour and engineers improving very fast. Because of international competition and because of foreign investment, the Chinese labour; the technicians and the engineers now are catching up with world standard.

Turn to the financial sector in China; the world opinion is that China has a relatively weak financial sector in comparison with that in India. Two years ago the major magazines and newspapers carried a lot of articles with the message: 'some day, somehow China will have a financial crisis because the NPL ratio is very high', or 'the commercial banks were very weak'. Here I want to make two things clear. One is that the government has made a very, very strong commitment to carry out the financial sector reform to change that situation. The second is that 80% of NPLs in China was caused by the economic transition. Before the economic reform, China was a centrally planned economy. During the gradual reform, the commercial bank actually had dual tasks: commercial loans and policy-oriented loans. There was very strong government intervention. So in this period, it was inevitable to accumulate a relatively large stock of NPL. In recent years, because of the government's efforts in the financial sector reform, most banks have already lowered their NPL ratio down to 5% or even lower. But we still have a few banks where the NPL level is over 15%.

Why doesn't the government reform them altogether by writing-off the NPL and re-capitalising them? The reason is: the government tried to encourage internal reforms of the banks and to avoid moral hazards as well as to provide positive incentives. Among other things, the open-door policy is very important. We welcome foreign banks and foreign financial institutions in equity participation and to introduce competition to this market.

We know that reforming the financial sector takes time. We can complete the re-capitalisation and balance sheet restructuring relatively quickly, but we need time to improve the legal conditions, create the new credit cultures, reform our accounting standard and introduce professional services like law firms, rating agencies, etc. Most of all we need time to train a new generation of bankers.

We also see that in the future we have very big challenges. We have some essential problems in our economy. One of the problems is that we have too much

## Advancing Enterprise 2005

investment in our economy and relatively weak domestic consumption, particularly household consumptions. This is probably related to the Chinese tradition - the 'Confucius tradition'. People care very much about their family. They save for the elderly and for their children, so they save much. It's exactly to the contrary of the situation in the United States.

In the 1980's and beginning of 1990s, the saving rates were around 30% to 35%. It has gone up recently, especially after the Asian financial crisis. People worried more about their future. In recent years, we started to reform our social security system so people feel the uncertainty - whether their pension was reliable, and their medical care was reliable or not. Education fees were also rising, so people tended to save more. We should accelerate our social security and welfare system reform to enhance the consumer confidence, and promote consumption.

Up to now a relatively high investment ratio can be explained by the large demand for investments in infrastructure and public utilities. Besides, China started the housing reform a few years ago. People can buy and own their own houses or apartments. In this period, investment should probably be higher than in the normal period.

Nonetheless, if savings ratio is continuously over 40%, we will find it difficult to find good investment direction. If many investors rush into the same manufacturing sectors, we will have a serious over-capacity in the manufacturing sectors. So we call for diversification, call for investments in service sector, and in other areas of the Chinese economy. We also encourage investing overseas.

The second big challenge in China is the agricultural sector. We have a large number of farmers living in the countryside, and because of the population size, the demand for agricultural production is huge, but we have relatively very few arable land. The productivity in agriculture is relatively low because there is no scale of economy. While an increasing number of farmers are migrating to the cities, the government needed to create new jobs for them. New jobs need new factories, new facilities and to take more lands from the agricultural use into the urbanisation, so China may import more agricultural goods. It may to some extent raise the international price of grain. It's another impact on the world economy. Personally I believe it's not a big problem. The price at which we reach the equilibrium point will not be too high. It will still be sustainable. Considering the 1.3 billion population, the Chinese government would be very responsible to the world economy, we should strengthen our agricultures so as not to depend too much on imports of agricultural goods. If China raises the price of grain, it's also not good for many developing countries, because they also depend on import.

Another issue is energy. China's energy consumption consists of 70% coal, 25% crude oil and 3-5% natural gas. We produce coal and natural gas all by ourselves and we even export coal. Forty percent of crude oil consumption depends on import.

Although the high growth rate of the Chinese economy may increase the demand, thus have some impact on the energy prices, China's import in absolute terms and

## Advancing Enterprise 2005

the dependence on imported energy is still relatively small. The problem is that, if the oil price is too high, then China has to use more coal, which is not so friendly to the environment. This is a difficult balance -how much we should depend on the coal.

Finally, returning to the comparison with India, as neighbouring countries, we try to learn as much as possible of the Indian experience. First, to substantially increase the proportion of our service sectors, it will also reduce the consumption of energy and raw materials. We need further deregulation and liberalisation to encourage service sector development. We need an open-door policy to introduce the competition. We need a free-entry policy and further reform. Second, in order to prevent the over-capacity of the manufacturing sectors, we will reduce the share of the investment in our GDP to a more sustainable level in three to five years time and increase the consumption. Reforms will be undertaken to facilitate consumption and provide more consumer loan. We will also speed up the reform of the social security system to increase consumer confidence. We are also reforming our enterprises system to improve their flexibility. For the exporting enterprises, if the external demand turns weak, they can be flexible and turn to serve more the domestic market.

I appreciate very much the efforts of maintaining good international economic orders. Let's strongly support the WTO and the other international organisations to co-ordinate the world economic orders. Through consultation and international communication like G20, G7, etc, I believe we can keep the global economy more balanced. Let us work together to solve the problem and achieve prosperity. Thank you very much.