3

China's Integration into the Regional and International Financial System

Peter Drysdale and Yiping Huang[1]

China's rise in the regional and international economy has been very rapid. Thus far its principal impact has been upon the transformation of international commodity markets. But already China is a major destination for international capital flows and the yuan is an important object of interest in the management of the regional and international exchange rate regime.

This paper examines the process of China's integration into the international financial system. In doing so, it seeks to provide a platform for assessing the future of China's role in the regional and international financial system.

The first part of the paper reviews the recent rise of China's importance of the global economy and its implications for financial market interactions. The paper then proceeds to review the effect of China's commitments under the protocols of its accession to the WTO on the opening up of its capital markets. Domestic financial market reforms are key to capital account liberalisation and this issue is the subject of attention in the body of the paper. A particular interest currently is the exchange rate and the evolution of the exchange rate regime and exchange rate policy is dealt with next. Finally, we make some preliminary comments on proactive approaches to policy that may help to smooth China's international financial integration and maximise its benefits both to China and to China's international economic partners.

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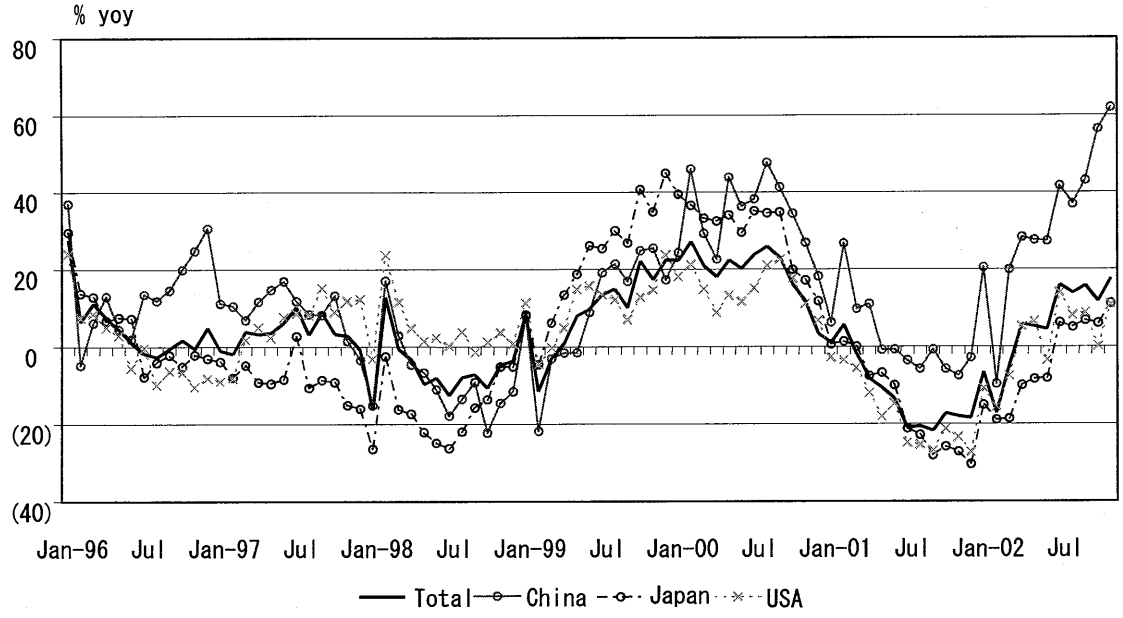
The rise of China in the global economy

China's importance in the global economy has been growing rapidly since it embarked on the task of economic reform more than twenty years ago. This process accelerated after China joined the WTO at the end of 2001. In fact, over the past year or more, China has been the main driver of East Asian economies' export recovery (see Figure 1).

Figure 1 Exports to China Led East Asia's Recent Export Recovery (% Year-on-Year)



Source: CEIC database, Hong Kong.

In 2002, East Asian economies' exports grew by a modest 5.3 per cent. East Asian exports to the US were virtually stagnant, growing by only 1.3%, and exports to Japan shrank by –4.8%. Yet, exports to China (including re-exports through Hong Kong) jumped by 32.7%. Without the help of the Chinese markets, East Asia's exports would have experienced no growth in 2002.

By the end of 2002, China had already surpassed Japan to become East Asia's second largest export market (see Table 1). Significantly, China's share is still on the rise while Japan's share is steadily falling. The United States is still by far the most important export market for the region but the relative importance of China within East Asia is on a strongly rising trend.

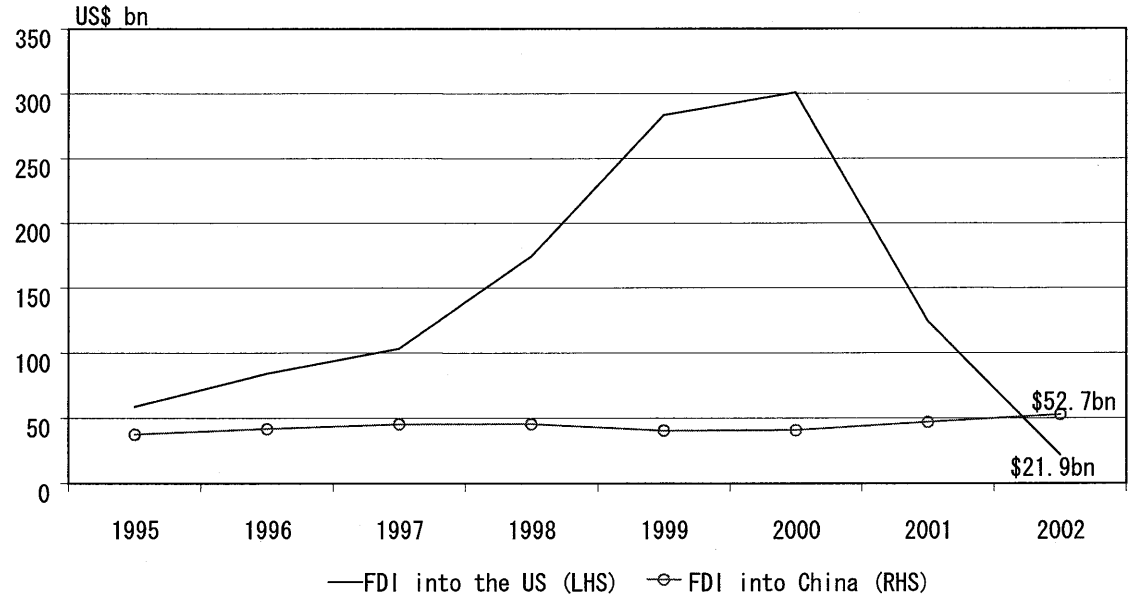
Table 1 Shares of China, Japan and USA in East Asia's Total Exports (%)

	China	Japan	USA
1995	5.8	12.1	20.7
1996	6.3	12.0	19.6
1997	6.6	10.7	20.0
1998	6.4	9.5	22.1
1999	6.4	10.6	22.3
2000	7.2	11.4	21.5
2001	8.3	11.1	20.3
2002	10.4	10.1	19.5

Note: East Asia here includes Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand.
Source: CEIC Database, Hong Kong.

China's rising importance in regional trade was mainly driven by resilient growth of domestic demand, with the help of tariff reductions under the WTO reforms, and improved international competitiveness. It was also supported by massive FDI inflows into China. FDI into China has been growing very rapidly since the early 1990s when China became the second largest FDI recipient in the world, next only to the United States. China's entry into the WTO in December 2001 further boosted foreign investors' confidence in the Chinese market. Actual FDI inflow reached US$52.7 billion in 2002, much higher than US$21.9 billion flowing into the United States during that year (see Figure 2). Although the recent fall in FDI into the United States may be temporary, affected by concerns about geopolitical conflict and likely to pick up after the looming conflict in Iraq and recovery of economic confidence in America, the long term trend is for capital flows to shift towards China. Barring a major collapse of investor confidence, China's status as a top destination for direct investment is unlikely to change in the foreseeable future. The Chinese government recently projected that FDI inflows will grow to US$100 billion each year between 2006 and 2010.

Figure 2 FDI into China Likely Exceeded That into the US in 2002 (US$ billion)



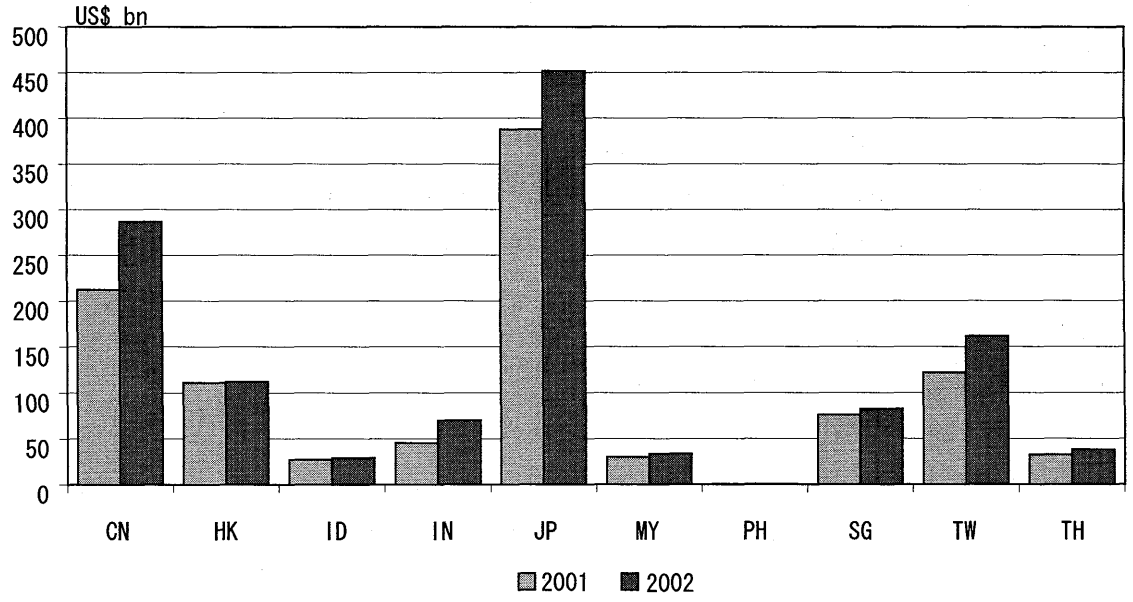
Source: CEIC database, Hong Kong.

The recent surge of foreign investment into China has been dominated by global corporations in a wide range of both manufacturing and services industries. A growing trend, however, is increasing investment in the electronic and higher-technology sectors, particularly around the Shanghai area. Part of growth of direct investment into these sectors in China involves relocation of production facilities from other East Asian economies. This has led to pessimism, particularly in Southeast Asia but right around the region, about the impact of China's joining the WTO of the rest of the regional economy.

This pessimism bears closer examination. Figure 1 shows that China not only competes with its East Asian neighbours but also, and more importantly, is now a major market for them. In 2002, China's total exports rose by 22 per cent but total imports also jumped, by 21 per cent. One of the factors driving China's unusual trade expansion is the shifting tech supply chain. With the continuing relocation of production facilities, China has emerged as a major exporter of electronic and higher-technology products at the labour-intensive end of the spectrum. At the same time China still needs to import more sophisticated intermediate goods and components from other East Asian economies, particularly Japan, Korea, Taiwan, Malaysia, Philippines and Singapore.

China's growing current account and capital account surpluses have contributed to a rapid accumulation on foreign exchange reserves, which increased by more than US$74 billion in 2002. China's total foreign reserves, at US$286.7 billion at the end of 2002, are now the second largest in the world, next only to Japan's (see Figure 3). This already makes China an important player in part of the international capital market. Significantly, recent speculation that China increased its holdings of euro-denominated securities impacted on global bond and foreign exchange markets.

Figure 3 Foreign Exchange Reserves in Selected Asian Economies, 2001 and 2002 (US$ billion)



Note: CN: China; HK: Hong Kong; ID: Indonesia; IN: India; JP: Japan; MY: Malaysia; PH: Philippines; SG: Singapore; TW: Taiwan; TH: Thailand.
Source: CEIC Database, Hong Kong.

While China's ascendancy in the international economy may be overstated somewhat in the context of the present sluggish external environment, the long-term trend seems likely to continue. In 2002, China's GDP amounted to US$1,273 billion, about a quarter of that of Japan's GDP or one-tenth of that of the United States. If the Chinese economy can maintain average growth of 7-8 per cent per annum over the next two or three decades, it will overtake the Japanese economy in 20-30 years even assuming that Japan can successfully return to a 2-3 per cent growth path quickly in the coming years.

WTO reforms and opening up of the capital markets

Compared to the transformation of commodity markets and changes in the real sector, integration of China's financial sector into the global system has lagged behind due to controls over the capital account. In 1996, China liberalized the current account and set a target for liberalising the capital account by 2000. That program was quickly shelved on the outbreak of the East Asian financial crisis in 1997. In many countries, the outflow of portfolio capital was blamed for collapse of the exchange rate system and the domestic financial system. Many Chinese economists and policy-makers were sympathetic to the view that, under these circumstances, capital account liberalisation would be unwise and the plan to liberalise the capital account was postponed indefinitely.

The pace of financial integration has, despite the brake on capital account liberalisation, picked up in recent times. In the agreements on WTO accession, the Chinese government made significant commitments to open up the domestic financial markets (see Table 2). In the banking sector, for instance, foreign banks were permitted to engage in foreign currency business immediately after the WTO accession. They will also be able to engage in local currency business with Chinese companies within two years and with Chinese households within five years. The government also undertook to open up Chinese cities to foreign banking, every year adding four cities in which foreign banks might operate over the first five years. After five years, subject to the routine granting of banking licences, there will be no more restrictions on geographic or business scope of foreign banks' operations. In May 2002, Citibank became the first foreign bank licensed to receive foreign currency deposits from Chinese households at its Shanghai branch. Shortly after, HSBC and Standard and Chartered Bank also received licenses.

Foreign investment banks and asset management companies can now set up joint-ventures with foreign equity limited to 33 per cent. The limit on foreign equity will be raised to 49 per cent after two years. For the insurance industry, foreign companies can form joint-ventures with 51 per cent equity for non-life insurers or 50 per cent for life insurers. For non-life insurers, the foreign equity share permitted will be raised to 100 per cent after two years. Initially only Shanghai and Guangzhou will be open to insurance joint ventures. Beijing and another nine major cities will be open after two years, and the geographical restrictions will be eliminated after three years.

China's obligations under accession to the WTO do not require any specific reform measures in regard to capital account liberalization. But it is likely that the opening of the financial markets, to which China has committed under the WTO agreements, will provide both pressure and incentive for China to liberalize the capital account. In fact, the pace of opening up domestic capital markets also accelerated during the past year, beyond the commitments made in the WTO agreements.

First, foreign investors are now allowed to buy into more domestic companies, including the state or legal person shares of listed companies. Many foreign institutions bought stakes in Chinese banks and insurance companies in 2002. Recently, Citibank acquired 5 per cent of the equity of the Pudong Development Bank, with the option of increasing its stake to 10 per cent within five years. Earlier HSBC bought equity in the Bank of Shanghai and the American investment company, New Bridge, became the largest shareholder in the Shenzhen Development Bank.

Second, in November 2002, the China Securities Regulatory Commission (CSRC) and the People's Bank of China (PBOC) announced what is called the new qualified foreign institutional investors (QFII) system. It allows foreign banks, insurance companies or fund management firms, with more than US$10 billion assets under management, to invest in bonds or stocks listed in the domestic markets (see Table 3). Although the regulators set stringent restrictions, including the minimum and maximum size of funds, investment limits on stocks, lock-in periods and conditions for repatriation, this is a very important step toward liberalisation of portfolio investment. And the authorities are also exploring policies towards the so called qualified domestic institutional investors (QDII) system (to invest primarily in Hong Kong market) and the Chinese depository receipts (CDR) system (for Hong Kong-listed H-shares to be traded in domestic markets).

Table 2 China's WTO Commitments on Financial Market Liberalization in the First Five Years

2002	2003	2004	2005	2006	2007	
Corporate Banking	Foreign currency business with all companies Local currency business with foreign companies 4 cities: Shanghai, Shenzhen, Tianjin, Dalian	Additional 4 cities: Guangzhou, Qingdao, Nanjing, Wuhan	Local currency business with all companies Additional 4 cities: Fuzhou, Chengdu, Jinan, Chongqing	Additional 4 cities: Zhuhai, Beijing, Xiamen, Kunming	Additional 4 cities: Ningbo, Shenyang, Shantou, Xian	No restrictions
Consumer Banking	Foreign currency business to Chinese consumers but branch license required					Local currency business to all consumers
Investment Banking	33% foreign joint-venture owned firms allowed to underwrite A share and underwrite/trade B shares and debt without Chinese intermediary		Increase ownership to 49% joint-venture			
Asset Management	33% foreign owned joint-venture allowed same access in fund management as Chinese companies		Increase ownership to 49% joint-venture			
Consumer Finance	Auto loans without market access limitations					Broad local currency business
Insurance	Non-life 51% or branch, life 50%; non-life products to foreign companies; individual life products available to local and foreign clients Shanghai and Guangzhou open		100% ownership permissible for all non-life insurers Access to Beijing and 10 major cities	Elimination of all geographic restrictions	Full range of non-life services permitted Full range of health insurance permitted	Full range of group, pension and annuity products

Source: Citigroup, compiled by the authors.

Table 3 The New Qualified Institutional Investors (QFII) Policy Frame

Area	Rules
To qualify	Foreign banks, insurance companies or fund management firms with assets of more than $50 billion under management
Fund sizes	$50-800 million
Lock-in period	Lock-in period for principal fund 1 year for open-end funds or 3 years for all others
Repatriation of funds	After the lock-in period, less than 20% each time with interval more than 3 months, conditional on approval by the authorities
Investment restrictions	Individual investors could hold no more than 10% of individual stocks; foreign investors collective could hold no more than 30% of individual stocks
Industries prohibited	Publishing & distribution; telecom infrastructure; power grid construction & management; securities companies; program production for TV & film, and cable TV; and Chinese medicine

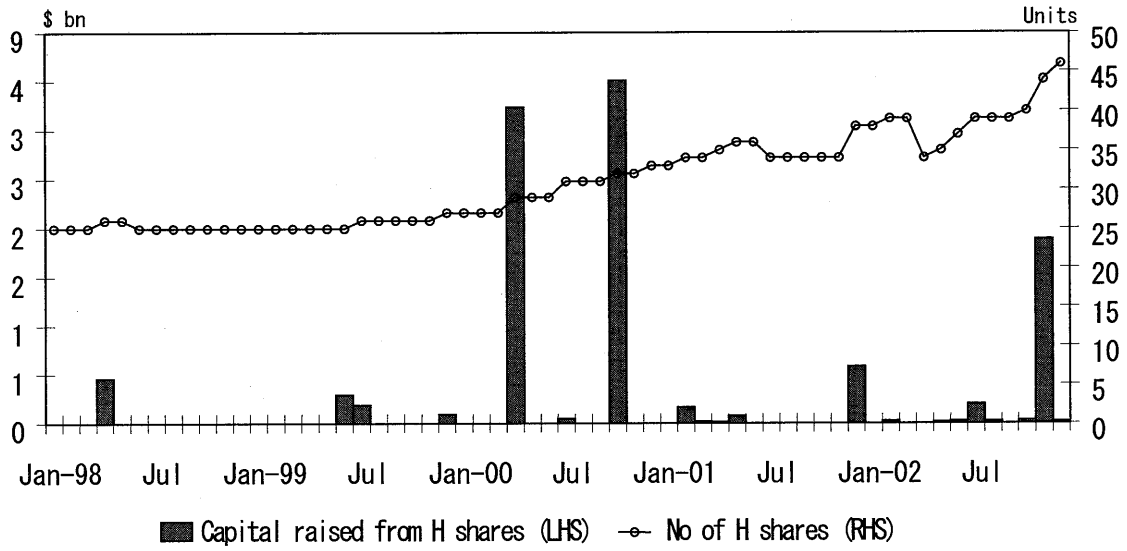
Source: Compiled by the authors.

Finally, the government started an experimental program of relaxing restrictions for external direct investment by Chinese companies. From November 2002, companies in Shanghai, Zhejiang and Guangdong wanting to invest overseas no longer need to seek approval from the central authorities so long as the aggregate size of investment does not exceed US$200 million in each province or municipality. The government plans to extend this experiment to Fujian, Jiangsu and Shandong in 2003.

The capital market in China is increasingly open, marked in many areas by the lax enforcement or avoidance of controls, especially in southern China. These are clear signs that capital market liberalisation is accelerating, although a free capital account still is likely to be years away.

Another channel of financial linkage to the outside world is through the issuance of Chinese stocks and bonds in international capital markets. H-shares (Chinese companies listed in Hong Kong stock market), for instance, are now an important component of the Hong Kong market (see Figure 4). However, the growth of this market has been poor in recent years. The incentives for Chinese companies to list in Hong Kong or New York stock markets are not very strong because of low price/earning ratios and higher requirements for transparency relative to the domestic market. The government has not raised much capital from the international market in recent years because of abundant supplies of domestic liquidity.

Figure 4 Shares Listed in Hong Kong (H Shares): Number of Shares and New Capital Raised



Source: CEIC Database, Hong Kong.

Financial reforms as a condition of capital account liberalisation

Concern over the vulnerabilities associated with a free capital account is largely related to the frequent and sometimes violent instability of short-term capital flows. An economy's ability to withstand such fluctuations is crucially dependent on the health of the domestic financial system. Therefore, a first step for capital account liberalisation must be to complete the reform of domestic financial systems.

The health of the Chinese banking system has come under a spotlight since the beginning of the East Asian financial crisis in 1997. In early 1998, the PBOC estimated that the average proportion of the non-performing loans (NPLs) was 24 per cent for the four major state-owned commercial banks (SOCBs). The Bank of China (BOC), the Industrial and Commercial Bank of China (ICBC), the Construction Bank of China (CBC) and the Agricultural Bank of China (ABC) comprise this group. The NPL ratio for these banks was much higher than the same ratio in pre-crisis Thailand, South Korea, Indonesia and Malaysia.

China's entry into the WTO, and the increased openness to competition from foreign financial institutions and among domestic banks that it foreshadowed, revived

anxieties about the sustainability of the Chinese banking system. Foreign bank competition is likely to be limited to the coastal area, at least initially, but it is also true is that the SOCBs generate 95 per cent of their profits from about half dozen of the coastal cities, including Shenzhen, Guangzhou, Xiamen, Shanghai, Tianjin and Beijing.

The Chinese banking system is already quite diversified, including the policy banks, the SOCBs, the small commercial banks, rural and urban credit cooperatives and foreign banks, having developed from a state-dominated mono-bank system in the pre-reform period (see Table 4). The big four SOCBs still dominate both in terms of deposits and loans. But these are the banks with the most serious financial burdens. Hence, whether China can avoid a banking crisis in the near-term critically depends on the success of the attempts at reform of these four big banks.

Recent official data reveal a consistent decline in the NPL ratio for the four SOCBs – it has fallen from about 28 per cent in late 2000 to slightly above 20 per cent in late 2002. While the reported trend is probably an accurate reflection of reality, we believe that actual NPL ratios are probably still somewhat higher than reported, averaging around 25 per cent at the end of 2002 (see Table 5). This is illustrated by recent revelation of the BOC scandals in both New York and Kaiping, and reinforced by the General Auditing Office findings of wrong-doing at the ABC and CCB. These ratios, of

Table 4 Structure of China's Bank System

Types of banks	Share in total loans (%)	Share in total deposits (%)
Policy banks (3)	12.2	0.2
State-owned commercial banks (4)	66.5	70.9
Small commercial banks (100)	5.9	8.8
Urban credit cooperatives (836)	4.3	6.5
Rural credit cooperatives (41775)	9.3	13.1
Foreign banks (65)	1.8	0.5

Note: The data are for end-2001. The numbers in parentheses in the first column are numbers of banks or cooperatives in the category. The three policy banks include China Development Bank (CDB), China Export and Import Bank (EXIM) and Agricultural Development Bank of China (ADBC). The four large SOCBs include the Industry and Commerce Bank of China (ICBC), the Bank of China (BOC), the China Construction Bank (CCB) and the Agricultural Bank of China (ABC). The small commercial banks include 10 joint-stock banks and 90 city banks.
Source: Compiled by the authors from data published by the People's Bank of China.

Table 5 Health of the Chinese Banks

	1996	1998	2000
Non-performing loan ratio (%)			
The state-owned commercial banks (4)	35.0	40.0	25.0
The joint-stock banks (10)	--	13.5	14.0
Capital adequacy ratio (%)			
The state-owned commercial banks (4)	4.4	8.0	5.0

Note: Proportion of non-performing loans for the four major banks for 1996 and 1998 are re-estimated based on new information recently made available. The proportion for 2002 excluded the Rmb1.4 trillion transferred to the Asset Management Companies in the previous years.
Source: Compilation and estimates by the authors

NPL ratios of around 20-25 per cent, still exclude the 1.4 trillion yuan already transferred to the four Asset Management Companies (AMCs) affiliated to the four SOCBs. In 1998, the government injected 270 billion yuan into these four banks (through issuance of special Treasury bonds) to raise their average capital adequacy ratio (CAR) from 4.6 per cent to above 8 per cent. By the end of 2001, however, the average CAR had fallen to around 5 per cent again.

The authorities now have a three-step reform program in place for the banking sector (see Table 6). The first step involves continuation of the reform of the internal management systems of the banks, including implementation of the international standard five-category loan classification system and improvement of the credit culture. In the second step, the four SOCBs will be transformed into share-holding entities, possibly introducing strategic domestic and foreign investors. And, all of the banks are to aim at public listing, domestic or overseas, as the last step in the process of reform.

Table 6 The Current Reform Program for the Banking Sector

Areas	Key Measures
Resolving NPLs	AMCs continue to deal with Rmb1.4trn of NPLs SOCBs are required to lower their NPL ratios by 2-3ppts each year in the next 5 years
Bank Supervision	Relatively independent bank supervision departments are established within the PBOC
Banking Reforms	Step 1: Reforms to internal management system Step 2: Implementation of the share-holding system and introduction of foreign or domestic strategic investors Step 3: Public listing

Source: Citigroup

The PBOC actually requires the four banks to lower their NPL ratios by 2-3 percentage points every year in order to reduce the average NPL ratio to below 15 per cent by 2005. Many officials appear to be confident that this target is achievable. First, with the new standard loan classification system in place, banks and regulators are able to better monitor and control credit risks. Second, the PBOC has already put in place arrangements for loan provisioning – 2 per cent for special mention, 25 per cent for sub-standard, 50 per cent for doubtful and 100 per cent for loss – and demanded that all banks to achieve these requirements in 3-5 years. Third, the PBOC has granted autonomy to the commercial banks in identifying and writing off NPLs. And, finally, to improve the banks' financial position and facilitate the workout of the NPLs, the PBOC has drafted 'Management Rules for Service-based Fee Charging of Commercial Banks', which is scheduled for introduction from 1 April 2003. Currently fees account for less than 10 per cent of the revenues of most Chinese banks. But in many other countries, fees hold a share of revenues as high as 30-40 per cent.

Problems in three areas, if not resolved quickly, will be a drag on the banking reform process. The first problem relates to state enterprise reform. Although China has already engaged in massive privatisation of the state sector over the past five years, the sector still accounts for more than 50 per cent of banks' total outstanding loans. Without successful resolution of state-owned enterprise problems, it is hard to expect the banking problem to vanish completely. The second problem relates to the causes of the current decline in NPLs. In recent years, banks have used more than 7 per cent of their funds to purchase government bonds with less than a 3 per cent yield. More importantly, about half of new loans over the last five years were extended to state-

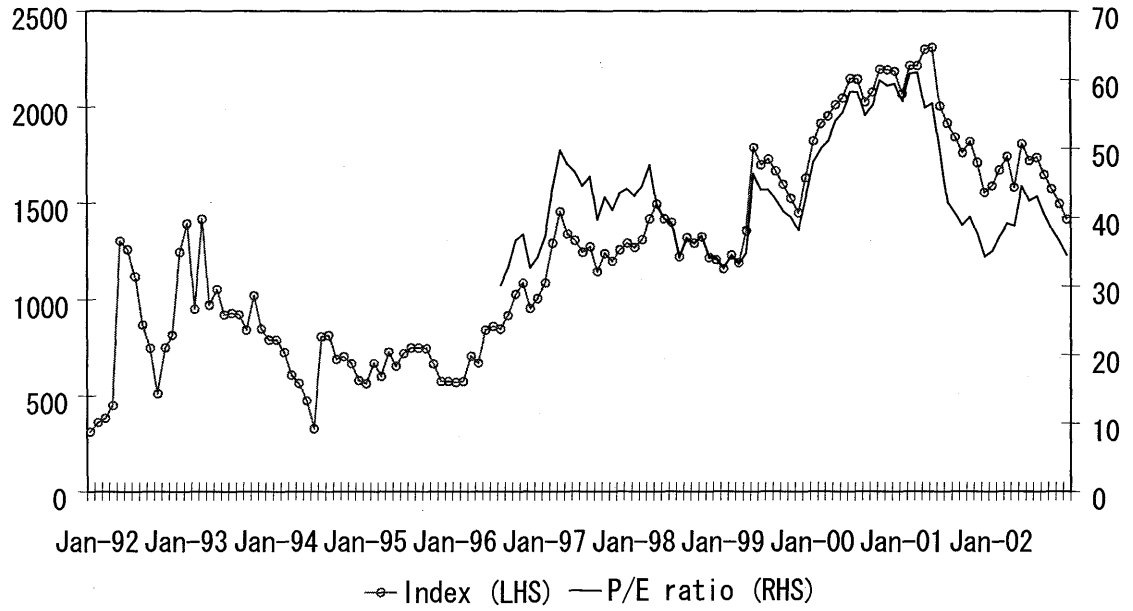
sponsored projects. These strategies are obviously not sustainable. And the third problem is related to the corporate governance and risk management. While banks are trying hard to change their lending behavior, most still rely on administrative measures under the state-ownership.

Conditions of the domestic stock market also present a major constraint to China's capital account reform. China started to develop its stock market after the early 1990s. The stock market was developed mainly as instrument of state sector reform. Of about 1,100 companies listed on domestic stock markets, more than 95 per cent are state-owned enterprises. To make it worse, the companies were picked by local government based on a regional quota system. In other words, they were often selected for their importance to the local government not because of their efficiency or potential. Because China maintains a closed capital market, stock market prices were pushed up consistently with price-to-earning ratios rising to above 60 at the beginning of 2001 (see Figure 5). Even after the recent collapse in the stock market, the price-to-earnings ratio still stands at about 35, way above the average of 10 for the H-share companies listed in Hong Kong.

There is no doubt that the domestic stock market needs substantial consolidation, in terms of company structure, corporate governance and prices. But in China as anywhere else in the world, adjustment in stock prices can be politically sensitive and risky. From 2001, the CSRC attempted to raise some revenues for the under-funded Social Security Fund through sales of state-shares in the domestic stock market. However, this triggered the close to 40 per cent decline of market prices. The CSRC was forced to shelve the plan in 2002.

For the same reason, the implementation of policies for QDII and CDR are being delayed for fear that they might cause further collapse of the market. Substantial steps towards capital account liberalisation are thus conditional on completion of the consolidation of domestic stock markets.

Figure 5 Shanghai A-Share Market: Price Index and Price/Earning Ratio



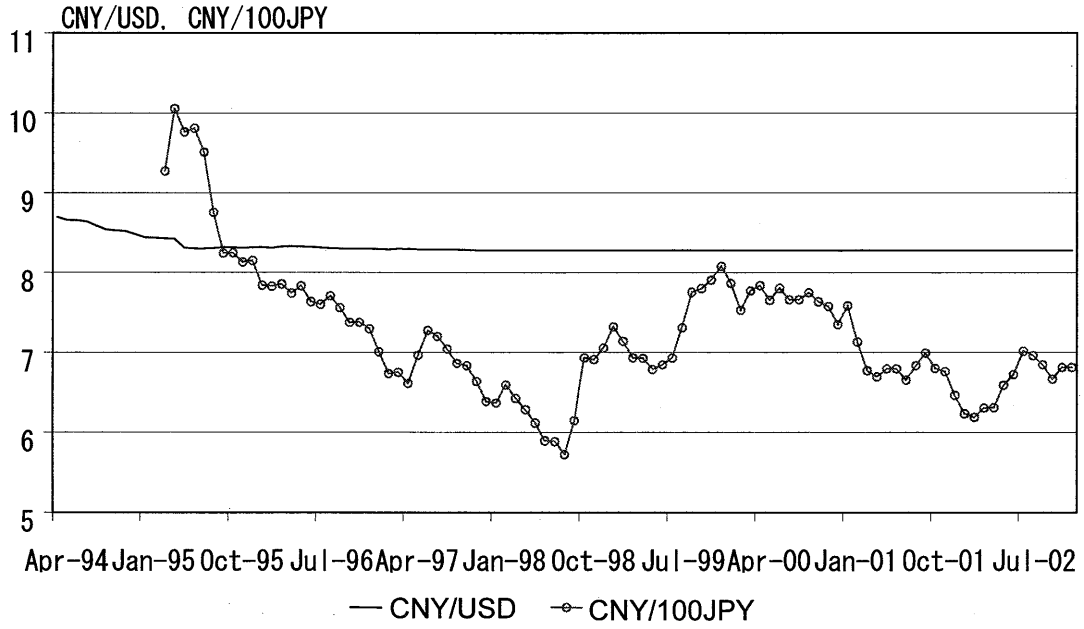
Source: CEIC database, Hong Kong

Future evolution of the exchange rate policy

During the earlier period of economic reform, China had a dual exchange rate system, with an official rate and a secondary market rate. From April 1994, the two rates were unified into one rate, which was set at 8.7 to the US dollar. This required a substantial depreciation of the official exchange rate (of around 50 per cent) but a relatively modest (8 per cent) effective depreciation of the currency because a very large proportion of foreign exchange transactions was already being conducted through the secondary market. In the following three years, the Chinese yuan appreciated steadily. By the time of East Asian financial crisis in mid-1997, the yuan had already appreciated by close to 5% (see Figure 6).

The crisis, of course, brought about very sharp declines in regional currencies. And the yuan was also under significant pressure to depreciate. However, the Chinese government made a strategic decision to maintain a stable exchange rate in order to avoid competitive devaluation in East Asia. Since then, the nominal Chinese yuan/US dollar rate has little changed. But speculation about whether and when the yuan might be devalued continued in the market.

Figure 6 Chinese Yuan's Exchange Rates Relative to the US Dollar and Japanese Yen



Source: CEIC Database, Hong Kong.

Circumstances changed dramatically in 2002 as Chinese exports expanded, the current account position continued to strengthen and foreign exchange reserves mounted. The talk outside China turned to the need for, and the possibility of, yuan revaluation. The issue of yuan revaluation is now also being debated among economists and policy makers in China.

Supporters of a fixed exchange rate policy regime are mainly concerned about impact of any exchange rate change on current momentum of the economy (see Table 7). It is argued that the current fixed exchange rate policy helps maintain stable expectations among investors. A change may affect FDI flows. Trade officials worry that revaluation of yuan could hurt exports, which are an important driver of growth. A stronger currency could further depress domestic prices, particularly wages, and thereby exacerbate the problem of deflation. And there is also concern about the distribution effects of revaluation as a stronger yuan might aggravate the inequality problem as rich import-consumers enjoyed lower prices while bread-winners in the export sector received less.

Table 7 The Case for and against CNY Revaluation

For revaluation	Against revaluation
Rapidly improving external accounts	Stable investor expectation
Need for macro policy flexibility	Exacerbation of wage and price deflation
Proper pricing of foreign capital and risks	Fear for export slowdown
International politics and policy considerations	Concerns over deteriorating income distribution

Source: Compiled by the authors.

The case for introducing more flexibility to China's exchange rate policy has recently been gathering strength. Rapidly improving external accounts call for a stronger yuan. In 2002, the trade surplus rose by 27.7 per cent to US$29.5bn and the current account surplus stood at around 1.8 per cent of GDP. The balance of payments position also improved steadily. Part of the improvement has been due to China's strong growth momentum but part of it has also been induced by an under-valued currency. The continuous build-up of distortions through misalignment of the exchange rate will make future adjustments more difficult. A flexible exchange rate system, the likely result of which would be some appreciation of the yuan in the short term, could also help better price foreign capital and risks. While a fixed exchange rate may be helpful in underpinning stable expectations up to a point, under this regime, investors may be seduced into under-estimating risks. More importantly, as a large and dynamic economy, China needs macroeconomic policy flexibility to accommodate changes in domestic markets. Although, China is not Hong Kong, the fixed exchange rate constrains flexibility in monetary policy and limits the government's ability to accommodate changes in domestic and external economic environment. There are increasingly strong demands from international community, particularly from the United States, Japan and other East Asian nations, for China to revalue its currency. All these nations are important Chinese economic partners, and interdependence between China and these economies is expected to rise further in the coming years. Introducing a measure of exchange rate flexibility when the pressures are towards appreciation is a favourable circumstance in which to seize the initiative. It would be unfortunate if China repeated the mistakes of Japan of inflexibility in adjusting the exchange rate regime as required in an earlier period.

The recent weakening of the US dollar adds to the case for a new approach to exchange rate policy. It is probable that the Chinese government might re-think

exchange rate policy in the coming months, although the exact timing of policy change is difficult to predict as the government is in the throes of a generational change in policy leadership. But even if the government adjusts exchange rate policy strategy, there is unlikely to be any drastic change in the value of the yuan. The most likely change would be a widening of the band for exchange rate movements to +/-3 per cent initially, equivalent to a 3 per cent appreciation in the first instance.

To gauge the impact of such a policy change, we apply the Oxford Economic Forecasting model to simulate outcomes.

(1) We assume China widens the band to +/-3%, which implies a 3% appreciation of yuan under current circumstances.

(2) We also assume that the policy change lasts for the full year of 2003.

The change has a direct negative impact on macroeconomic indicators. A 3% revaluation of the currency could cut 0.36 of a percentage point off China's GDP growth (see Table 8). This is a relatively large effect for a 3 per cent revaluation and the structure of the model used here may well exaggerate its magnitude, if not its direction. The growth of total consumption, total fixed asset investment and industrial production would also slow somewhat. This result also highlights reality that the government would be more reluctant to change its exchange rate policy when domestic and external economic conditions are sluggish.

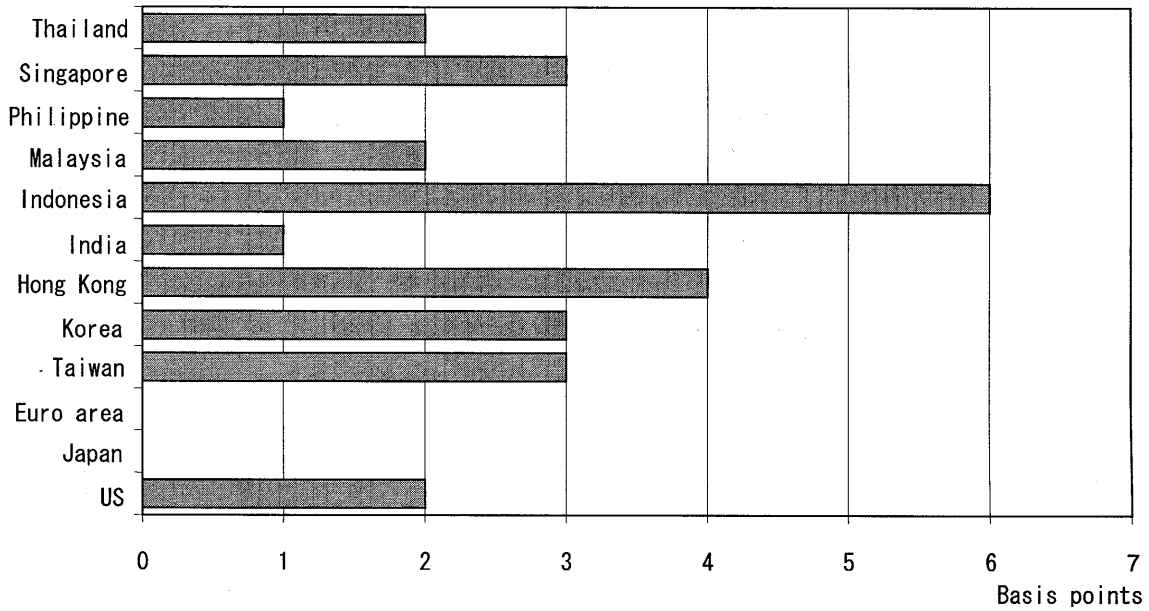
Table 8 Likely Impact of 3% Yuan Appreciation on the Chinese Economy in 2003

	Citigroup base-case scenario	Scenario assuming 3% Yuan appreciation	Difference
GDP Growth (% yoy)	7.60	7.24	-0.36
Total Consumption (% yoy)	8.30	8.26	-0.04
Fixed Capital Investment (% yoy)	8.30	8.06	-0.24
Exports (% yoy)	12.80	12.16	-0.64
Imports (% yoy)	13.00	13.2	0.2
Trade Balance (US$ bn)	34.0	31.4	-2.6
Current Account Balance (% GDP)	1.80	1.6	-0.2
Foreign Exchange Reserves (US$ bn)	330.0	326.5	-3.5
Fiscal Balance (% GDP)	-2.80	-2.92	-0.12
Industrial Production (% yoy)	11.60	11.3	-0.3
CPI (% yoy)	0.50	0.4	-0.1

Source: Citigroup estimation applying the OEF model.

The simulations also allow calculation of the impact Chinese appreciation on GDP growth of other economies (see Figure 7). These effects are largely positive but very small in magnitude. The leading beneficiaries are Indonesia and Hong Kong, followed by Singapore, Korea and Taiwan. Interestingly, growth in Japan and the Euro area are not affected.

Figure 7 Impact of 3% Yuan Revaluation on GDP Growth of Other Economies



Source: Simulation results using the OEF model.

The need for a proactive policy strategy

The discussion above underlines the need for proactive policy strategies directed at smoothing China's integration into the international financial system and maximising the benefits to both China and her major economic partners. The following are some of the priorities.

The top priority in the promotion of effective integration between the Chinese and international financial markets is domestic financial and enterprise reform. Interest rate liberalisation is an essential part of the process of financial system reform and the integration of the domestic and international capital markets. Financial market and enterprise reform is an urgent and necessary task in preparation for opening the capital account. It is also a considerable task. Steps towards capital market opening

ought not be held over until domestic financial market reform is complete. The two processes cannot easily be sequenced discretely. The powerfully attractive idea that domestic financial reform must be 'completed' before capital account controls are relaxed is a flawed idea. That would take the pressure off building robust institutions and efficient markets at home precisely when they are needed to cope with the changes wrought by deeper real and commercial sector interaction in world markets. This, it could be argued, was a point not sufficiently well understood in the management of the policy choices surrounding deeper integration into international financial markets at critical stages in the development of other East Asian economies, like Japan and Korea, that confronted the challenge earlier.

Capital account liberalisation can be staged in significant degree independently of the opening of financial services to international competition, as suggested above. But China's various commitments to financial market liberalisation under its obligations in accession to the WTO are a central step in laying the foundations for capital account liberalisation.

Foreign participation provides a key discipline in encouraging institutional change and improving efficiency in the financial marketplace. The commitments to opening the opportunities for foreign participation in the capital market are likely to strengthen market practices and efficiencies. The Chinese authorities have been remarkably forward-looking in acknowledging and accepting the role of foreign participants in the non-financial corporate sector to growth and international orientation and competitiveness of the Chinese economy. China's openness to foreign direct investment was introduced on a scale and at a pace that, in comparative historical terms, puts it well ahead of all the other major East Asia economies. As described above, they have now committed to a similarly big role for foreign players in the financial corporate sector. This will not only assist in the strengthen of domestic markets and institutions but, it should be understood, force the pace of international financial market integration, multiplying the channels and links via which the international market interacts with the domestic market.

A policy choice that is fundamental to success in managing deeper financial market integration is the choice about change to the exchange rate regime. Almost always the strategic initiative in exchange rate regime change has been missed managing economic and financial transformation in East Asia. This was most notably

so in the lead-up to the East Asian financial crisis in the late 1990s. But, even more importantly, Japan and Korea historically were reluctant to change the approach to exchange rate management when their old rigid exchange rate regimes had long since used their used-by dates. It is possible to explain this reluctance in each country's circumstance at the time. But the generic problem is clear enough. A rigid exchange rate regime and inflexible exchange rate policy is invariably the linchpin of the whole policy framework in a pre-reform controlled economy and pulling the plug on the exchange rate regime embraces a major retreat from control, particularly of the financial sector. Introducing flexibility into the exchange rate regime is, therefore, a key part of the process of correcting distortions between Chinese and domestic capital markets. We have argued above that the time is now right to introduce more flexibility into exchange rate management as a first step in this process.

The stronger and more supportive the international framework within which Chinese policymakers can interact with policymakers and policy professionals elsewhere the more likely it is that policy judgment and choice will be well informed and strategically directed. Failure to take into account the feedback effects of policy action and lack of their awareness becomes an increasingly important policy frailty as the scale and importance of an economy grows. This frailty is not only plays out through policy circles and in international policy commentary, but it also plays out directly through the market. Enhanced policy transparency through appropriately structured international dialogue and financial cooperation arrangements will assist timely policy development and intervention. This is good reason for attaching increased importance to regional and international financial cooperation and openness in policy dialogue. The emergence of regional financial cooperation arrangements in the form of the Manila Framework Group and the ASEAN+3 dialogues, alongside the global financial cooperation arrangements through the IMF, mark the beginnings of a new regional financial architecture in which China must play a more and more active role.

China already accounts for 5.6 per cent of world trade, if Hong Kong trade (net of intra-Hong Kong-China trade) is added to that of the mainland. The projections of trade and economic growth mentioned above will see China overtake Japan as the region's largest economy and the world's third largest economy after the United States and Europe.

With successful implementation of the financial and economic reforms to which significant commitment has already been made, China appears bound to become a

significant financial player in international financial markets over the next two to three decades. There is every likelihood that in the process Shanghai, for example, will emerge to overtake Hong Kong, Singapore, and even Tokyo, as the major financial hub in East Asia.

At the same time China will steadily assume a larger and more important role in the international and regional financial system and its management.