Financial Markets in China

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September 16, 2015
The purposes

1. Gain insights into the Chinese economic/financial system (past, present, future);
2. Understand new trends in the Chinese economy and on-going reforms;
3. Hook up with continued growth of the Chinese economy.
The topics

1. A snapshot of the Chinese economy
2. Major financial markets in China
3. History of China’s financial markets/economic development and current problems
4. New trends of the Chinese economy
5. On-going financial liberalization
A Snapshot of the Chinese Economy
### GDP 2014 (IMF)

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country/Region</th>
<th>GDP (Millions of US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td><strong>World</strong></td>
<td>77,301,968[^9]</td>
</tr>
<tr>
<td>1</td>
<td><strong>European Union[^1]</strong></td>
<td>18,495,349[^9]</td>
</tr>
<tr>
<td>2</td>
<td>United States</td>
<td>17,418,925</td>
</tr>
<tr>
<td>2</td>
<td>China</td>
<td>10,380,380[^2]</td>
</tr>
<tr>
<td>3</td>
<td>Japan</td>
<td>4,616,335</td>
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<tr>
<td>4</td>
<td>Germany</td>
<td>3,659,547</td>
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<tr>
<td>5</td>
<td>United Kingdom</td>
<td>2,945,146</td>
</tr>
<tr>
<td>6</td>
<td>France</td>
<td>2,846,889</td>
</tr>
<tr>
<td>7</td>
<td>Brazil</td>
<td>2,353,025</td>
</tr>
<tr>
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<td>2,049,501</td>
</tr>
<tr>
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<td>Russia</td>
<td>1,857,461[^3]</td>
</tr>
<tr>
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</tr>
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<tr>
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<td>South Korea</td>
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</tr>
<tr>
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<td>Spain</td>
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</tr>
<tr>
<td>15</td>
<td>Mexico</td>
<td>1,282,725</td>
</tr>
</tbody>
</table>

[^9]: [IMF data](https://data.imf.org/home.aspx)
[^1]: [European Union data](https://ec.europa.eu/economy_finance/db_indicators/index_en)
[^2]: [China data](http://data.china.gov.cn)
[^3]: [Russia data](http://www.gks.ru)
GDP growth (IMF)
GDP per capita

Countries by 2014 GDP (nominal) per capita.[1]

- $129,696
- $64,848 – $129,696
- $32,424 – $64,848
- $16,212 – $32,424
- $8,106 – $16,212
- $4,053 – $8,106
- $2,027 – $4,053
- $1,013 – $2,027
- $507 – 1,013
- < $507
- unavailable
## GDP by sector

<table>
<thead>
<tr>
<th>№</th>
<th>Country</th>
<th>nominal GDP</th>
<th>Agri.</th>
<th>Indus.</th>
<th>Serv.</th>
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</thead>
<tbody>
<tr>
<td>0</td>
<td>World</td>
<td>74,699,268</td>
<td>5.9%</td>
<td>30.5%</td>
<td>63.6%</td>
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<tr>
<td>1</td>
<td>United States</td>
<td>17,418,925</td>
<td>1.12%</td>
<td>19.1%</td>
<td>79.7%</td>
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<tr>
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<td>China</td>
<td>10,380,380</td>
<td>9.1%</td>
<td>42.6%</td>
<td>48.3%</td>
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<tr>
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<td>Japan</td>
<td>4,616,335</td>
<td>1.2%</td>
<td>27.5%</td>
<td>71.4%</td>
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<tr>
<td>4</td>
<td>Germany</td>
<td>3,859,547</td>
<td>0.8%</td>
<td>28.1%</td>
<td>71.1%</td>
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<tr>
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<td>United Kingdom</td>
<td>2,945,146</td>
<td>0.7%</td>
<td>21%</td>
<td>78.3%</td>
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<tr>
<td>6</td>
<td>France</td>
<td>2,846,889</td>
<td>1.9%</td>
<td>18.3%</td>
<td>79.8%</td>
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<td>7</td>
<td>Brazil</td>
<td>2,353,025</td>
<td>5.4%</td>
<td>27.4%</td>
<td>67.2%</td>
</tr>
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<td>8</td>
<td>Italy</td>
<td>2,147,952</td>
<td>2%</td>
<td>24.2%</td>
<td>73.8%</td>
</tr>
<tr>
<td>9</td>
<td>India</td>
<td>2,047,811</td>
<td>17.4%</td>
<td>25.8%</td>
<td>56.9%</td>
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<tr>
<td>10</td>
<td>Russia</td>
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<td>3.9%</td>
<td>36%</td>
<td>60.1%</td>
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<tr>
<td>11</td>
<td>Canada</td>
<td>1,788,717</td>
<td>1.8%</td>
<td>28.6%</td>
<td>69.6%</td>
</tr>
<tr>
<td>12</td>
<td>Australia</td>
<td>1,444,189</td>
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<td>39.8%</td>
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<td>14</td>
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<td>1,406,855</td>
<td>3.3%</td>
<td>24.2%</td>
<td>72.6%</td>
</tr>
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<td>15</td>
<td>Mexico</td>
<td>1,282,725</td>
<td>3.7%</td>
<td>34.2%</td>
<td>62.1%</td>
</tr>
</tbody>
</table>
Quick summary

- Second largest economy in the world, largest transitioning economy;
- An emerging economy on per capita basis ($7500, 79th);
- Fast growing, recently slowing down;
- Significant regional disparity;
- Unbalanced sector composition.
Composition of aggregate financing to real economy

Chart 1: Flows of total social financing components

- bank credit flows have been falling since 2009
  => shadow banking flows have been accounting for most of the liquidity flows in the system

- shadow bank credit
- stocks
- bonds
- bank loans

* Bank acceptance bills, trust loans, entrusted loans and curb lending

sources: CEIC, BNPP IP (Asia)
### Stock markets

<table>
<thead>
<tr>
<th>Rank</th>
<th>Exchange</th>
<th>Economy</th>
<th>Headquarters</th>
<th>Market cap (USD bn)</th>
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<tbody>
<tr>
<td>1</td>
<td>New York Stock Exchange</td>
<td>United States</td>
<td>New York</td>
<td>19,223</td>
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<td>United States</td>
<td>New York</td>
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<td>3[1]</td>
<td>London Stock Exchange</td>
<td>United Kingdom</td>
<td>London</td>
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</tr>
<tr>
<td>4</td>
<td>Japan Exchange Group – Tokyo</td>
<td>Japan</td>
<td>Tokyo</td>
<td>4,485</td>
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<tr>
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<td>Shanghai Stock Exchange</td>
<td>China</td>
<td>Shanghai</td>
<td>3,986</td>
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<tr>
<td>6</td>
<td>Hong Kong Stock Exchange</td>
<td>Hong Kong</td>
<td>Hong Kong</td>
<td>3,325</td>
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<tr>
<td>7</td>
<td>Euronext</td>
<td>Netherlands, Belgium, Portugal, France</td>
<td>Amsterdam, Brussels, Lisbon, Paris</td>
<td>3,321</td>
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<tr>
<td>8</td>
<td>Shenzhen Stock Exchange</td>
<td>China</td>
<td>Shenzhen</td>
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<td>9</td>
<td>TMX Group</td>
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<td>Toronto</td>
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<tr>
<td>10</td>
<td>Deutsche Börse</td>
<td>Germany</td>
<td>Frankfurt</td>
<td>1,762</td>
</tr>
</tbody>
</table>
Equity Market Valuations
(In percent unless otherwise specified)

3rd largest in the world after U.S. and Japan

Fig. 1: China’s bond market growth over the last 10 years

Source: Wind, as of December 2014
Fig. 5: China’s debt remains low relative to GDP.
Size of various bond sectors

Fig. 4: The size of various sectors of the market

- Policy Bank Bonds: 9,708
- Ministry of Finance Bonds: 9,591
- Others: 6,168
- Medium-Term Notes: 3,390
- Enterprise Bonds: 2,924
- Commercial Paper: 1,764
- Local Gov't Bonds: 1,162
- Corporate Bonds: 757
- Central Bank Notes: 422

RMB billion
Size of various bond sectors

Fig. 6: Chinese bonds have historically offered attractive yields versus other bond markets

Government bond yields

Money market rates

Source: Reuters
As of January 15, 2015

HIBOR = Hong Kong Inter-bank offering rate
LIBOR = London Inter-bank offering rate
SHIBOR = Shanghai Inter-bank offering rate
Commodity exchanges

- Shanghai: Industrial metals, gold, petrochemicals, rubber
- Dalian: Agricultural, plastics, energy
- Zhengzhou: Agricultural, chemical products (PTA)
Key characteristics of financial markets in China

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- Underdeveloped bond and equity markets relative to economic development;
- Shadow banking and financial innovation experienced explosive growth in recent years;
- Fundamental reforms are on the way.
Commercial banks dominate China’s financial system—bank credit constituted 51% of total social financing in 2013.
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Strategic capital allocation: prioritizing the development of particular industries; subsidizing the state-owned enterprises (SOEs).
Interest rate control

- Interest rates are effectively controlled in China.
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  - Binding deposit rate ceiling
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- High reserve requirement ratio (RRR) of 18.5% for large banks
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  - A deposit insurance system was introduced in May (about US$80,000 per account).
Development of China’s Financial Markets
(Economic Strategies and Reforms)
Debut of economic development (1949-1979)

- **Strategy:** prioritizing the development of heavy industry.

Why such strategy?
- Geopolitical environment required quick establishment of a strong national defense system (Wars: Korean War 1950; India, 1962, the former Soviet Union, 1967; Vietnam 1979);
- The impoverished agricultural economy was unable to provide necessary market conditions for industry growth;
- The heavy industry has desirable features of sustaining and expanding its own growth;
- Same strategy was applied by the former Soviet Union, India, and Eastern European and Latin American countries in their early economic development.
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How to develop heavy industry?

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- However, capital is the most scarce element among the production resources (capital, labor, and land) during the early stage of economic development;

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Affiliating policies: high exchange rate, low wage, and low raw material and agriculture product prices.
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Adoption of plan economy

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  - Enterprises were nationalized to ensure their profit will be invested in the heavy industry;
  - State-controlled procurement systems of the agricultural products and raw materials;
  - Minimum commodity supply and low living standard.
China established a complete heavy industry system within a short period of time (1949-1956);
Early economic development in China

- China established a complete heavy industry system within a short period of time (1949-1956);
- Achieved high-speed economic growth due to high output and high profit of heavy industry. Really?

The true reason is surplus transfer to the heavy industry:
- Repressed interest rates reduced the cost of capital of the heavy industry—wealth transfer from savers;
- Low wage and low raw resources prices;
- Artificially high exchange rates at the expense of primary commodity (mostly agriculture) exportation.
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- Growing dissatisfaction due to unimproved living standard, especially compared to neighboring regions (Hong Kong, Taiwan, South Korea, and Singapore).
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**Economic reforms became inevitable!**
China has gradually liberalized the industrial and agricultural sectors since 1979—a transition from plan economy to market economy.
Economic reforms since 1979

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  - The state controlled procurement system of agricultural products was demolished;
  - Prices of almost all resources became market-based;
  - Some state owned enterprises (SOEs) were privatized and went public to raise capital—leading to the birth of stock markets;
  - Rigid low wage policy was abandoned;
  - Rigid official exchange rates were replaced with floating exchange rates, which were gradually allowed to fluctuate in greater range.
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- China’s growth was fueled by net exports (overseas) and investment (domestic).
<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>Foreign exchange reserves (Millions of US$)</th>
<th>Figures as of</th>
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<tr>
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<td>Japan</td>
<td>1,250,073</td>
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<td>Saudi Arabia</td>
<td>686,431</td>
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<td>Switzerland</td>
<td>599,906</td>
<td>Apr 2015[4]</td>
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<td>Republic of China (Taiwan)</td>
<td>423,171</td>
<td>Apr 2015[5]</td>
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<td>374,750</td>
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<td>Brazil</td>
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<td>United Kingdom</td>
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<td>16</td>
<td>France</td>
<td>141,503</td>
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Interest Rate Liberalization
(An Illustration of China’s Economic Reform Mechanism)
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Shadow banking in China

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- Shadow banking in China has different characteristics from shadow banking in the developed economy:
  - Primarily carried out by commercial banks to evade regulatory restrictions on the banking sector;
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(A) Scenario 1: Absence of Shadow Banking (Past)

- PE Firms
- SOE Firms
- Commercial Banks
- Central Bank
- Households

Loans (Quota) → Commercial Banks → Deposit Required Reserve
Bonds → Commercial Banks
Deposits → Central Bank

Central Bank Fund
Deposits (Interest Rate Ceiling)

(B) Benchmark Model (Present)

- PE Firms
- SOE Firms
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- Central Bank
- Households

Loans (Quota) → Commercial Banks → Deposit Required Reserve
Bonds → Commercial Banks
Wealth Management Products

Central Bank Fund
Deposits (Interest Rate Ceiling)
Our perspective...

- Shadow banking essentially constitutes a dual-track approach to interest rate liberalization in China.
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Has NEVER been fundamentally reformed!
China’s interest rate policy and liberalization

- Interest rates have long been rigidly controlled in China until very recently.
- Primarily exercised through the banking regulations, such as deposit rate ceiling, loan quota, and high deposit reserve requirement.
- Has NEVER been fundamentally reformed!
- Underlies the economic structural imbalances and distortions in China.
Economic imbalance and structural distortions

- Over investment and high inflation
Economic imbalance and structural distortions

- Over investment and high inflation
  - Low interest rate induces excessive incentive to investment;
Economic imbalance and structural distortions

- Over investment and high inflation
  - Low interest rate induces excessive incentive to investment;
  - Consumption demand and investment demand tend to comove, resulting in high aggregate demand and high inflation;

- Policy-driven cycles of “releasing policy restriction—investment boom—investment mania—tightening policy restriction—economy hard landing”;

- Overprotection of SOEs leads to low efficiency and slow technological innovation;

- Capital misallocation results in overcapacity and pollution;

- Repressed development of entrepreneurship and private sector;

- Corruptions arose from the insidious network of local government, bank, and SOEs.
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Why is there lack of fundamental reforms in the interest rate policy?
Dilemmas of reform

Why is there lack of fundamental reforms in the interest rate policy?

- Commercial banks are used to high profit margin due to repressed deposit rate and under-supplied credit, they have no incentive to reform. Banks are not equipped with modern risk management knowledge and techniques and lack of self-discipline in conducting business;

- Borrowers, particularly the SOEs and LGs, enjoy stable and cheap bank loans and are lack of the consciousness and knowledge of operating in interest-sensitive environment;

- In the absence of smoothly-functioned bond markets, monetary policy is more effective through interest rate control, rather than through a market mechanism (Zhou Xiaochuan, governor of the PBoC, 2009).

How to formulate a pragmatic reform mechanism to liberalize China's interest rate policy?

Hao Wang (Tsinghua University)
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- Dual-track interest rate liberalization begins with a pre-existing plan track, that is, the controlled bank credit track, where the deposit rate and loan quantity are artificially set below their market equilibrium levels;

- A market track of shadow banking is introduced to allow economic agents to satisfy their funding demand and supply at the market interest rates.
Interest liberalization in China

- Shadow banking provides a pragmatic dual-track reform solution to China’s rigid interest rate policy.
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- Different from its counterparts in the developed economies, shadow banking in China essentially constitutes an effort of covert interest rate liberalization.
- The shadow banking track prepares the central bank and the other economic agents for the transition to full interest rate liberalization.
China’s economic/financial reforms almost all follow a "dual-track" approach.
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Takeaway—China’s reform mechanism

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- Does not require to dismantle the old system or completely restructure institutions under the preexisting plan track, creating no losers if implemented properly.
- Can have least opposition \textit{ex ante}, and minimize the likelihood of reversal \textit{ex post}. 
Trends in the Coming Decade
Will still see continued high growth? China’s "New Normal"

More efficient, balanced, sustainable, and mid- to high-speed growth.

Real GDP Forecasts
(In percent)

Sources: Consensus Forecast; and IMF staff estimates and projections.
Spillovers

**Contribution to Global Growth**

(In percentage points)

Sources: IMF *World Economic Outlook*; and IMF staff calculations.
Potential economic growth rate (PEGR) refers to the highest possible growth rate within a certain period of time.

- The decline in China’s PEGR will be a trend.
Why slow down?

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- It is decided by factors such as labor input, capital input and total factor productivity.
- Cheap production inputs have constituted the most important driving force for China’s growth into a “world factory”.
Labor input

China's working-age population (15-59 years old) shrank for the first time in 2012. It is predicted from 2010 to 2020 the country's working-age population will decrease by more than 29 million people, which means the labor input growth will gradually slow down.

On the other hand, the aging population means more people need to be supported by others in the society.

Capital input

China was able to maintain a high savings rate and high investment ratio in the past because of the plentiful cheap labor. The savings rate will drop and the capital that can be invested will also decrease.

Land input

Resource and environmental restrictions become more serious.
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Supply (prices) of labor, capital, land, and other factors is on the decline (rise).

Investment- and export-driven growth model is not sustainable, forcing China to seek new catalysts.
• The Chinese economy is finally undergoing true rebalancing.

Domestic Investment → Domestic Consumption
Overseas Export → Overseas Investment
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- Financial reforms facilitate such transition...
- Challenge: how to strike a balance between economic structural adjustment and financial vulnerability?
Why mid- to high-growth?

- China’s new comparative advantages:
  - Technology: high-speed railway; electronics; Internet technology; automobile, aviation;
  - Wage is rising but labor is still an advantage (low per capita GDP; undeveloped western regions);
  - Large amount of foreign capital reserve;
  - A catching-up economy (great room for investment and learning);
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Domestic Value Added
(In percent of world's domestic value added)

Sources: OECD June 2015 TiVA database; and IMF staff
Urbanization has been the weakest spot in China’s economic development.
Trend 1. Urbanization

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- There is tremendous room to improve—expect to boost domestic demand by USD 4.5 trillion in the next two decades (the World Bank).
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- There is tremendous room to improve—expect to boost domestic demand by USD 4.5 trillion in the next two decades (the World Bank).
- Signs have indicated acceleration.
As of October 2014, urban population accounts for 53 percent of the total population in China; Urbanization continues to hold significant economic potential, as long as it spreads to the mainland’s inland provinces and medium-size cities.
Trend 2. Growth in the western regions

- Regional disparity is extraordinary in China, constituting a great engine for growth.
- While growth levels are decelerating in the first-tier coastal megacities, they remain relatively high in the inland provinces. The mainland’s income distribution and regional balance are slowly improving.
Green investment program is expected to have annual growth rates ranging from 20 to 35 percent over the next five years.
Trend 3. Green investment

- Green investment program is expected to have annual growth rates ranging from 20 to 35 percent over the next five years.
- Push hard on new technology (through technology innovation, importation, international cooperation).
Trend 4. Service industries

- Service sector only accounts for 46% of GDP, suggesting tremendous room for growth
- A key source of FDI (55.4% of total FDI of $128 billion in 2014)
The trend

- The proportion of the first and second industries, which consume capital, land and energy heavily and pollute the environment, will fall.
- The service industry, which relies less on capital, land and energy, will grow fast.
Integrate mobile Internet, cloud computing, big data, and the Internet with modern manufacturing and services.

Encourage the development of e-commerce, industrial networks, and Internet banking.

Guide Internet-based companies to increase their presence in the international market.
Trend 5. Invest globally

- China is already the largest international investors
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  - Emphasizes on "Win-Win" solutions
One Belt, One Road (OBOR)

- Also known as the Belt and Road Initiative, focusing on connectivity and cooperation among countries primarily in Eurasia.
- Consists of two main components, the land-based "Silk Road Economic Belt" (SREB) and oceangoing "Maritime Silk Road" (MSR).
- Silk Road Fund: a USD 40 billion development fund for the initiative.
The bank was proposed as an initiative by the government of China and supported by 37 regional and 20 non-regional members.
Asian Infrastructure Investment Bank (AIIB)

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- The United Nations has addressed the launch of AIIB as "scaling up financing for sustainable development".
<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>Number of Shares</th>
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<td>Philippines</td>
<td>9,791</td>
<td>1.00</td>
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  - In the longer term, as reserve currency
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- In 2007, RMB-denominated bonds issued outside of mainland China.

The creation of a system of “one currency, two markets”: onshore RMB designated CNY; offshore RMB designated CNH.

Today, offshore RMB centers have been established in Hong Kong, Singapore, Taiwan, London, Paris, Frankfurt and Luxembourg. More than 40 central banks from around the globe have allocated partial reserves to the currency.

The scale of the offshore renminbi (CNH) market is still limited: 1.5% of that onshore (around RMB 100 trillion), which is much lower than the ratio of 30% of offshore versus onshore US dollar deposits.
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The road to the RMB Internationalization is far from complete.

- The size of the home economy must be large relative to others (✓).
- Economic stability in the form of low inflation, small budget deficits and stable growth (✓).
- Strong political and institutional support (?)
- Deep, open and well-regulated capital markets (?)
Greater exchange rate flexibility

- Important for maintaining an independent monetary policy as the capital account opens (the "impossible trinity").
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- Reform aims to achieve an effectively floating exchange rate within 2-3 years.
- The key is to forge a domestic consensus so that implementation can proceed, with the understanding that there will be some learning-by-doing and fine tuning along the way.
Understand the new needs of the Chinese economy

- China needs:
China needs:

- Boosting domestic demand
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  - Boosting domestic demand
  - Green technology and investment
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  - Partners for global economic cooperations
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- China no longer needs:
  - Funds of investment
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  • Funds of investment
  • Export for the sake of GDP and employment
  • Publicity
Take-away messages

- Historically, China successfully tailored economic development strategies to its own situations and needs.
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- Today, China is fundamentally adjusting its economic growth strategy being more sustainable and balanced.
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- The road ahead is challenging, requiring to strike a balance between economic growth and fundamental reforms.
Thank you!

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Email: wanghao@sem.tsinghua.edu.cn
Tel: 86 10 62797482