International Monetary and Financial Committee

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On behalf of People’s Republic of China
I. THE GLOBAL ECONOMY AND FINANCIAL MARKETS: OUTLOOK, RISKS, AND POLICY RESPONSES

The global economy maintained its strong momentum in the first half of 2007. The emerging market and developing economies saw particularly strong expansion and became a major driving force of global growth. However, activities in the major advanced economies slowed in the second quarter of 2007, posing significant downside risks to global growth.

First, growth in the United States has been hampered by a housing market correction over the past two years, resulting in heightened downside risks to growth. Credit market retrenchment may further dampen the housing market, suppressing consumption and investment, giving rise to potential risks of recession with a spillover effect on other countries. As the turbulence in the global financial markets caused by the U.S. sub-prime mortgage market developments has adversely affected global growth prospects, it is all the more urgent a priority to strengthen surveillance of the systemically important advanced economies in order to safeguard global financial stability and economic prosperity.

Second, the impact of financial market turbulence on the global economy may be broader and more pronounced than previously anticipated. This round of adjustment has not yet come to an end. Despite the major central banks’ liquidity injection, credit conditions are unlikely to be restored within a short period of time. Due vigilance against threats to global financial stability and economic growth is warranted.

It is necessary to thoroughly analyze the root causes of the recent financial turmoil, re-examine the role of financial innovation and the development of derivatives as well as the associated risks, reflect on the weaknesses in information disclosure and market regulation, and draw lessons for the future.
We call on the relevant countries to enhance financial market regulation, particularly in strengthening the oversight of hedge funds and the monitoring of cross-border capital flows, so as to minimize the adverse impact of financial market volatility on the macro economy.

Third, despite global growth moderation, inflationary pressures persist. Fuel and other commodity prices remain high and volatile. Rising energy and food prices have led to higher inflationary pressures in many emerging market economies. In addition, turbulence in the financial markets has further complicated the conduct of monetary policies. Therefore, central banks should remain vigilant and take actions when necessary.

Fourth, trade protectionism should not be overlooked. The Doha Round of trade negotiations has failed to achieve tangible progress, and protectionist sentiment is on the rise in major advanced economies. Worldwide multilateral trade liberalization remains the key to maintaining sustained global growth. We call on all parties to stand firmly against trade protectionism and to push ahead with the Doha trade talks so as to allow all countries to equitably participate in—and benefit from—globalization.

**CHINA’S ECONOMIC DEVELOPMENT AND POLICIES**

Growth has remained steady and rapid. In the first half of 2007, GDP grew by 11.5 percent. Consumption growth accelerated while fixed-asset investment growth moderated. Economic efficiency further improved, and the growth of corporate profits, fiscal revenue, and household income all accelerated. Despite these positive achievements, challenges remain. In addition to the excessively large trade surplus, the unduly rapid expansion of investment, and the higher-than-desired money and credit growth that feed into inflation pressure, energy and environmental concerns are also constraints to sustainable growth. A major task is to prevent overheating.

The Chinese government has taken measures to strengthen macroeconomic management, improve investment structure, increase fiscal expenditure in social sectors, boost domestic demand, and speed up reform in the financial sector. The central bank has raised the required reserve ratio and the benchmark interest rates for deposits and loans on many occasions. Meanwhile, steps have been taken to optimize credit structure, promote financial market development, and further increase the flexibility of the RMB exchange rate. As regards structural reforms, we have revised the trade policies which were designed to
encourage exports and limit imports. We have also lowered the export tax rebate rate, cut import tariffs, and introduced strict restrictions on energy-intensive and environmentally unfriendly exports. Moreover, measures have been taken to utilize foreign capital more efficiently, improve the pricing mechanism of resources, and raise environmental protection standards. Reform of the foreign exchange management system has further accelerated, controls for enterprises and individuals purchasing and holding foreign exchange have been relaxed, and enterprises are encouraged to invest overseas. These policy measures have started to achieve the expected results.

Going forward, we will continue to improve macroeconomic management, accelerate structural adjustments, improve the quality of growth and resolve the risks in the economy. The central bank will continue to pursue sound monetary policy. It will adopt a stable but moderately tightened monetary stance to control inflation expectations and safeguard stability of the currency.

The Hong Kong SAR economy expanded briskly in the second quarter of 2007, with GDP having accelerated to 6.9 percent in real terms from 5.7 percent in the first quarter. Such economic expansion marked the 15th consecutive quarter of above-trend growth, which has remained broad-based. The seasonally-adjusted unemployment rate edged down to 4.2 percent in the second quarter, the lowest since mid-1998. Notwithstanding the rapid economic growth, the underlying inflationary trend remains moderate, with rising labor productivity helping to alleviate price pressures from the external front. Barring any abrupt adverse changes in the external environment, the Hong Kong economy is expected to continue its solid growth in the second half of 2007. GDP growth for 2007 as a whole is estimated at 5-6 percent and the composite CPI is expected to be close to 2 percent.

Growth of the Macao SAR economy in the first half of 2007 reached 28.9 percent. The employment situation was good, with the unemployment rate at 3 percent in the second quarter of 2007. Inflationary pressures have increased somewhat. The y-o-y CPI rose 6.4 percent in August. It is expected that Macao SAR will maintain its strong growth momentum through 2007. Diversified development of the tourist industry will be the main driving force for Macao’s future economic growth.
II. THE FUND’S QUOTA AND VOICE REFORM

Recent discussions have led to preliminary agreement on some aspects of the Fund’s quota and voice reform. Nevertheless, a number of important issues need to be resolved.

According to the Singapore Resolution, one of the objectives of the Fund’s quota and voice reform is to realign quota distribution with members’ relative position in the world economy, which means the reform should aim at significantly raising the overall quota shares of the developing countries, particularly the emerging market economies. To achieve this, the size of the second round ad hoc quota increase must be sufficiently large. We believe an overall increase of at least 12.5 percent is appropriate. The overall size of the increase should not be restricted to liquidity considerations.

The first round ad hoc quota increase agreed in Singapore has been broadly welcomed by the international community. Its positive role should be recognized. Subsequent efforts should build on this achievement rather than starting allover from the pre-Singapore level. The first round ad hoc increase only partly alleviated the under representation of China, Korea, Mexico, and Turkey, which still remain the most severely underrepresented. Therefore, it is appropriate to adjust their quota or voting power based on the post-Singapore level.

At this stage the quota formula is the focus of the reform. We agree that the new formula should be simple, transparent, and easy to implement, and should include four variables—GDP, openness, variability, and reserves. We are in favor of giving GDP the greatest weight, using a blended GDP variable with at least 25 percent PPP weight. At the same time, we support a slightly lower weight for openness and a higher weight for variability, which we believe will better reflect members’ potential need for financial resources from the Fund. We encourage staff to examine issues related to the definition, scope, and weight of these two variables. More importantly, there should be a built-in mechanism for periodically reviewing and adjusting members’ quota to reflect timely changes in the global economic landscape.

Based on this, we are ready to show the utmost sincerity and maximum flexibility. While we believe a quota formula including PPP GDP, which is simpler and more transparent, is the most effective way to raise the overall share of developing members, for the sake of facilitating progress of the reform,
we are open to the MER GDP plus filter framework proposed in the TWG report, which is based on the Australian proposal. However, if the MER GDP plus filter is adopted, we cannot accept use of the compression factor in the formula.

Another important objective of the quota and voice reform is to preserve the voting power of low-income countries. In this regard, we call for a substantial increase in basic votes, and support efforts to increase the resources and capacity of the African Executive Directors’ offices.

In order to complete the reform agenda within the timeframe set in the Singapore Resolution, we call on the relevant countries to take a flexible and pragmatic approach in advancing the reform. In particular, we call for stronger political will from the authorities of the advanced economies to facilitate the smooth implementation of the quota and voice reform.

III. PROGRESS IN DEVELOPING A NEW INCOME MODEL

We note staff’s specific proposals based on the recommendations of the Committee of Eminent Persons. However, progress in developing a new income model has been disappointing. In the face of an increasingly large income shortfall, the lack of progress in the Fund’s income reform reflects governance problems, which will not only adversely affect the Fund’s reputation but prevent it from effectively fulfilling its mandate. We hope that Fund management and the relevant member countries will make greater efforts to advance this reform.

We are in favor of appropriately broadening the Fund’s investment authority, and of using a portion of the quota resources for investment. All members should participate. We also support selling part of the Fund’s gold holdings for investment.

The Fund should enhance its risk analysis and investment management to ensure the safety, profitability, and liquidity of its invested resources. It may have to adopt different investment policies in line with the different liquidity and profitability requirements of reserves, quota resources, and gold sale proceeds. The Fund’s current governance structure can serve as a basis for the new governance framework under the enlarged investment authority. Relevant arrangements should be further enhanced to avoid conflicts of interest.
We are of the view that the issue of charging for technical assistance—a modest contribution to the Fund’s income, affecting mostly low-income members—should not be taken up in discussing the new income model.

IV. THE FUND’S SURVEILLANCE

We regret the rushed adoption of the Decision on Bilateral Surveillance over Members’ Policies (the 2007 Decision) in the absence of members’ consensus. We note that application of the 2007 Decision over the past few months has given rise to some controversy due to lack of clarity on some core concepts. This had hampered the effective implementation of the Fund’s surveillance.

We believe that the Fund’s exchange rate surveillance should focus on whether a member country’s exchange rate regime is consistent with its medium-term macroeconomic policies, rather than on its exchange rate level. Given the apparent weakness in the concept and measurement of the equilibrium exchange rate, its estimation can serve only as one of references for technical analysis, but not as the basis for the assessment of members’ policies.

We hope the Fund will fully recognize the diversity of members’ situations, the limited role exchange rates play in macroeconomic management and the limitations of the tools used for exchange rate analysis. We also hope that the Fund will respect the autonomy of its members in choosing exchange rate regimes. Moreover, in its exchange rate surveillance, the Fund should have an appropriate focus and enhance its surveillance over countries issuing the major reserve currencies. The Fund should also take concrete steps to address problems related to the 2007 Decision and its application. The aim of these efforts is to enable the Fund to conduct surveillance in a prudent, fair, and effective manner based on clear consensus so that, through its surveillance, the Fund will contribute significantly to financial stability and economic prosperity.