Thank you for this invitation. Over the next two days you are going to hear some very knowledgeable people talking about the issues of China’s economic and financial reforms and their implications for capital markets.

I want to set the scene with a broad overview of the reform process.

Because along with the enthusiasm of foreign businesspeople for engagement with China, along with the rivers of foreign direct investment flowing in, you still hear nervous whispers in the background that the reforms will falter or even come undone. Every half year or so some new pundit comes along to predict ‘China’s looming crisis’ or even ‘China’s coming collapse’. Sometimes the trigger is said to be internal unrest, sometimes financial disaster, sometimes ecological catastrophe, sometimes an outbreak of military conflict.

I don’t deny that the question of whether the reform process will continue is an important one. And I don’t underestimate China’s problems. But let me lay my cards on the table. I think China’s economic and financial reforms have about them an unstoppable momentum. That momentum is generated by a powerful consensus on the part of the Chinese leadership that China needs an economic model that has the capacity to reliably continue to deliver economic growth.

Measuring the size of economies is a long way from being an exact science. On purchasing power models China is already larger than Japan and will overtake the United States by the 2020s. But if you take a guess somewhere between purchasing power and traditional product measurements of the global economy, the world looks something like this: the US with GDP at about $10 trillion of GDP, Japan at $5 trillion and China at around $3 trillion to $4 trillion.

By the time the Chinese economy doubles from its present base to around about $7 trillion, China will have the mass and velocity to really get into its stride: on the way to becoming a much more developed economy. And this platform is, I believe, well within its reach.

What we are seeing in China is one of the great – perhaps the greatest - economic transformation in world history. Faster than the industrial revolution in Europe, faster than the great burst of industrialisation in the United States in the 19th century. The American industrialisation in the 19th century grew from a population of 40-60 million. This one has one and a quarter billion people re-joining the world economy with a new post industrial economy.

The big turning was made by Deng Xiaoping in 1978. I often think that no political figure in the 20th century will have done more, to shape the 21st century than Deng.
His policy of reform and his call to ‘seek truth from facts’ has ensured that China is increasingly prosperous and actively participating in global politics and economics, rather than being marginalised and disaffected. Of course, it didn’t have to be this way. Deng was not slated to materialise politically and socially the way in which he did. China could very easily have gone down a different pathway. We should never lose sight of the consequences of what that other sort of world might have been.

When Deng said he wanted to quadruple Chinese output by the end of the century, almost all observers thought this was wildly optimistic. But his goal was met well ahead of time.

China’s GDP grew by 9.7 per cent a year on average between 1989 and 2000 and real urban incomes doubled.

- With reform of the state owned enterprises, the private sector now produces over 40 per cent of China’s output.

- 70 million people have access to mobile phones and 30 million can use the internet on personal computers

  - these figures are significant because they underline one of the important drivers of change in China. Its leaders know that the country missed out on the industrial revolution and they are determined not to miss the information revolution as well.

- The economy has been driven to be more open and internationalised

  - international trade quadrupled during the 1990s and represents now more than 50 per cent of GDP

  - this year China will attract $50 billion worth of FDI and will surpass the United States as the world’s largest recipient of foreign investment.

As we saw from the results of the 16th Party Congress a few weeks ago, Deng’s successors, including Jiang Zemin and Zhu Rongji and now Hu Jintao have moved steadily towards creating a new economic model for China. One that is no longer state socialism and certainly not state capitalism.

If any good came out to the 1997-1998 financial crisis in Asia it was to put a final nail in the coffin of the idea of that China’s model should be state capitalism of the Korean variety or tops-down resource allocation of the Japanese kind.

Instead China is developing an economy which will be based much more on the individual and on smaller to medium enterprises. One that is also subject to mainstream world disciplines, with resources being allocated more by economic signals and less by ministries for trade and industry. The great difference between the Chinese and the Koreans and Japanese models is that consumers will enjoy the lion’s share of the benefits and savers will be rewarded.
The key to success of this new model is, of its essence, competition.

That the Chinese leadership should have lit upon the driver of competition rather than relying on chaebols or planning ministries to pick winners is remarkable.

That is why China’s admission to the WTO in December 2001 was one of the defining events of our time. By signing on to a global system of trade rules, and committing itself to open up its own economy to foreign competition, China finally cemented the reform process into place. The main advantage of WTO membership for China has not been in the markets it opens up overseas but in the disciplines it imposes at home. In the competition that flows from it, and the productivity it will produce. WTO membership will probably add about 1 per cent to China’s growth rate each year. An all important indice.

This year China’s economy is growing at around 8 per cent. But the other side of the equation is that China has to maintain such growth rates if it is to cope with its challenges.

Governing any country is a tough business. But governing a country of 1.3 billion, many of them poor, getting food and resources to them and delivering education and health is a challenge most of us could barely contemplate.

I must say, I regard Zhu Rongji and his colleagues as the most effective government anywhere in the world. I certainly can’t think of any which has managed structural change and growth so well in the face of so many challenges. Even the most capable policy maker would feel some sense of awe in the face of these problems and these achievements.

Because every step along the reform path generates new problems.

- Reforms of the State owned enterprises increases unemployment and underemployment and the social problems that come with them.
- As growth powers along in some areas, others relatively fall behind and the differentials between the coast and the hinterland widens
- And environmental problems of air, soil and water in both the cities and the countryside loom as severe impediments to accelerating economic activity.

Growth is more difficult to achieve as the base of the economy enlarges.

The Chinese government understands that an economy this big cannot grow at the desired rates only by adopting the export-focussed model of the other East Asian economies. The focus has to be on domestic demand and private demand with net exports playing a complementary rather than a primary role. No first world economy has private demand in the back seat. And there is a limit, a clear limit, as to how much public demand can be the loss leader.

Since the crisis of 1997-1998 public demand has played an important role in economic activity. But heavy reliance on public demand is no long term substitute for
a healthy balance to the economy. The growth of private demand has to be a core objective of Chinese economic policy.

Luckily, China still has a lot of growth available from productivity improvements, better labour force employment and especially a more marked movement towards services.

The size of China’s services sector – 35 per cent of GDP – is less than half that of Australia’s. China’s leaders know that China will not be a first rate economic power until it has a competitive services sector. They also know that foreign expertise and foreign competition are essential to getting there.

Financial services, for example, will be a key to economic growth.

The financial system is the artery that gets the blood to the muscle of the economy. It needs to deliver finance efficiently to every part. In China, it is still not doing that. Certainly not as effectively as it might.

The system relies too much on the banks and the stock market.

The banks suffer from cultural problems and from old debts of the State Owned Enterprises. They also have relatively ordinary risk management protocols. While the stock market is still small. And only about one-third of it is free-floating, with the rest in the hands of the government. The fixed income market is still rudimentary. Chinese capital markets have a long way to go but without a truly efficient capital market, marshalling the necessary economic resources will be much more difficult.

The Chinese financial system needs greater transparency and certainty. The range of its capital market structures needs to be broadened, especially the fixed income market.

All this is well understood by Chinese leaders and the central regulatory organisations like the PBOC and the CSRC. We have recently seen the opening of the stock market to qualified foreign institutional investors. Issues like greater convertibility of the currency, deregulation of interest rates, a more liberal financial products market, and further reforms in the banking industry and the entry of foreign banks to the retail market are all on the table.

We will hear a great deal more about them in the course of the conference.

I will make just one prediction. It is that the process will unfold faster than many observers think.

If I learned one thing from the process of forcing open Australia’s sclerotic financial system in the decade between the mid-’80s and mid-’90s, it was how quickly the players in the economic system factored anticipated changes into their own plans and behaviour. The announcement effect itself represented a large part of the ongoing policy effect.
But perhaps the area that more than any other holds the key to whether China’s reforms are a never-ending story will be education.

As the economy is transformed, the demands on the educational system are going to increase enormously. At present only 5 per cent of China’s school leavers go on to tertiary education. That figure will have to increase quickly – placing further resource demands on the government.

One final thing that may slow China’s reforms is military conflict.

China shares borders with 15 countries, among them some of the most volatile in the world. In addition, Japan and South Korea lie just across the sea. The task of managing cross-Straits relations is always complex. And the relationship with Washington too has been tense in the past and may be again.

To reach its goals, China needs time – uncluttered time. Uncluttered by strategic interference or by strategic distractions. Does it understand this and will it get that time?

I am optimistic on this front, too. It looked for a time as if China might be saddled by some on the American Right with the role of Evil Empire Mark 2. But the appearance of a much more immediate and obvious enemy in the form of international terrorism got some welcome balance back into US-China relations. The Beijing-Washington relationship will always require careful tending, not least because China has the population, resources, geographic size and cultural confidence to be a future peer-competitor of the United States. But the signs are promising that it can be managed sensitively on both sides.

For China, no international issue will be more delicate to deal with than its future relationship with Japan. As Japan reaches its apogee, an aging country, rich but with a declining population, China will need to find ways of keeping it calm while finding for it a valuable and secure place in the society of North Asian nations.

North Korea’s military machinations for instance, have set Japanese minds worrying. China has an opportunity here to provide some ballast to regional considerations and some re-assurance to Japan in respect of its strategic circumstances.

China’s growth is changing Asia and those changes are more likely to reinforce the imperatives for further reform in China. Increasingly, China will be the engine of growth for its neighbours. Intra-Asian trade is growing strongly, reflecting an increasingly integrated pattern of production. This is all mutually reinforcing and good.

China is so large that it will always make its smaller neighbours apprehensive. It is hard to live next door to a giant. This means that China, like other great powers, has a particular responsibility to exercise leadership and statesmanship. That it has done so recently on so wide a range of issues - from the proposed China-ASEAN free trade arrangement to regional security – gives good grounds for optimism about regional stability into the future.
China faces opportunities and challenges on a grand scale.

But the way of maximising the first and dealing with the second is primarily the same: continuing economic and financial reform. That is why the forces that are propelling China’s reform seem to me to be so strong and self-reinforcing.