China's Next Step in Yuan Overhaul Is Convertibility, Zhou Says

By Zhou Xin Editors: Nerys Avery, Andrew Langley

The People's Bank of China's next step in overhauling the exchange-rate system will focus on convertibility, Governor Zhou Xiaochuan said, as his omission from a top Communist Party committee indicated he will retire.

“For the central bank, I think the next movement related to the yuan is going to be reform of convertibility,” Zhou told the annual meeting of International Financial Forum, an advisory organization, in Beijing yesterday. “We are going to realize it, we are moving in this direction, we need to go further, we will have some deregulation.”

The governor's comments underscore pledges made by the ruling Communist Party during a once-a-decade power transition last week to promote freer movement of capital in and out of the country for investment purposes and to make the exchange rate more market based. China is seeking to boost the use of the yuan in international trade and finance to reduce the U.S. dollar's global dominance and curb its own reliance on the currency of the world's biggest economy.

Zhou, who has headed China's central bank for the past decade, wasn't named to the new central committee of the Communist Party on Nov. 14, suggesting he will probably leave his job. At a Nov. 11 press briefing, Zhou didn't directly answer a question on retirement.

Possible replacements include Shang Fulin, head of China's banking regulator; Guo Shuqing, chief securities regulator; Industrial & Commercial Bank of China (601398) Ltd. Chairman Jiang Jianqing; and Bank of China Ltd. Chairman Xiao Gang, according to David Loevinger, former senior coordinator for China affairs at the U.S. Treasury Department and now an Asia analyst in Los Angeles at TCW Group Inc.

Yuan Revaluation

During Zhou's tenure, the country started to overhaul its exchange-rate system and financial markets. Changes included revaluing the yua'n and ending its peg to the U.S. dollar in 2005, allowing the currency to become convertible for trade purposes, giving banks more freedom to set interest rates and allowing some foreign institutional investors access to the country's stock and bond markets.

The yuan has appreciated about 33 percent against the dollar since the revaluation. The currency had its biggest weekly gain in a month, closing at 6.2356 per dollar in Shanghai on Nov. 16.

HSBC Holdings Plc analysts led by Qu Hongbin, the chief economist for China, said in a report this month that the new leadership may liberalize interest rates and push to make the yuan fully convertible within five years as part of an overhaul that will “revolutionize the country's financial system.”

Economic Slowdown

Premier Wen Jiabao's government in March picked Wenzhou, a city in eastern China dominated by smaller, non-state enterprises, for a trial program designed to boost capital for private companies that bore the brunt of an economic slowdown that started in 2010.

Zhou said the pilot was hindered partly by the euro area debt crisis as the local economy was heavily reliant on exports to European markets.

China has designated areas including Shanghai, Tianjin and the Pearl River Delta to trial reforms in the financial services industry, Zhou said. This will allow the country to accumulate experience and test for what could go wrong, he said.

The new government will continue to value changes initiated at local level by governments and companies to protect their enthusiasm and innovation, he said. At the same time, it will also still attach great importance to overall planning, he said.

Overheating Risks

In a separate speech at Caixin Media's annual conference in Beijing yesterday, Zhou said China's central bank needs to be especially alert to the threat of inflation as the country transitions from a planned to a market economy.

The central bank is often pressured by interest groups to relax monetary policy and to support growth, Zhou said. Monetary policy needs to be prudent most of the time because “the risks of overheating are always bigger than the risks of an economic downturn,” he said.

China's 4 trillion yuan ($586 billion at the time) stimulus, unveiled at the end of 2008 to cushion the economy from the impact of the global financial crisis, was effective in spurring growth, Zhou said. “But every medicine has side effects.”

The two-year package, accompanied by an unprecedented bank- lending spree, pushed up consumer and asset prices. Inflation accelerated to 6.5 percent in July 2011, a three-year high, forcing the central bank to tighten monetary policy through raising interest rates and increasing the amount of deposits banks must set aside as reserves to rein in credit growth.

Consumer-price gains slowed to 1.7 percent in October from a year earlier, a 33-month low.