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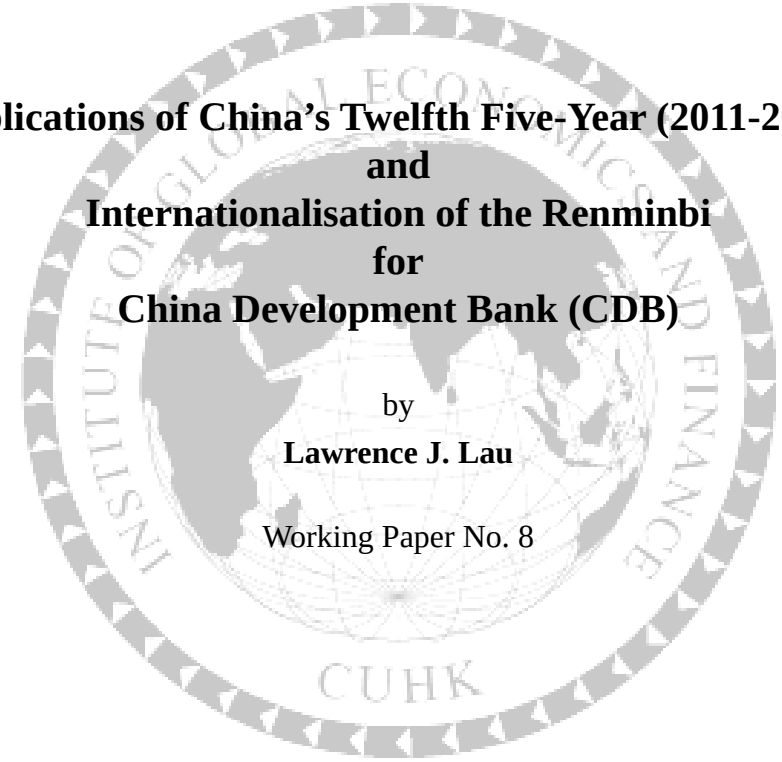

The Implications of China's Twelfth Five-Year (2011-2015) Plan and Internationalisation of the Renminbi for China Development Bank (CDB)

by

Lawrence J. Lau

Working Paper No. 8

December 2012

Institute of Global Economics and Finance
The Chinese University of Hong Kong
13/F, Cheng Yu Tung Building, 12 Chak Cheung Street, Shatin, Hong Kong

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1. Introduction

China Development Bank was founded as a policy bank in 1994 with the mission of financing projects that are too large, too risky, or too long-term for ordinary commercial banks to be able to finance. It is under the direct supervision of the State Council of the People's Republic of China and is owned directly or indirectly by the State and enjoys quasi-sovereign credit rating. China Development Bank has provided most of the funding for major infrastructural projects such as the Three Gorges Dam, major Chinese airports and seaports, high-speed railroads, bridges, highways, power plants, communication networks, urban mass transit systems, and basic and innovative industries. It has been a major supporter of urbanization in China, providing credit to major cities such as Beijing, Shanghai, Tianjin and Chongqing. By the end of 2010, CDB had almost US$800 billion in assets and US$715 billion in loans, more than double the amount at the World Bank. The bulk of the growth of CDB occurred under the leadership of Chairman CHEN Yuan. In 2010, Chairman CHEN

[1] This paper will be published in Andrew SHENG, ed., Finance, Development and Reform: A Tribute to Chen Yuan, forthcoming.

[2] The author is Chairman, CIC International (Hong Kong) Co., Limited, Ralph and Claire Landau Professor of Economics, The Chinese University of Hong Kong, and Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University. An earlier version of this paper was presented at the Twelfth Meeting of the International Advisory Council of China Development Bank, Beijing, 19th May 2011. The author is most grateful to Ms. Ayesha Macpherson Lau for her helpful comments and suggestions. All opinions expressed herein are the author's own and do not necessarily reflect the views of any of the organisations with which the author is affiliated, including China Development Bank. (Email: lawrence@lawrencejlau.hk; WebPages: www.igef.cuhk.edu.hk/ljl)

was able to keep the non-performing loan ratio to 0.68% (and it has since declined to less than 0.4%), a most enviable record for not just Chinese banks, but for all major banks worldwide.

China has now become the second largest economy in the World, and has embarked on its new Twelfth Five-Year (2011-2015) Plan, with a commitment to transform its mode of economic development. The Renminbi has begun to be used in Chinese cross-border transactions: in trade, investment, and loans. These developments can potentially open up great opportunities for China Development Bank. This article studies the implications of the Twelve Five-Year Plan and the internationalisation of Renminbi for China Development Bank.

2. The Twelfth Five-Year (2011-2015) Plan for National Economic and Social Development

The Eleventh Five-Year (2006-2010) Plan for National Economic and Social Development of China officially ended on 31st December 2010. Most of the Plan targets were achieved or exceeded, including the reduction in energy consumption per unit GDP of 20 percent compared to the beginning of the year 2006. The Eleventh Five-Year Plan provided for a target rate of growth of real GDP of 7.5 percent per annum between 2006 and 2010. The actual rate of growth achieved was 10.84 percent per annum. The only major target not achieved was the percentage of GDP expended on R&D—the target was 2 percent and the actual achieved was 1.8 percent.

The Twelfth Five-Year Plan for National Economic and Social Development of China was approved by the National People's Congress in mid-March of 2011. It is mostly an indicative plan rather than a mandatory plan. The most remarkable feature of the Twelfth Five-Year Plan is the lowering of the target real rate of growth from 7.5 percent per annum in the Eleventh Five-Year Plan to 7 percent per annum. It is almost certain that this target will be exceeded, just as the target of the Eleventh Five-Year Plan was exceeded (the actual rate achieved was 10.8 percent). However, the reduction in the target rate of growth signals the

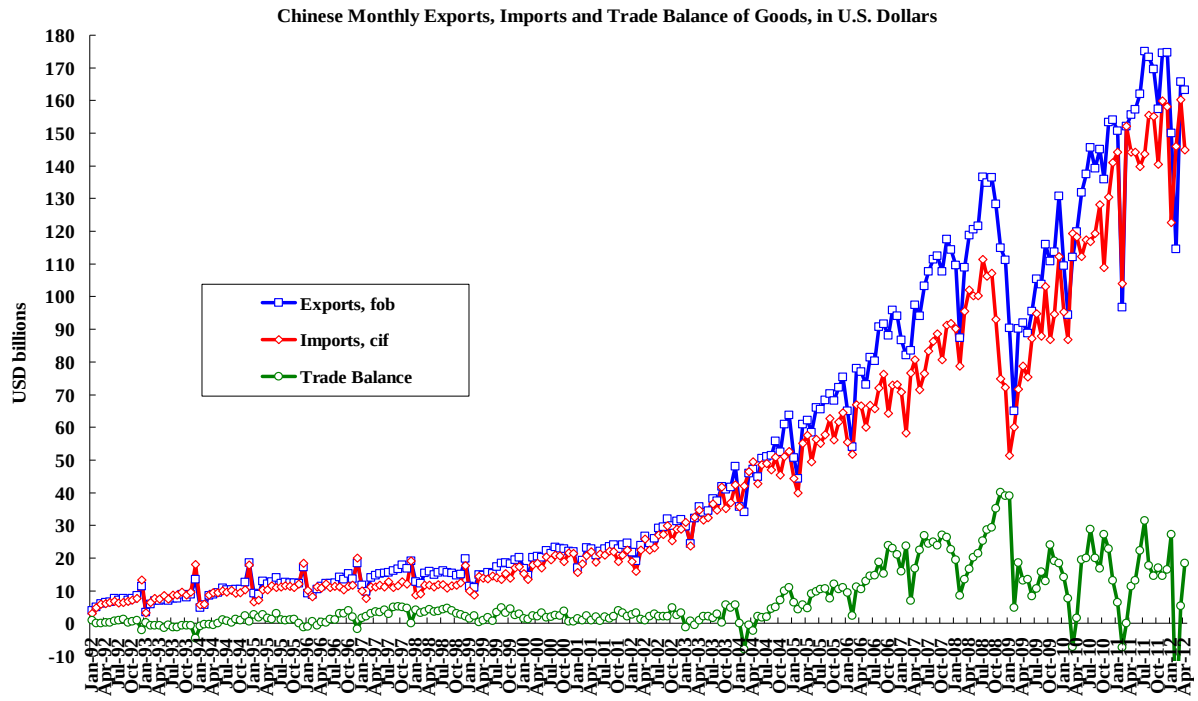
determination of the Chinese Government to de-emphasise quantitative economic growth and to focus on the quality of the economic growth in the Twelfth Five-Year Plan period.

A principal theme of the Twelfth Five-Year Plan is the transformation of the mode of Chinese economic development—first, from export-oriented to domestic demand-oriented and second, from input-driven to technical progress- or innovation-driven. The Plan also aims at essentially balanced international trade in goods and services by the end of the Plan period.

The Plan calls for accelerated urbanisation. The proportion of rural population in total population is expected to decline during the period of the Twelfth Five-Year Plan from 51 percent to 47 percent. Accelerated urbanisation can provide much of the needed increases in domestic aggregate demand. The Plan also provides for increased expenditures for education and healthcare, especially in the rural regions, environmental preservation, protection and restoration, and air and water pollution control. It has mandatory targets for improvement in energy efficiency (energy consumption per unit GDP to decrease by 16 percent) and reduction in carbon emission (to decrease by 17 percent) over the Plan period. The Plan also provides for reduction in real income disparity through taxation, transfer payments and targeted government expenditures on public goods such as education and health care, the improvement of the social safety net and the pension system. It also calls for more infrastructural investment in the Central and Western parts of the country, which, coupled with the accelerated urbanisation, should help to improve the inter-regional income distribution.

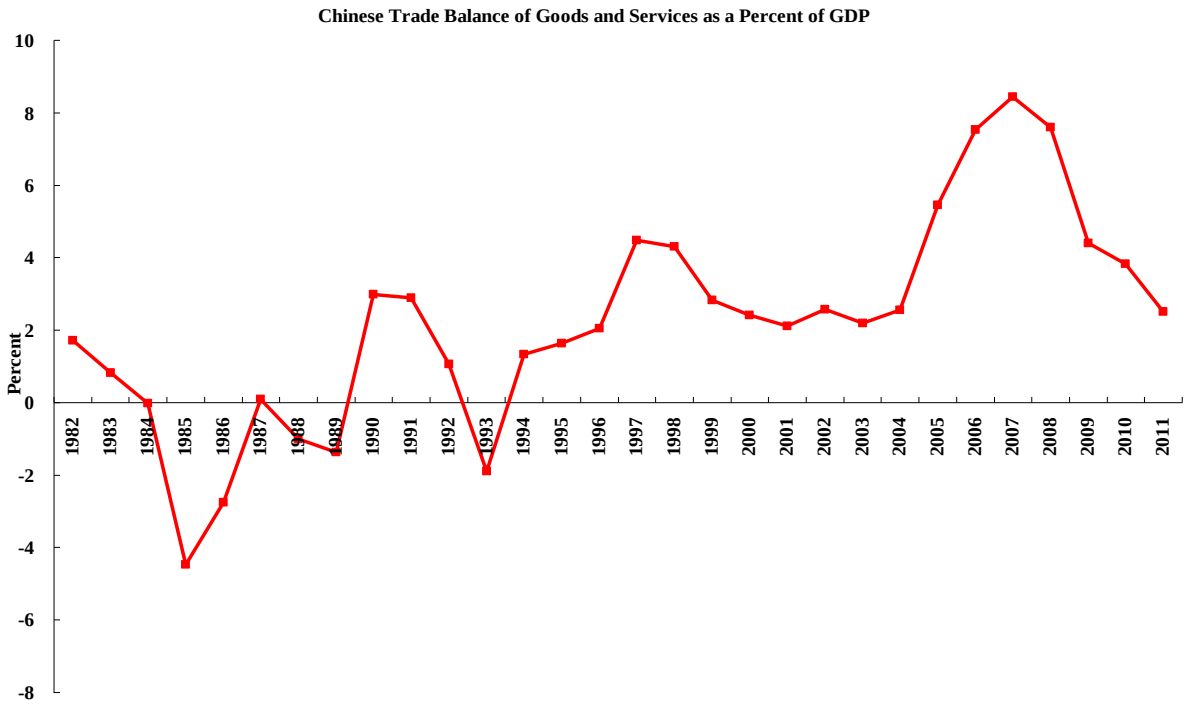
There is a common mis-impression that the Chinese economy is highly dependent on exports, and in particular, on its export surpluses, as a source of growth. The facts are that China only began to have a significant trade surplus vis-à-vis the World in 2005, whereas the Chinese economy has been growing at an average real rate of almost 10 percent per annum since 1978. It should therefore be clear that the trade surpluses could not have been an important source of growth for the Chinese economy during the past three decades. Chinese economic growth has not depended, does not depend and will not depend on Chinese trade surpluses.

Chart 1: Chinese Monthly Exports, Imports and Trade Balance, US$



Chinese trade surplus as a percent of Chinese GDP fluctuated between -4.5 percent and 4.5 percent between 1982 and 2004 with an average of less than 2 percent of GDP. It then rose to a peak of almost 9 percent in 2007. It has since declined significantly, to less than 3 percent in 2010 and approximately 2 percent in 2011. China should have no problem meeting a 4% trade surplus to GDP target as proposed by the United States. Chinese international trade in goods and services vis-à-vis the whole world is expected to be essentially balanced in a couple of years, without necessarily any large adjustments in the Yuan/US$ exchange rate. This is possible because of the gradual closing of the savings-investment gap in China as well as the substantial real appreciation of the Yuan versus the US$ that has occurred since mid-2005 of approximately 25 percent.

Chart 2: Chinese Trade Balance of Goods & Services as a percent of GDP, 1982-present

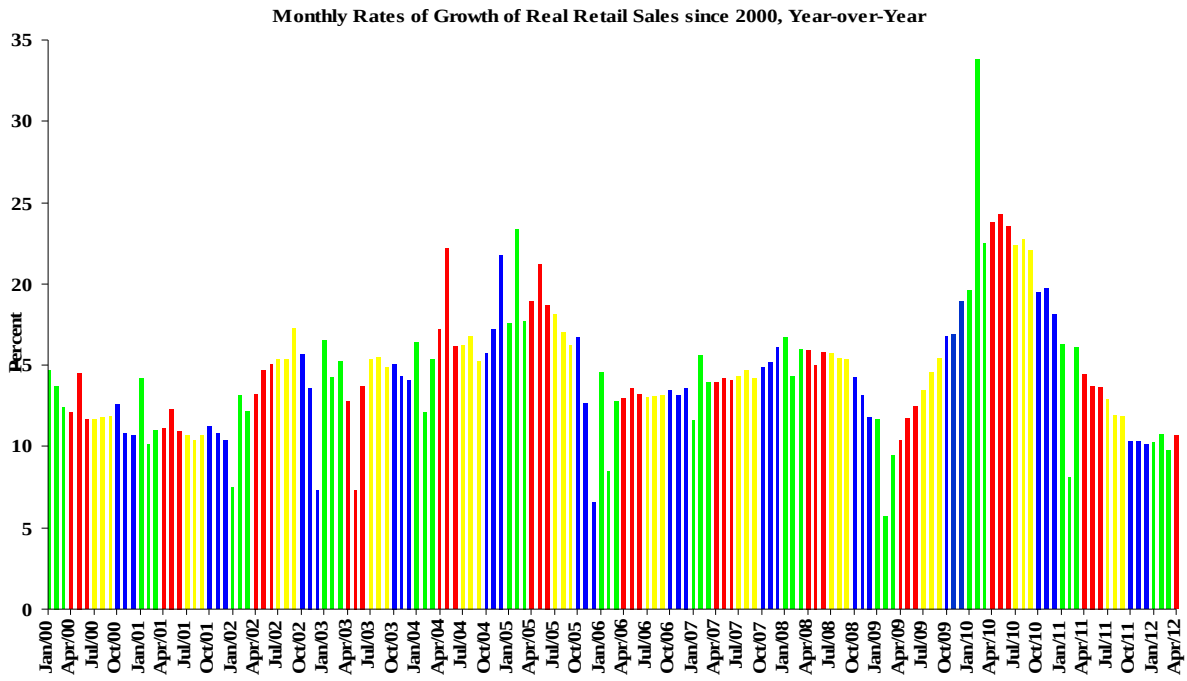


Chinese exports as a ratio of GDP rose steadily beginning in 1978 and reached a peak of almost 40 percent in 2006 and then began to decline to approximately 25 percent in 2009. While this ratio appears large, it is not when compared to the ratios of Hong Kong, Singapore, South Korea and Taiwan, where exports can be a multiple of the respective GDPs. And the Chinese Exports/GDP ratio actually exaggerates the importance of exports in the Chinese economy because it fails to take into account the low average domestic value-added content of Chinese exports.

Chart 3: Chinese Exports of Goods and Services as a percent of GDP, 1970-present

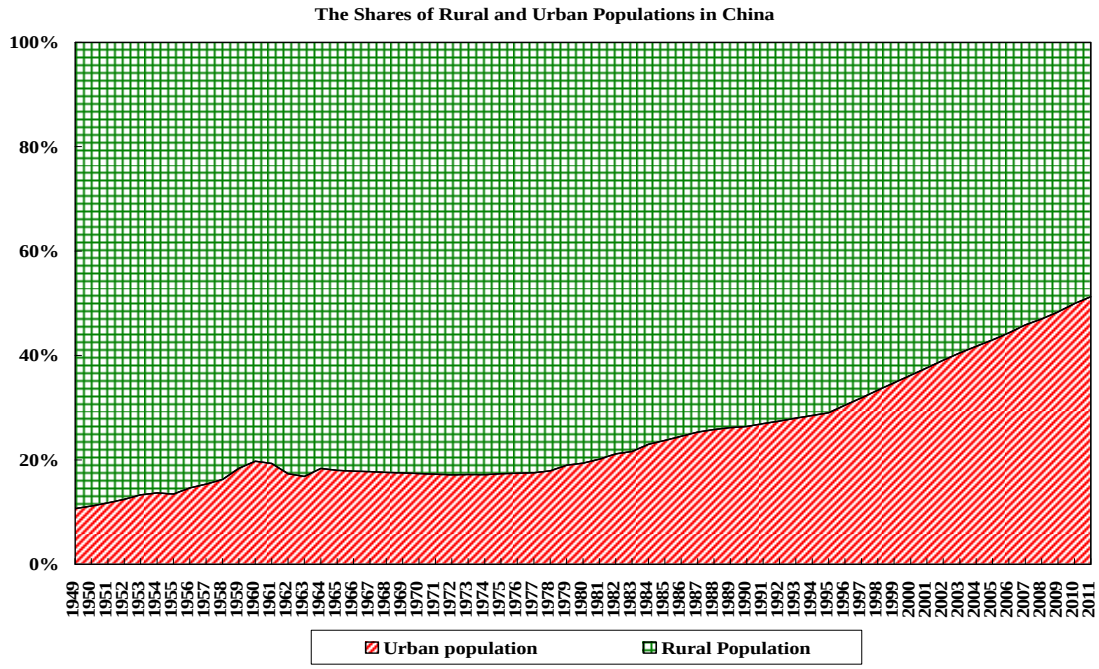
Chinese household consumption is sometimes viewed as a potential sustainable source of growth of Chinese domestic aggregate demand. It has actually been growing quite rapidly, as indicated by the double-digit monthly year-over-year rates of growth of real retail sales since the first quarter of 2009. The rates of growth of real retail sales have far exceeded the rates of growth of real GDP or real household income during the same period, reflecting in part the lagged adjustment process of household consumption to increases in household income. Thus, even as the rate of growth of real GDP falls, the rate of growth of real consumption can continue to rise, at least for a while. Of course, real rates of growth of consumption that are significantly higher than the rates of growth of real GDP may persist only if real household income continues to grow at a higher rate than real GDP. And this is possible only if the share of household income in GDP, currently less than 50 percent, can continue to increase.

Chart 4: Monthly Rates of Growth of Chinese Real Retail Sales, Year-over-Year



The share of rural population in China was just under 90 percent in 1949. By 1978, the share of rural population was 82 percent. By 2010, the share of rural population fell to 51 percent--still almost half of Chinese population lived in rural areas. It is expected to continue to fall during the period of the Twelfth Five-Year Plan to 47 percent. The rate of decline of the share of rural population has been approximately 1 percentage point per year, about the same rate of decline as the share of employment of the primary (agriculture) sector.

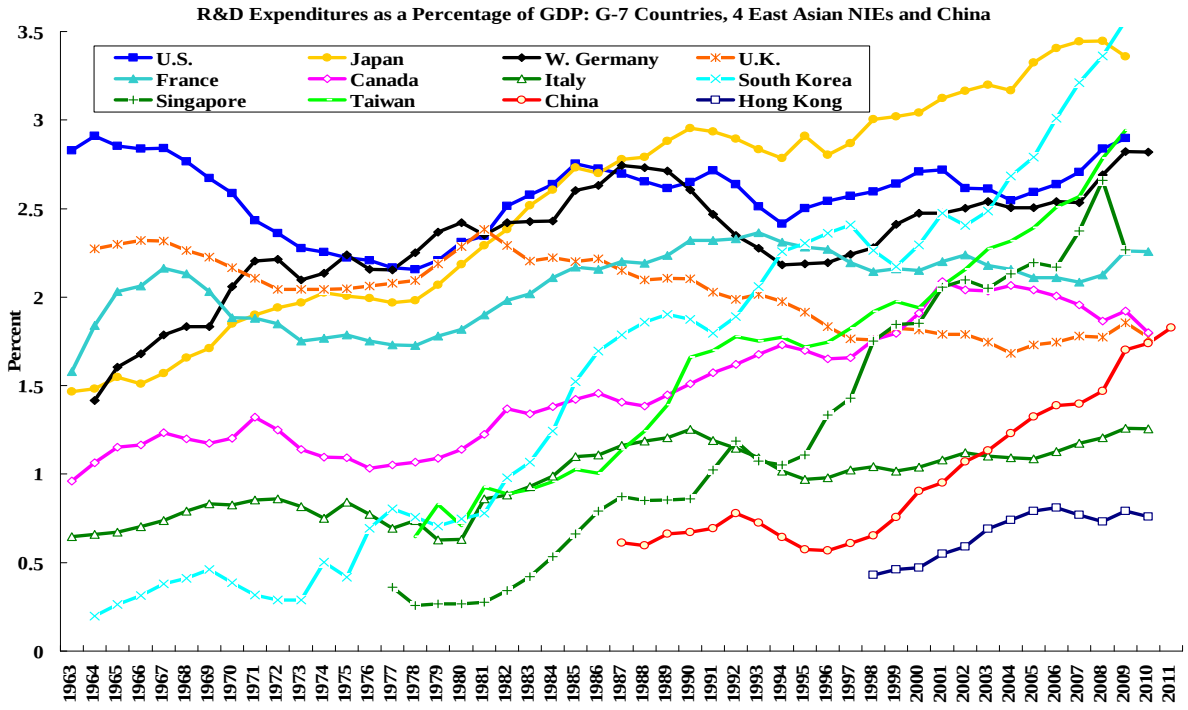
Chart 5: The Shares of Rural and Urban Population in China, 1949-Present



Sustained investment in R&D is essential for technical progress in an economy. China has also begun to invest heavily in R&D in recent years--R&D expenditure has been rising rapidly, both in absolute value, and as a percentage of GDP, but still lags behind the developed economies as well as the newly industrialised economies of East Asia. The Chinese R&D Expenditure/GDP ratio is targeted to reach 2.2 percent in 2015, still below the U. S., which has invested on average approximately 2.5 percent of its GDP in R&D since the late 1950s. By comparison, both Japan and South Korea invest more than 3 percent of their GDPs in R&D annually.

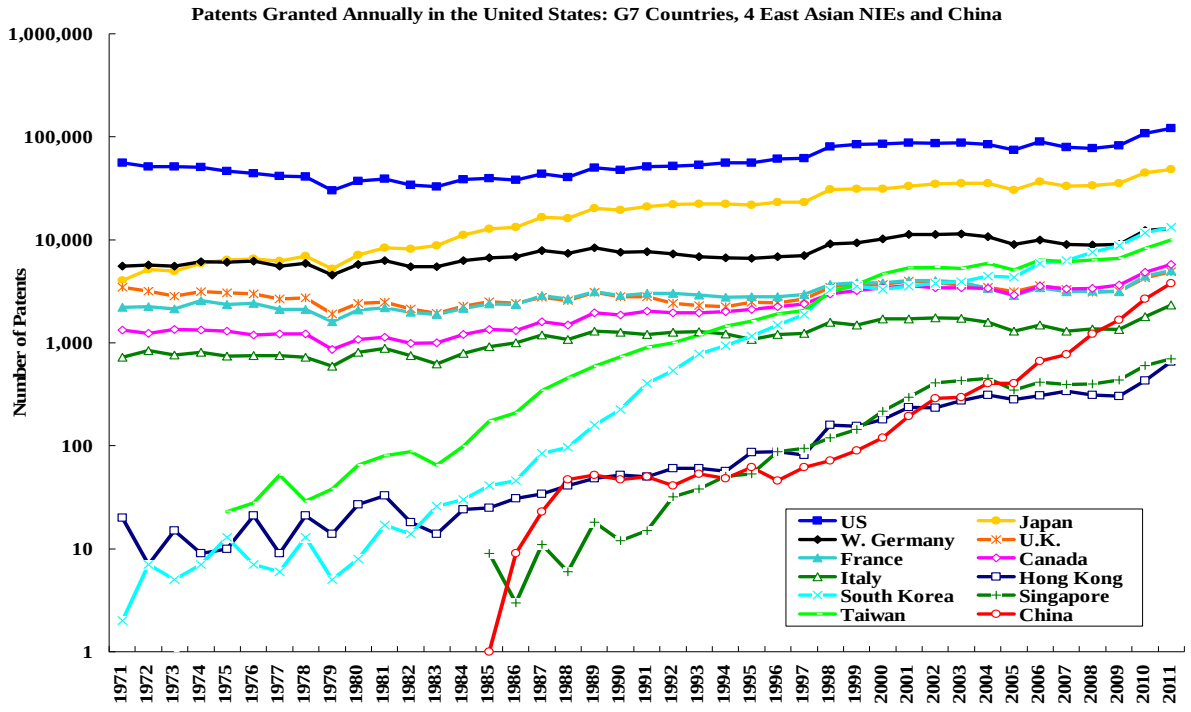
Chart 6: China's R&D Expenditure and Its Share of Chinese GDP

Chart 7: R&D Expenditures as a Ratio of GDP: G-7 Countries, 4 East Asian NIES & China



One indicator of the potential for technical progress (national innovative capacity) is the number of patents created each year. In the following chart, the number of patents granted in the United States each year to the nationals of different countries, including the U.S. itself, over time is presented. The U.S. is the undisputed champion over the past forty years, with more than 100,000 patents granted in 2010, followed by Japan, with approximately 45,000. Since these are patents granted in the U.S., the U.S. may have a home advantage; however, for all the other countries, the comparison across them should be fair.

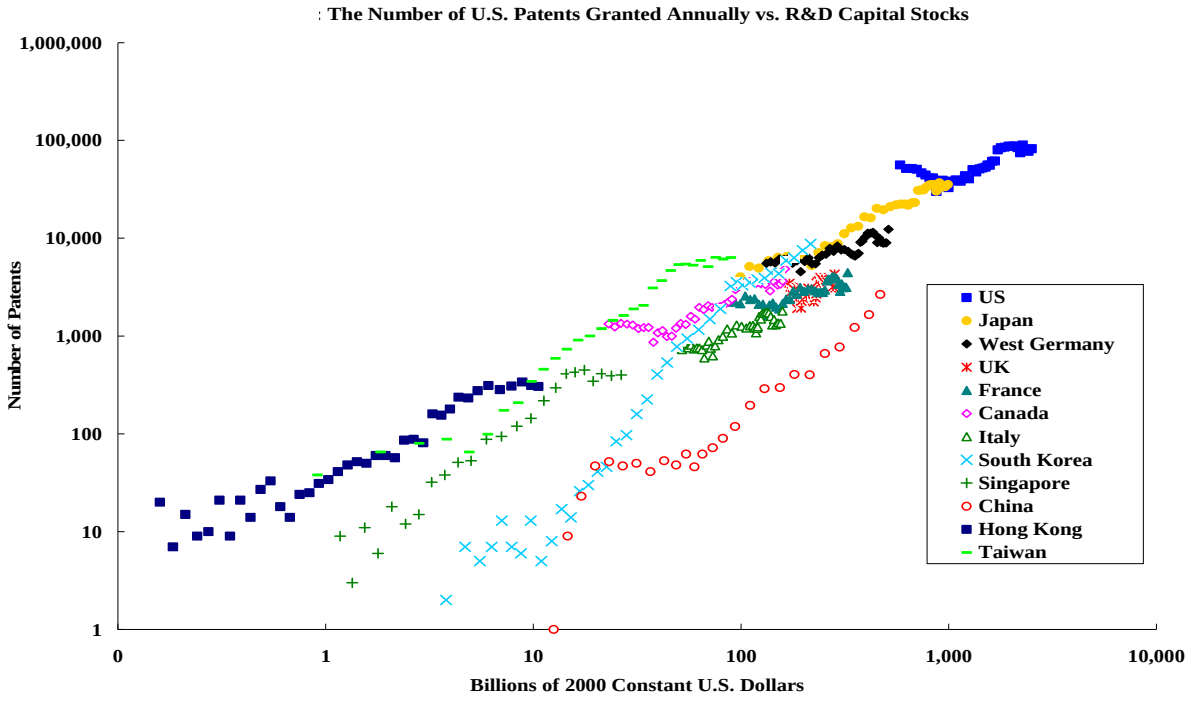
Chart 8: Patents Granted in the United States: G-7 Countries, 4 East Asian NIEs & China



The number of patents granted to Chinese applicants each year increased from 1 in 1985 to 2,657 patents in 2010. South Korea and Taiwan were still ahead of China in terms of the number of patents granted in the U.S., with 11,671 and 8,238 patents in 2010 respectively.

The stock of R&D capital, defined as the cumulative past real expenditure on R&D less depreciation of 10 percent per year, can be shown to have a direct causal relationship to the number of patents granted (see the following chart, in which the number of patents granted is plotted against the R&D capital stock for each country and each year).

Chart 9: Patents Granted in the United States and R&D Capital Stocks in Selected Economies



The huge domestic market of China greatly enhances the productivity of intangible capital (e.g., R&D capital, goodwill), whether indigenously developed or acquired abroad. The fixed research and development costs of a new product or process can be easily amortised over a large market. The benefits of investment in goodwill, e.g., brand-building, are also much greater in a large market. However, the key to the promotion of innovation is the protection of intellectual property rights, so that the Chinese entrepreneurs will have the incentive to commercialise indigenous innovations as well as patents and technologies acquired from abroad. The huge domestic market also enables active Chinese participation in the setting of product and technology standards, for example, fourth-generation (4-G) standards for telecommunication, and sharing the benefits of such standard-setting.

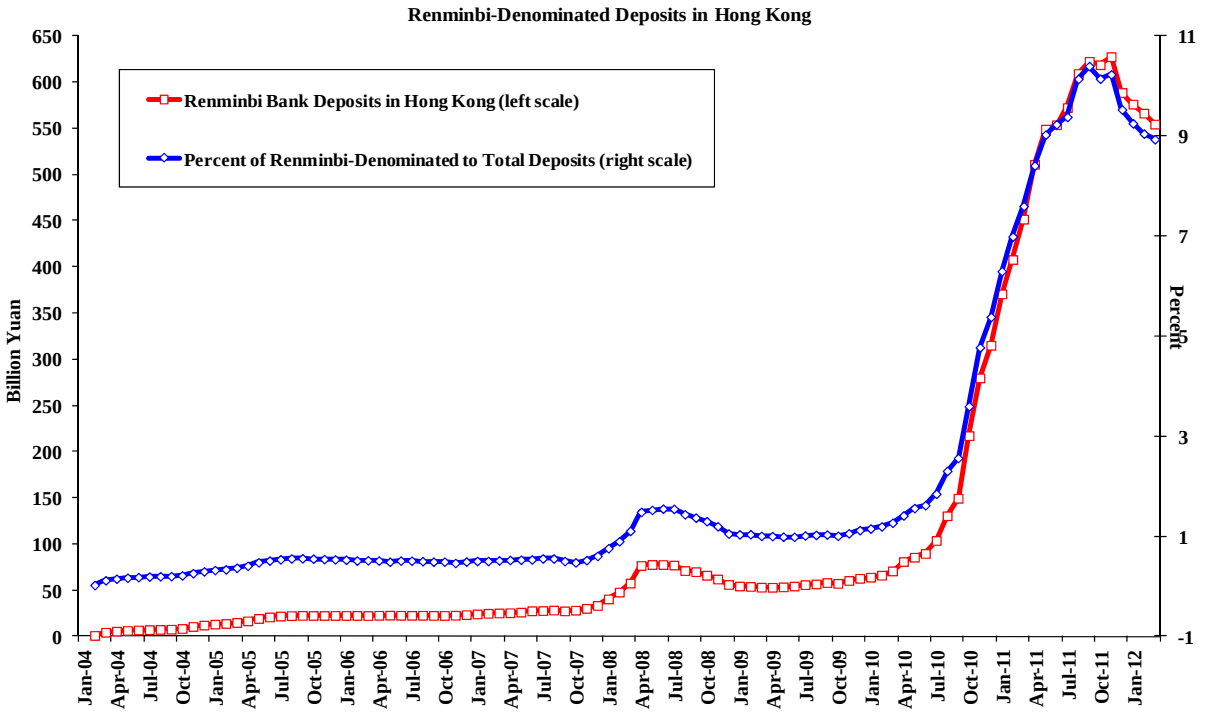
3. The Internationalisation of the Renminbi

The Renminbi has been current accounts convertible since 1994. However, it has not become fully capital accounts convertible. There still exist both inbound and outbound capital controls in China. Some categories of capital movements require prior government approval. But individual Chinese citizens can remit up to US$50,000 per person overseas each year, with few questions asked.

The willingness to accept and to hold a non-local currency depends on whether the currency is convertible, but it does not need to be fully convertible, in the sense of being both current accounts convertible and capital accounts convertible. A person (firm) may be quite willing to accept and to hold a non-local currency, fully convertible or not, if he (it) knows that the next person (firm) he (it) comes across is also likely to accept the currency.

Thus, for example, an exporter to China may be quite willing to accept Renminbi as payment as long as he knows that importers of Chinese goods and services in his country can use the Renminbi balances to pay for the imports. Even though the Renminbi is not de jure fully convertible, it has gradually become de facto convertible in many economies in East Asia because of its wide general acceptance. For example, the Renminbi is widely accepted and used in Hong Kong, Macau, Laos, Myanmar, and other border areas as a medium of exchange and a store of value even though it is not legal tender in these places. In Hong Kong, Renminbi bank deposits have risen rapidly from virtually nothing to almost 10 percent of total bank deposits in all currencies (see Chart 10). This demonstrates that it is possible for a non-local currency to gain wide general acceptance even without full convertibility.

Chart 10: Renminbi-Denominated Bank Deposits in Hong Kong



Almost all Chinese international trade, including both exports and imports of goods and services, has been denominated and settled in U.S. Dollars since China began its economic reform and opened to the rest of the World in 1978. Chinese exporters and importers in selected regions have been permitted to settle their trade in Renminbi since 2009 on a voluntary basis, by mutual agreement between the exporter and the importer in each case. The practice was extended to the whole nation in 2011. Approximately 30 percent of Chinese trade is conducted with East Asian economies. If the Renminbi is to be used as the settlement currency by Chinese exporters and importers with their trading partners in East Asia, the Chinese demand for U.S. Dollars for international transactions purposes would be greatly reduced, and the People's Bank of China, China's Central Bank, would no longer need to hold as much foreign exchange reserves as it does now. For comparison, approximately half of Japanese international trade is denominated and settled in Yen.

Chinese imports from East Asia except Japan amount to US$300 billion a year. If these imports alone can be settled in Renminbi, the requirement for foreign exchange reserves for transaction purposes can be reduced. Similarly, Chinese exports to East Asia except Japan amount to more than US$300 billion a year. To the extent that the importers in these East Asian economies can obtain Renminbi (for example, from their exporters), they may also be able and willing to pay for their imports from China in Renminbi. If this happens, the US$ assets held in the foreign exchange reserves of their central banks for transactions purposes can also be reduced.

The proportion of Chinese trade settled in Renminbi grew from 2.5 percent in 2010 to 7 percent as of the end of 2011Q1. This proportion is expected to increase further in the future. Thus far, trade settlement in Renminbi is predominantly for Chinese imports, accounting for approximately 90 percent. In order for Renminbi settlement to be more widely used by Chinese exporters, overseas importers must be able to have access to Renminbi themselves. This will take some time but as exporters to China in these economies are paid in Renminbi their Renminbi balances will in principle be available for the importers. The use of the Renminbi as a trade settlement currency may also be facilitated by an offshore forward market for Renminbi established by or under the authority of the People's Bank of China with participation restricted to bona fide exporters and importers to and from China.

Moreover, if other East Asian economies, such as Hong Kong, Indonesia, South Korea, Malaysia and Thailand also begin to use either their own currencies or the Renminbi as their settlement currency for trade amongst themselves, it would further reduce the demand for U.S. Dollars for international transactions purposes and hence the proportion of the foreign exchange reserves that the central banks of these economies hold in terms of U.S. Dollar-denominated assets.

In May 2011, the Ministers of Finance of China, Japan and South Korea, meeting on the sidelines of the Asian Development Bank annual meeting in Hanoi, issued a statement to the effect that they would study the use of their own currencies in trade settlement with one another. Trade settlement in the own currencies of the trading partner-countries is straightforward if the bilateral trade is basically balanced. A problem arises only when there are persistent bilateral surpluses or deficits. The central bank of the surplus country will wind

up holding the currency of the deficit country. What can be done to reassure the surplus country that it will not lose out by holding the currency of the deficit country for more than a short period?

A commitment by the central bank of a country through mutual agreements to redeem its currency held by other central banks in terms of other hard currencies (e.g., US$ or Euro), gold, or its inflation-indexed bonds will go a long way to reassure the central banks of surplus countries that they will not lose out in terms of purchasing power, which is ultimately what really matters. If trade settlement in own currencies turns out to be a widespread and durable arrangement, it may supplant the use of the U.S. Dollar as the principal international trade settlement currency eventually.

Even if the Renminbi is not fully convertible in the sense of a total absence of inbound as well as outbound capital controls, it may nevertheless be maintained as part of foreign exchange reserves by the central banks and monetary authorities of other countries and regions as long as there is a credible commitment through mutual agreements by the People's Bank of China to convert any Renminbi presented by a foreign central bank into U.S. Dollars or Euros or any other so-called "hard" currencies, or even gold at a pre-agreed parity. Foreign central banks can hold the Renminbi for potential transactions purposes with China or other economies willing to accept the Renminbi. The People's Bank of China already has bilateral currency swap agreements in place with the central banks or monetary authorities of Argentina, Belarus, Hong Kong, Indonesia, South Korea, Malaysia and Mongolia and more such agreements are expected to come.

Whether the Renminbi will become a major international reserve currency eventually remains to be seen. There are both pros and cons for a country's currency to be used by other countries as an international reserve currency. The Japanese Yen is fully convertible but the Japanese Government has not promoted its use by other countries as a major international reserve currency. At the present time, Hong Kong, Singapore and South Korea have all been considering investing part of their foreign exchange reserves in Yuan-denominated securities to diversify its portfolio, even though the Yuan (Renminbi) is not yet fully convertible.

4. Implications for China Development Bank

What implications does the Twelfth Five-Year Plan have for China Development Bank? Under the Twelfth Five-Year Plan, the Chinese economy is supposed to undergo a transformation of its mode of development from "Export-Oriented to Domestic Demand-Oriented" and from "Input-Driven to Innovation- or Technical Progress-Driven".

What are the possible sources of sustainable growth of domestic demand? They include, in addition to household consumption and public infrastructural investment (e.g., high-speed railroads, intra-urban mass transit systems, power plants, etc.): (1) Accelerated urbanisation; (2) Owner-occupied residential housing; (3) Investment in the conservation of energy, clean and renewable energy, and environmental protection and preservation; and (4) Education and health care and the application of high technology in these sectors.

Long-term financing of infrastructural projects is China Development Bank's forte, so there should be many opportunities under the Twelfth Five-Year Plan. Urbanisation will require infrastructure—roads, railroads, airports, power plants, water works, communication and optical fibre networks, mass-transit systems as well as residential housing. Reduction of energy consumption and carbon emission require new investment in power plants—gas-fired, hydroelectric power, nuclear power—clean coal, and other alternative forms of energy.

Under the Twelfth Five-Year Plan, 36 million new affordable residential housing units are to be built. China Development Bank can help make these units more widely affordable by establishing a home loan unit that issues long-term fixed-rate bonds to financial institutions and pension funds and other long-term investors, and with the proceeds purchases qualified long-term fixed-rate mortgage loans from originating lenders, who should be required to retain a residual interest, say, between 5 and 10 percent, in the mortgage loans originated by them (so as to discourage moral hazard).

In order to promote innovation, China Development Bank can finance the completion of a national optical-fibre network that links the entire country, with free or low-cost access to the internet everywhere. This will greatly accelerate the transmission of information and knowledge and equalise the opportunities between the more developed coastal areas and the

less developed interior and the Western regions. With access to the internet, a student in Qinghai, one of the poorest provinces in China, will have access to the same information as a student in Shanghai, the richest municipality; and small enterprises can compete with large enterprises on a more equal footing on the World Wide Web.

In addition, China Development Bank can through its investment unit invest in venture capital around the world. The basic idea is to try to finance the future Apple, Microsoft, Yahoo, Google, Facebook and Twitter at a very early, start-up stage. The probability of success of venture capital investment is low, approximately one in every ten ventures. But the payoff can be huge if one is able to invest in the right start-up early. Moreover, it is almost impossible for a Chinese enterprise to try to buy say 10% of Apple or Microsoft (too expensive, local political opposition) after it has become successful, but it would have been quite possible at the start-up stage. However, it is difficult to predict, a priori, which venture will be successful. China Development Bank should therefore invest widely and early—sow many seeds early and harvest a few large trees years later.

China Development Bank can also play a leading role in financing the development of commercial-scale pilot plants for new technologies, for example, the coal-to-oil conversion technology, the shale-gas fracking technology, the nuclear fusion technology, or new materials, for example, plastics that can be as strong as steel. Once proven, the unit cost of subsequent plants can be considerably lowered. These new technologies can provide credible substitutes to conventional forms of energy and materials and hence restraints on their price increases over time. The only effective long-term hedge for commodity-price-led inflation is the development of credible substitutes.

China Development Bank can provide long-term US$- or other foreign-currency-denominated loans to Chinese direct investors with good credit investing overseas with funds raised through the issuance of foreign-currency-denominated bonds by China Development Bank both within China and outside China. China Development Bank can also borrow US$ or other foreign currency directly from the State Administration of Foreign Exchange (SAFE) of the People's Bank of China (PBOC), at close to the rates offered by U.S. Treasury or other government bonds of similar maturities. By being able to borrow long-term in the currencies of the investee-countries, the outbound Chinese direct investors can also effectively hedge the

long-term exchange rate risk. China Development Bank is also uniquely suited to the provision of infrastructural loans. As Chinese enterprises go overseas to acquire natural resources, they will need to develop the infrastructure of the investee-countries so that the natural resources can be exploited and exported. This is where China Development Bank can also play a major role.

With the internationalisation of the Renminbi, meaning the increasing availability and use of the Renminbi outside China, China Development Bank can also take advantage of the opportunity to further internationalise its operations. China Development Bank can provide long-term financing for inbound foreign direct investment. For example, it can provide long-term Yuan-denominated loans to foreign direct investors with good credit (e.g., Intel and Microsoft) for their projects in China, thus allowing the foreign direct investors to essentially match their assets and liabilities in terms of currency and maturity. With such a loan, a foreign direct investor can effectively hedge the long-term exchange rate risk. However, in order to discourage moral hazard, the foreign direct investor (actually the ultimate parent thereof) should be required to provide a direct loan guarantee to China Development Bank of an amount equivalent to the loan in terms of US$ or another hard currency. If the project fails commercially and the outstanding loan cannot be fully offset by the remaining assets, the parent will have to make up the difference.

The increasingly widespread use of Renminbi for Chinese international trade settlement implies that a great deal of the Renminbi balances used by Chinese importers to pay their foreign suppliers will remain outside of China at least for a while until they begin to be used by foreign importers of Chinese goods and services to pay their Chinese suppliers. Chinese commercial banks operating abroad will play a major role in the intermediation of these Renminbi balances. However, recycling of such Renminbi balances back into China in the form of loans or bond proceeds on any significant scale is likely to create difficulties for the Chinese financial sector because of the large interest-rate differential between on-shore and off-shore Renminbi funds at the present time.

However, China Development Bank can engage in a form of “recycling” that does not affect the Chinese domestic financial sector. China Development Bank can issue Renminbi-denominated bonds, to be purchased in Renminbi, outside of China, for example, in Hong

Kong (but perhaps also elsewhere as Chinese international trade settlement in Renminbi grows). Currently, with China Development Bank's quasi-sovereign credit rating, it can probably borrow offshore at no more than 2% per annum, probably less, compared to 4% per annum or more within China. With the Renminbi proceeds, it can purchase U.S. Dollars or other foreign exchange from the People's Bank of China, to be used to support China Development Bank operations overseas. It can also use the proceeds to lend to overseas borrowers with a legitimate need for Renminbi, e.g., to pay for imports from China or to make direct investment in China. In so doing, China Development Bank actually helps to reduce the foreign exchange reserves held by the People's Bank of China as well as the cost of sterilisation operations that the People's Bank of China otherwise has to conduct in order to prevent the Yuan from appreciating too much or too fast.

Finally, China Development Bank, as a Chinese policy bank with a global reach, can also operate an offshore interbank market in forward Renminbi on behalf of the People's Bank of China as a public service. The commercial banks that participate in the interbank market can in turn sell forward Renminbi and US$ to bona fide exporters and importers of goods and services in the Chinese market (but not to pure currency speculators).

5. Concluding Remarks

China Development Bank should maintain its unique status as the leading policy bank of China and its unique ability to finance projects that ordinary commercial banks are either unwilling or unable to finance (either too large, or too risky, or too long a time horizon). In order to meet the demands for long-term, fixed-rate financing, banks cannot rely on the relatively volatile short-term and variable-rate bank deposits for funding. China Development Bank has the unique advantage that it is able to raise, through the capital markets, long-term fixed-rate funds at a lower cost than commercial banks, given its sovereign or quasi-sovereign credit rating. It should capitalise on this advantage.

It should therefore remain wholly state-owned and not be privatised either in whole or in part. By remaining wholly state-owned, it will continue to enjoy sovereign or quasi-sovereign credit rating and will not be subject to pressure from private shareholders to maximise profits, especially short-term profits. The disastrous experience of the partially privatised and publicly listed Fannie Mae and Freddie Mac in the United States should be a lesson. Policy banks should never be privatised. Once privatised, whether in whole or in part, pursuit of profit will become the most important consideration of the management to the exclusion of the policy goals; and it will either lose its sovereign or quasi-sovereign credit rating, so that its cost of funds will rise, or, if it is allowed to keep its quasi-sovereign rating, it will induce moral hazard on the part of the management, private shareholders and all the market participants, because of the perception that it will never be allowed to fail.

Acknowledgements

I would like to thank China Development Bank and Chairman CHEN Yuan for inviting me to participate in the Twelfth Meeting of the International Advisory Council of the China Development Bank. It is my great honour and pleasure to be invited to this Meeting once again. Chairman CHEN Yuan has really done wonders for China Development Bank and through the Bank for the Chinese economy. He is a leading pioneer in Chinese banking and has introduced many new concepts and practices. In more recent years he has also expanded the activities of the Bank beyond China itself, greatly elevating the profile, the reach and the influence of the Bank overseas. The first time I met Chairman CHEN Yuan was probably in the late 1980s, when he served as the Vice Governor of the People's Bank of China, the central bank of China. Among his many duties at the time was the management of the foreign exchange reserves of China. During his tenure at the People's Bank of China, Chinese foreign exchange reserves rose from US$3 billion in 1988 to almost US$140 billion in 1997. In 1998, Chairman CHEN was appointed Governor of China Development Bank, and has served continuously as its Chief Executive Officer since then (with his title changed from Governor to Chairman a couple of years ago).