Challenges to China's monetary policy

People's Bank of China

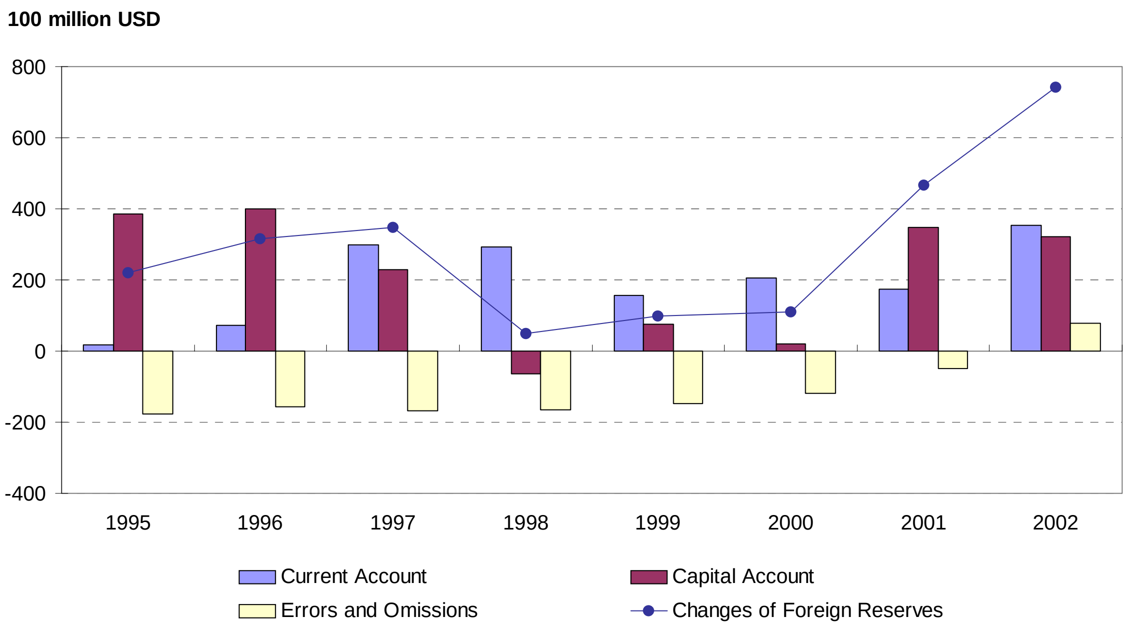
In recent years, China's economy has witnessed rapid, sustained and healthy growth, particularly after its accession to the WTO. Regardless of the considerable negative impact of SARS on several sectors and regions, GDP grew 9.1% in 2003, while CPI rose by 1.2%. Nonetheless, with financial and economic globalisation and domestic reform well under way, China's monetary policy now faces severe challenges.

1. Strong growth of foreign reserves makes neutralisation more difficult

China enjoys a balance of payments surplus, due to its robust growth and improving external conditions, which has resulted in rapidly increasing foreign reserves (Graph 1). The surplus is largely on the capital and financial accounts, with current account surpluses kept small and declining. From 1994-2003, the annual current account surplus averaged USD 19.9 billion, while the annual capital and financial account surplus reached USD 22.2 billion. In the first half of 2003, the current account surplus actually declined year on year, while the capital account surplus grew significantly. FDI proved to be the major source of capital inflows, with the FDI surplus totalling USD 26.9 billion in the first half (total capital account surplus amounted to USD 44.4 billion). As a result, foreign reserves reached USD 346.5 billion by the end of June 2003.

Graph 1

Changes in China's BOP and foreign reserves



The People's Bank of China (PBC) has clarified that its policy is not aimed at trade surplus, but at a relatively balanced current account. In order to maintain a sound balance of payments position, the People's Bank of China has made efforts to relax constraints on foreign exchange purchases by both enterprises and individuals, including:

- Considering the adoption of a Qualified Domestic Institutional Investors (QDII) system, following the adoption of the Qualified Foreign Institutional Investors (QFII) system.

- Relaxing the constraints on enterprises' foreign exchange holdings.
- Simplifying verification procedures for both imports and exports.
- Modifying regulations on multinationals' non-trade foreign exchange sales and purchases, so as to facilitate their operation in China.
- Raising the limit for individuals' foreign exchange purchases and relaxing the restriction on foreign currency taken abroad.
- Launching a pilot project on the reform of overseas investment regulation, gradually expanding channels for capital outflow.

Since 2003, mounting pressure on China from abroad to appreciate its currency has triggered overreaction in financial markets, leading them to expect a renminbi appreciation. To maintain the economic stability of China and of Asia as a whole, China has taken steps to alleviate the appreciation pressures and maintain economic equilibrium both domestically and externally. First, it adheres to its commitment of keeping a stable renminbi. Second, efforts are being made to achieve a sound balance of payments position. Third, open market operations (OMOs) to sterilise the monetary impact of reserves have intensified since 2003. In particular, gross issuance of central bank bills by the PBC amounted to RMB 455 billion in the first eight months of 2003. In addition to OMOs, the PBC raised the reserve requirement by 1 percentage point, so as to moderate pressures on the monetary base and the monetary supply posed by the increasing renminbi position resulting from foreign exchange purchases. Fourth, the PBC has been keeping a closer watch on exchange rate movements of the renminbi and international currencies.

Due to moderate global political conditions and reduced uncertainties, the world economy has gained momentum and external conditions for China are expected to improve further. In this setting, imports and exports will still be substantial and capital inflow will still see a rapid increase. Nonetheless, further US dollar weakness may lead to additional appreciation pressure on the reminbi. The reminbi interest rate is higher than the US dollar interest rate following successive interest rate cuts in the United States, which creates arbitrage opportunities between the reminbi and the US dollar. Consequently, sales of foreign exchange could increase significantly and sterilisation could become even more difficult and costly.

2. A partially overheated economy fuels underlying inflation pressure

The partial overheating can be seen in three aspects:

- There has been a substantial increase in fixed asset investment in several sectors and regions.

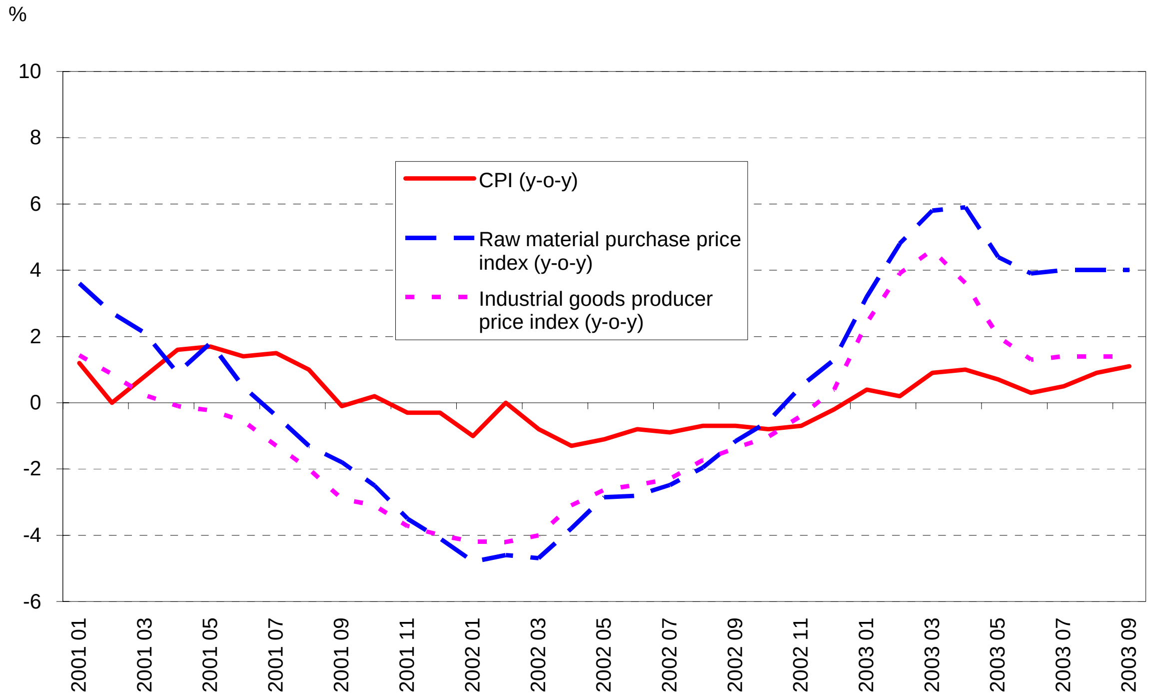
  Total fixed asset investment increased by 30.5% in the first three quarters of 2003, of which investment in the real estate sector increased by 33%. In the first eight months of 2003, real estate investment increased by over 50% (in some cases nearly 90%) in eight provinces out of the total 31 provinces and municipalities. Additionally, the investment structure in the real estate sector is not reasonable, with investment in residential space rising only by 28% and that in office building and commercial space rising by 39.8% and 44.6% respectively.
- Some industrial sectors experienced rapid growth and overlapped construction emerged again, which could lead to excess supply in these sectors in the future. In the first eight months, investment in steel, cement, aluminium, automobiles and textiles increased (year on year) by 140%, 130%, 150%, 84% and 140% respectively.
- Rapid investment growth has mainly been financed by the high increase in bank credit. Bank credit has funded 25% of fixed asset investment, which increased by 52%. The especially rapid growth in some sectors may thus imply significant financial risks. By the end of September, total outstanding loans, including RMB and foreign currency loans, had increased by 23.7%. New lending (net) reached RMB 2.7 trillion, 1.3 trillion higher than in the same period last year. RMB new lending (net) increased by RMB 2.5 trillion, 1.1 trillion higher than in the same period last year, or RMB 620.3 billion higher than all of 2002.

In response to overheating, the PBC mainly resorted to economic management efforts to contain the particularly large increase in the credit and monetary supply. This included open market operations to drain liquidity, higher reserve requirements, window guidance and structural adjustments (for instance, intensified regulation of lending to the real estate sector and a clampdown on illicit real estate loans). In general, policy measures taken have started to take effect. However, to completely eliminate the source of overheating requires further reforms on investment and financial institutions and greater efforts to boost capital markets to reduce the proportion of indirect financing.

Associated with the partial overheating of fixed asset investment, producer prices and real estate prices rose continuously, with only a moderate rise in CPI. Therefore, China's monetary policymakers have to be alert to either inflation or deflation, which highlights the importance of a correct assessment of the economic outlook. In the first nine months of 2003, CPI rose by only 0.7% year on year, which indicates that the large increase in credit and monetary supply since the last quarter of 2002 has not been fully reflected in CPI. However, the underlying inflation pressures are still worth monitoring closely. Once inflation pressures are transmitted to asset prices, including prices of real estate, stocks or other investment instruments, a bubble could take shape, which is even more damaging. On the other hand, the moderate positive increase in CPI mainly came from price rises for food and some services, whereas the movements in food prices mainly reflected seasonal factors and some external shocks, including SARS or natural disasters. According to the estimate of the National Bureau of Statistics, food prices rose by 2.2% in the first three quarters, which contributed 0.7 percentage points to the increase in the overall price level. In other words, if food and energy are excluded from the CPI basket, the core inflation could be negative, representing a still oversupplied market.

Graph 2

Changes in price indices in China



3. The rising money market interest rate highlights the importance of coordination between monetary and fiscal policy

After late August 2003, the interest rate in the money market rose rather quickly, due to the increase in reserve requirements and new stock issues. From 23 August to 30 September, the interbank lending rate gained 45 basis points and the repo rate 97 basis points. The rapid rise in the money market interest rate led to a substantial increase in the cost of bond financing and therefore a sharp decline in treasury bond prices. To maintain the stability of the money market interest rate, the PBC employed various monetary policy instruments, including combined open market operations of various types and maturities. The aim was to meet the need for liquidity of the financial system and ensure steady growth of the monetary base. Given that treasury bonds in China are mainly in medium and long maturities, instruments for open market operations are rather limited. As bond financing becomes more costly and the contribution of debt service payments to the fiscal deficit increases significantly, the Ministry of Finance is planning to adjust the maturity structure of treasury bonds, introducing more short-term treasury bonds.

Faced with a complex economic and financial situation both at home and abroad, and severe challenges to monetary policy, the PBC will continue to be forward-looking, active and flexible in its monetary policy management. At the same time, it will keep on improving indirect management and enhancing coordination among various macroeconomic polices. Only in this way can the reminbi’s value be secured and monetary policy’s ultimate target of boosting economic growth be achieved.