Zhou Xiaochuan: The current financial situation and development of the financial market in China

Speech by Mr Zhou Xiaochuan, Governor of the People's Bank of China, at the National Conference for the Work of Foreign-funded Banks, Beijing, 12 April 2004.

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I. The current macro financial performance is broadly stable, but some problems remain.

This year, China's national economy continued to grow rapidly. Consumer demand rose stably, urban and rural incomes increased steadily, foreign trade soared, and treasury revenue surged. The current financial performance is broadly stable. It is noteworthy, however, that there still exist in the economic performance such problems as faster than desired investment expansion and money and credit growth as well as heightened pressure of inflation.

According to preliminary statistics, at the end of March 2004, broad money M2 increased to RMB23.18 trillion yuan by 19.2 percent over the same period of 2003. Loans in renminbi and foreign currencies by all financial institutions increased to RMB17.90 trillion yuan by 20.66 percent over the same period of 2003. New loans registered RMB912.2 billion yuan in the first quarter. In particular, loans in renminbi increased by RMB834.2 billion yuan, representing an acceleration of RMB23.8 billion yuan over the same period of 2003. To prevent inflation and assets price bubbles and the emergence of bad loans in banks resulted from faster than desired growth of money and credit, and to forestall financial risk as well, the People's Bank of China (PBC) took and will take some policy measures, including the hike of another 0.5 percentage point in the required reserve ratio from April 25 on, the arrangement of differentiated required reserve ratios and floating central bank lending rates. Besides, the PBC raised the central bank lending rates and rediscount rates.

From the macroeconomic perspective, the major issues in the current macroeconomic situation are reflected in the following four aspects. First, money supply grew faster than desired with actual M1 and M2 higher than predicted and so did credit with its growth rate 10 percentage points higher than that forecasted in the beginning of 2004. Hike of required reserve ratio will help control money injection and loan growth, ensuring the stable performance of the financial market. Second, the direct financing accounts for too low a ratio to the total financing in China and the indirect financing too high a ratio. Although it is quite common that in developing economies the securities market is not developed yet and direct financing is difficult for enterprises to access, such a high ratio of indirect financing in China exerts some difficulties for the asset-liability management and risk control for the whole economy. Third, the ratio of M2 to GDP is too high. In 2003, that ratio in China was close to 200 percent. So high a ratio does not exist across the globe except for extremely exceptional cases. While the Chinese economy has its particularity, excessively high ratio of M2 indicates that financing relies too heavily on the banking system in the course of the economic development and thus the risk concentration is higher than desired. Fourth, the total savings rate is still on the high side. In 2003, the rate edged higher to 47 percent. Economic growth is mainly driven by investment, with contribution of consumer demand yet to increase. All the above issues are yet to be studied and discussed. Their resolution will all hinge on the development of the financial markets.

II. Significant headways have been achieved in the development of the Chinese financial market since China adopted the reform and opening-up policy.

First, the financial market system has taken its initial shape. At present, China has basically established the securities futures market, the money market and the inter-bank foreign exchange market. Second, the financial market has cultivated diversified participants. It not only has accommodated commercial banks, the social security fund, trust companies, insurance companies and securities companies but also has introduced, since 2003, qualified foreign institutional investors (QFII), which has played an important role in the development of the Chinese financial market. Third, products in the market have gradually been diversified. While there are financial debts, treasury bonds, central bank bills, corporate equity and other products with features of debts, new securities and banking products have been continuously innovated. Such innovative banking products as ABS, MBS and CDO and securities products as open-ended funds have attracted strong demands in the markets. Fourth, innovations keep crossing boundaries of the markets themselves, e.g. money market funds and securitization of credit assets by banks.

Compared with developed economies, however, the Chinese financial market is still lacking in product varieties and is not sophisticated enough. Financial deepening is still inadequate and there still exists the depression of innovation in quite a few aspects.

III. With the steady development of the economy and the deepening of the opening up, the Chinese financial market calls for further development and relevant departments shall thus adapt to the situation and transform their conception. Meanwhile, financial products will inevitably change accordingly.

First, with the transitional period coming to an end for China's accession to the WTO, the national treatment in place and the gradual easing of market entry, financial institutions shall face even bigger international competition. The commitments China made when joining the WTO and the requirements of the Chinese economy itself call for the accelerated development of the financial market. Secondly, with the gradual opening of the market and the progress of the economic globalization, the ratio of foreign trade to GDP in China has reached 60% in 2003. More and more enterprises are involved in international businesses. Objectively, the Chinese financial institutions are required to provide corporate customers with a series of financial services such as arbitrage, risk control and FX cash management. The expansion of market demand opens windows of opportunity for the development of the financial market and financial products. Third, with the deepening of the opening up, China will improve the formation mechanism of renminbi exchange rate, phase out inappropriate measures of foreign exchange control and realize in the end the Renminbi convertibility under the capital account. All the above calls for further development of the financial market and further diversification of financial products. The development and the diversification have been defined as developing the financial market system in an all-direction and multi-level manner.

IV. As a developing country and a transitional economy, China shall, despite setbacks in the past, attach great importance to innovation of financial products without refraining from it simply for fear of running risks. In the process, efforts shall be made to deal well with the interaction between accumulation of experience and improvement of regulations and to standardize innovation of financial products by means of the positive and negative lists.

In the preliminary period of the opening of the Chinese economy in the 1980s and mid-1990s, there were turns and twists for the innovation of financial products and in turn the annulment of some products and closure of problematic financial institutions due to lack of talents, outmoded technology, deficient management and supervisory inadequacies. The innovation of financial products like those in other sectors, have to undergo the process of learning, personnel training, growth of institutions, maturing of the market and progress of supervision. Risks would rise if some conditions are not ripe. Besides, the closure of the problem financial institutions has also exposed some weaknesses in the Chinese legal system, for example, there are still considerable problems in terms of closure as a result of bankruptcy.

Of course, different decision-making departments and different experts and scholars will have different opinions in terms of development and supervision of innovation of financial products. In particular, one idea is that as there were turns and twists historically, there shall be, first and foremost, the regulations to draw international experience for the purpose of developing new financial products. The case holds to some extent. In practice, however, it invites some problems. First, the experience and lessons in the international context differ from country to country, and different countries differ considerably from each other as well. For instance, the British and US models differ immensely from the Continental model in Europe and from the Korean and Japanese models, which needs further analysis, judgment and selection.

Furthermore, development of rules without practical experience usually costs quite a long period of time and even could never be finished. As such, the rules lack practicability and comprehensiveness. In terms of methodology, the belief that everything will not be practiced until the rules are established, is against the objective law that human being enhances perceptual knowledge through practice. The practical way at present, might as well be, to draw experience from the current implementation of the sectoral policies and to deal with the issue by setting positive and negative lists. Where products are relatively mature in the international context and where financial institutions, with strong risk management, carry out product innovation, the negative list will be adopted, i.e. “all those business items that laws do not clearly prohibit are allowed to develop.” Where the financial products are not very mature and are prone to produce systemic risks, a positive list will be adopted to regulate the operation.

In the course of innovation of financial products, efforts shall be made to properly define the positioning of financial products. Attention shall be paid to differentiate products designed for institutional investors from those for individuals. As institutional investors usually have advantages of its own and thus have relatively strong capability of analysis, judgment and resilience against risks, requirements for permits of products designed for institutional investors shall not be so tight and prudential as those designed for individuals. So is with the information disclosure and supervision. In particular, financial innovations for select customers shall be differentiated from those for common customers. Besides, the financial innovations like derivatives, which are sophisticated in terms of pricing and risk control and designed for complex financial institutions, shall be differentiated from others as well from the perspective of supervision.

Development of innovative financial products will enable the transformation of the structure of assets and liabilities in financial institutions. Take banking innovations for example. At present, from the perspective of assets, there have been such new financial products as consumer credit, assets securitization, securitization for non-performing loan (NPL) package and turnovers of credit risks. From the perspective of liabilities, there have emerged substitutions for savings products, e.g. funds products, securities investment and insurance products etc. Besides, fee-based business is now in the ascendant. In the international context, banks are no longer simply regarded as institutions that deal in savings and loans, rather as commercial and service entities with enormous branch network and as sales and service network capable of coping with various products. Meanwhile, financial services are regarded as information processing by connecting electronic networks.

V. The continuous change of market demand and appearance of trans-sectoral products increasingly call for functional supervision, in order to adapt to the changing situation and to strengthen coordination.

After the establishment of China Securities Regulatory Commission (CSRC), China Banking Regulatory Commission (CBRC) and China Insurance Regulatory Commission (CIRC), the framework of functional supervision has basically taken shape, playing important role for the stable development of the financial industry and effective prevention of financial risks. Meanwhile, it is observed that the continuous change of market demand objectively calls for the rational and effective allocation of financial resources among different markets. Therefore, demand unfolds gradually for trans-sectoral products. For example, corporate customers have cultivated demands for investment and cash management, arbitrage and insurance besides loans while individuals have further developed demands for consumer credit, housing loans and even investment and cash management and annuities besides deposits. The appearance and development of trans-sectoral business items produce new opportunities of changing irrational proportions of direct and indirect financing.

Trans-sectoral products objectively call for more comprehensive functionalities of financial institutions. From the perspective of the current practical situation in China, supervisory organizations take on de facto acquiescence toward the advent and development of financial holding companies. It is recognized that the extensive branch network and long-term special information of customers in the financial institutions provide opportunities for development of trans-sectoral business. It is observed, therefore, that the development of market demand and requirement of resource sharing have exerted impact on the old, divided supervisory conception that financial institutions be supervised by the issuers of “Certificates of Birth” (permits for operation). In fact, it is not necessary at all to set up hurdles between functional supervision, market entry and development of financial products. With economic development, whichever department is responsible for approval of establishment of institutions, business innovation shall not be impeded. There shall, not necessarily, be contradictions between functional supervision and business development. Supervisory departments are adapting to the changing situation, transforming conception and strengthening coordination. Besides, to maintain the stable and balanced development of the macro economy, the Reports of the Third Plenary Session of the 16th Congress of the CPC have stated clearly that the PBC, the Ministry of Finance and the three supervisory commissions shall further strengthen coordination. The tendency has been reflected in relevant legislations.

VI. The inherent advantages of foreign-funded banks have provided great potential for their development in China, and their development shall correspond with the demands of the macro financial situation.

Since reform and opening, more and more foreign-funded banks have entered the Chinese market, playing significant roles in improvement of the Chinese financial system and development of the financial market. In the course of economic transition, foreign-funded financial institutions have exhibited some advantages in corporate governance, risk control, risk management, credit culture, decision-making procedure, incentive structure and assets management, producing great potential for their development, and particularly for promoting development of the financial market and financial product innovation.

Development of foreign-funded banks shall take into consideration the needs of the Chinese macro financial situation as well. In the course of economic transition, different industries and regions will have different stages and potential of development. Foreign-funded banks might as well attach greater attention to development of some relatively weak financial markets, weak financial products or weak links and to the transformation of the economic structure, by supporting the development of Northeastern Old Industrial Bases and Western Region of China. They shall compete with the Chinese counterparts on one hand and complement them on the other. It is hoped that foreign-funded financial institutions in China will do more to meet the needs of the Chinese macro financial situation. They shall not only share the profits out of the rapid and stable growth of the Chinese economy during the booming period but also weather possible busts and even crises for long-term operation and benefits. The above is also a topic for discussion and deliberation during the meetings of the Bank for International Settlements in February, 2004.