

Wu Xiaolin: China's monetary and interest rate policy in year 2004

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The 3rd Plenum of the 16th CPC National Congress calls for deepening financial reform through pushing forward financial institutions reform and improving financial supervisory and regulatory regime. Commercial bank reform, one important component of financial reform, is inseparable from the improvement of financial regulatory regime, which will not only lay the foundation for commercial bank reform, but also intensify the requirements for the operation and management of commercial banks. Given current economic and financial situation, central bank's monetary policy stance in year 2004 is to rein in excessive money and credit growth, avoid excessive volatility of interest rates and accelerate interest rate liberalization. Next, I would like to focus on China's Monetary and Interest Rate Policy in Year 2004.

I. Monetary policy targets in 2004

We expect to keep the M2 and M1 growth rates at around 17%, new RMB lending around RMB 2.6 trillion yuan, and CPI around 3%. The ultimate objective of our monetary policy is to maintain balanced economic growth. Large population and comparatively insufficient resources in China pose constraints on economic growth. Therefore, the economy should be developed in a pragmatic, coordinated and balanced way. According to the 7% growth rate target for 2004 set by the Central Committee, and considering that money supply growth and new lending in 2004 should be lower than those in previous year due to the time lag of excessive credit growth in 2003, we decided on the aforementioned monetary policy targets. With appropriate macroeconomic adjustment and regulation, the CPI in year 2004 is expected to be kept at around 3%. To be more specific, hangover effect may contribute 2.2 pp to CPI, new inflation factors and price adjustment policies contribute 1 pp. Combined with other non-quantifiable upward price pressure, the CPI growth rate could maintain at around 3% if macroeconomic adjustment measures gradually take effect.

Given that China's economy, in recent years, has been in the process of transition and integration into the world economy, the correlations among economic variables kept changing; hence the selection of intermediate monetary policy targets provoked debate in academia. Before any clear conclusion is reached, we have to make the intermediate targets a synthetic target, focusing on M2 and credit scale while considering money market rates.

II. Apply various monetary policy instruments in a flexible manner to reach monetary policy targets

China's economy, currently right in the transition period, is not comparable to command or developed market economy. The complexity of macroeconomic development poses challenges to monetary policy. In this connection, only if we utilize various monetary policy instruments in a flexible manner, can we reach the monetary policy targets. At present, the major monetary policy instruments include: open market operation, reserve requirement, interest rate policy, re-lending and rediscount, and credit policy.

i. Sterilize excessive forex position through open market operation while maintaining sufficient liquidity in the market

Over the past two years, China's foreign exchange reserve has grown fast, leading to substantial increase in base money injection as a result of Forex purchase. In line with the overall money and credit plan, the People's Bank of China (PBC) has maintained the stable growth of base money through open market operation. Since 22nd April 2004, the central bank has intensified currency withdraw from circulation through issuing central bank bills. By the end of 2003, the central bank has made 63 issues of central bank bills, with a total issuance amount of RMB 722.68 billion yuan, and outstanding amount of RMB 337.68 billion yuan. In 2003, base money injection as a result of Forex purchase added up to RMB 1,145.9 billion yuan, while open market operation withdrew

RMB 269.4 billion yuan base money, resulting in a net base money injection of RMB 876.5 billion yuan.

At the same time, the PBC has provided sufficient liquidity to financial institutions through flexible market operation. At the end of last August, the IPO of Huaxia Bank led to relatively large liquidity shortage in the commercial banks. Under such circumstance, the PBC, on August 26 and September 2nd, 2003, twice reduced the issuance scale of 3-month central bank bills and injected liquidity to commercial banks through 7-day reverse repo transaction; At the time of Changjiang Power IPO on November 11 last year, the PBC again conducted 7-day reserve repo transaction. Under the guidance of open market operation, the 7-day repo rates, typical inter-bank interest rate, have remained stable at around 2.15% despite of the liquidity fluctuations resulted from IPOs, which indicates that open market operation has reached expected target.

Given sufficient liquidity of financial institutions and falling trend of money market rates during the first quarter of this year, the PBC intensified sterilization operation. In this period, the cumulative amount of central bill issuance reached RMB 435.2 billion yuan and outstanding amount stood at RMB 615.45 billion yuan; Base money injection as a result of Forex purchase amounted to RMB 291.6 billion yuan, and open market operation withdrew RMB 281 billion yuan, resulting in a net base money injection of RMB 10.6 billion yuan and basically offsetting the Forex position of base money.

ii. Use reserve requirement policy in a flexible way to lower the cost of currency withdraw and improve the operation of commercial banks

In order to rein in the obviously excessive credit growth, the PBC raised the required reserve ratio by one pp on September 21, 2003. Traditional Money and Banking theories regard required reserve ratio hike as a relatively drastic measure, nevertheless the central bank interpreted it as a mild move. The major reason is that the central bank has to withdraw a large amount of excess liquidity because of fast growth of foreign exchange reserves, To do so, if the central bank only issue CB bills without any other measure, it has to raise the interest rates on CB bills to a very high level given strong economic expansion momentum and commercial banks' wide interest rate differentials which is larger than the returns on CB bills, however, high interest rate would have significant implications on the economy. In contrast, the 1 pp rise of required reserve ratio enabled the central bank to reduced at a lower cost the commercial banks' excess reserve by around RMB150 billion yuan, accounting for only 6% of their holdings of treasury bills, financial bonds and CB bills. Therefore, the required reserve ratio hike is actually a mild policy measure. Moreover, the policy was announced one month in advance, giving sufficient time for financial institutions to manage their liquidity. The PBC also provided timely support to those financial institutions with short-term liquidity difficulties, so as to maintain the overall stable developments of financial operation and money market interest rates.

With the approval of the State Council, the PBC announced on March 25, 2004 that the required reserve ratio for financial institutions with capital adequacy ratio below a specific level would rise 0.5 pp to 7.5%, while the ratio for other financial institutions remained unchanged. State-owned commercial banks, urban and rural credit cooperatives were exempt from the differentiated required reserve ratio policy. On April 11, 2004, the PBC announced again that the required reserve ratio for all financial institutions except from urban and rural credit cooperatives would rise 0.5 pp since April 25, 2004.

The differentiated required reserve ratio scheme is both a transitional policy in line with China's current financial system, and an innovation based on the original purpose of required reserve ratio policy, i.e. to ensure the payment and settlement of commercial banks, and to prevent over-lending by financial institutions attracted to favorable loan terms which may undermine their liquidity and payment capacity. The required reserve ratio policy then gradually evolved into a monetary policy instrument, and the deposit insurance regime combined with supervision on capital adequacy ratio started to replace it as policy tools to impose prompt corrective actions on financial institutions based on different risk profiles. Given the fact that China has yet to establish deposit insurance system, and quite a number of financial institutions failed to reach the 8% capital adequacy ratio, the differentiated required reserve ratio scheme is conducive to curb excessive credit expansion of the financial institutions with low capital adequacy ratio and poor asset quality, and to prevent the one-size-fits-all approach in macro financial adjustment and regulation.

iii. Utilize other monetary policy instruments

At the same time, the PBC will strengthen credit management by rigorously curbing loans to over-invested industries, and keeping the proportion of medium and long term loans at reasonable level. The PBC will also endeavor to adjust loan structure, urge financial institutions to implement credit policy, promote financial ecological development, enhance re-lending and rediscount management, continue to improve financial service to rural economy, and further promote inter-bank market development.

III. The priority of China's current interest rate policy is to enhance institutional reform so as to facilitate monetary policy transmission mechanism

In a market economy, interest rate policy is conducted through adjusting interest rates to influence market financing costs and signal the central bank's judgment on economic development and liquidity position. In the games between central bank and the public, the signal effect is bigger than financing cost.

i. Adjust interest rates flexibly on the condition of maintaining both internal and external equilibrium

Since September 2003, the Year-on-Year (YOY) consumption price level has grown fast to 3.2% at the end of December, implying increasing inflation pressure. From January to March 2004, the YOY CPI rose 3.2%, 2.1%, and 3.1% respectively and month-to-month (MOM) rose 1.1%, -0.2% and 0.3% respectively. The CPI in the first half of this year may continue to rise, but current one-year loan rate is only 5.31%. If real loan rates fall negative at some point of time, the behavior of economic agents will be distorted. The enterprises will accumulate raw materials because they can make profits simply by borrowing, thus aggravating raw material shortage, pushing price level further up and leading funds to circulate in retailing rather than be invested in manufacturing. Therefore, price level is one indicator the central bank must closely monitor when considering interest rate policy.

In addition, the central bank must also take into account the issue of Forex arbitrage. Over the past two years, capital inflows have led to substantial rise in Forex position. The amount of capital inflow is directly linked to domestic and foreign interest rate differentials. Currently the one-year domestic RMB deposit rate is 1.98%, 1.4 pp higher than the 0.5625% one-year domestic USD deposit rate and 0.92 pp higher than the 1.06% one-year US CD rate. In this connection, we must flexibly adjust interest rates on the condition of maintaining both internal and external equilibrium.

ii. Establish floating benchmark interest rate regime and signal to the public in a timely manner

With the approval of the State Council, the PBC decided to adopt floating relending rate regime. Relendings refers to the loans central bank grants to financial institutions. Floating relending rate regime means that the PBC, according to macroeconomic and financial situation, can set and announce the extent by which the relending rates move above benchmark rates within the fluctuation band authorized by the State Council. Effective on March 25, 2004, the rates on one-year-or-less liquidity relendings rose by 0.63 pp from existing benchmark level. In order to support agricultural development, floating relending rate regime for rural credit cooperatives will be implemented gradually in three years, and three years later, the rate increments for RCCs will be half those for other financial institutions.

The adoption of floating relending rate regime is another important step toward interest rate liberalization. It helps not only improve interest rate formation mechanism and the central bank's capability of guiding market rates, but also upgrade the effectiveness and transparency of relending management.

iii. Change the ways of resetting loan rates to guide commercial banks to enhance risk management and make positive reaction to the interest rate changes by central bank

With the approval of the State Council, the PBC changed the way of resetting loan rates. Effective on January 1st, 2004, the ways of resetting loan (excluding household mortgages) rates are determined by borrowers and lenders through negotiation. The frequency of resetting rates on medium and long

term RMB loans, previously once a year and now determined by borrowers and lenders, can be monthly, quarterly, annual, or fixed. This policy move has corrected the asymmetry between fixed deposit rates and annually changed loan rates. Consequently, commercial banks can determine the way of resetting loan rates according to customer's credit rating, and flexibly design loan products. Also, shortened resetting intervals help commercial banks spot problems the customer's solvency problem. In addition, when central bank changes benchmark rates, commercial banks can promptly adjust loan rates based on lending agreement, thus mitigating interest rate risk, facilitating the transmission of monetary policy to manufacturing and consumption. The change of loan rates resetting policy forced commercial banks to establish offer system, to factor in credit risk and interest risk when estimating profits, and to set up internal transfer pricing mechanism.

iv. Speed up the adoption of loan rate floor and deposit rate ceiling policy and urge commercial banks to improve asset/liability management (ALM)

With the control of lending scale and deposit/lending rates, the commercial banks' ALM only focuses on the ratio of deposit to lendings. Interest rate liberalization, nevertheless, requires commercial banks to focus on interest rate risk and capital adequacy ratio.

(i) Loan rates floor management

Loan rate floor management calls for commercial banks to adjust asset structure with risk pricing. According to a survey on September 2002, less than half of the outstanding commercial bank lendings are fixed rate, while in stock-holding commercial banks, the percentage of fixed rate loans is only 36%. Since the 0.9-1.7 pp floating range has basically liberalized the lending rates, commercial banks must learn how to price risk.

Loan pricing must take into account such factors as fund cost, direct and indirect costs, loan taxation cost, loan maturity, loan risk and target profit.

Fund cost rate refers to the cost for commercial banks to obtain fund in the market with similar maturity and cash flows as the loan extended to clients, i.e. the internal transfer price of the loan. Direct costs, including all costs related to loan product and client services, can be derived from direct cost rate using activity-based-cost (ABC) or average-cost method. Indirect costs, generated from operations other than loan activities, can be calculated using average-cost method. Because the calculation of direct and indirect costs both use historical data, the data must be updated regularly so as to ensure its effectiveness and applicability. In China, taxation cost rate is the operating tax rate plus added cost per loan. Credit risk premium is used to cover expected loan loss and the expected loan loss rate equals default rate multiplied by loan loss rate. To estimate loan loss, commercial banks must set up internal rating modes. The longer the loan's maturity, the higher the lendings rate. The logic behind is that longer maturity means longer financing period, consequently higher financing cost and greater possibility of changing cost, therefore, the loan rates should rise accordingly. Target profit can be estimated using return on capital and the ratio of capital to lending.

At present, loan pricing is one weakness of our commercial banks, because in the past they didn't have much chance to do it due to interest rate control. In the process of interest rate liberalization in coming years, commercial banks need step up efforts in pricing product, accumulate experience and basic data, and strengthen international competitiveness.

(ii) Deposit rate ceiling management

Deposit rate ceiling management requires commercial banks to actively adjust their liability scale and structure, and adapt themselves to capital adequacy ratio management.

Western commercial banking management theories have evolved from asset management, to liability management, finally to asset/liability management. Liability management originated at the end of the 1960's, when high inflation and sharp and unexpected interest rate hike, combined with rigorous interest rate control in many countries, led to disintermediation and fund shortage in commercial banks. Commercial banks then had to attach great importance to liability management and attract fund back into commercial banks through innovation.

However, China's liability management originated in a very different backdrop. In China, funds and risks are over-concentrated in banks while capital adequacy ratio of most commercial banks are low. To meet capital adequacy ratio requirements, commercial banks must reduce either asset or liability. With deposit rate ceiling policy, commercial banks can tailor deposit price to specific situation.

Commercial banks with low capital adequacy ratio can reduce deposit by lowering deposit rates so as to mitigate the pressure of excessively expanding loans to avoid loss due to large liability. Therefore, deposit rate ceiling policy not only helps rein in excessive credit growth and mitigate inflation pressure and non-performing loan risks, but also guide funds into capital market to promote capital market development.

v. *Actively push forward financial derivatives transaction with a purpose of providing commercial banks and customers with hedging instruments during interest liberalization.*

Both financial institutions and their customers need instruments to hedge interest rate risks after interest rates are liberalized. In fact, according to option-pricing theory, financial institutions, even without derivatives, can use basic instruments to create transactions with the same nature as derivatives to hedge risks. But the pitfall is its relatively high cost and risk. Derivative hedging is cost-effective and convenient, but risky due to high leverage, which was reflected to some extent in the meltdown of Barrings and LTCM. In this regard, we will enhance the internal control of financial institutions before pushing forward derivative transactions and finally provide commercial banks and customers with hedging instruments.

With the approaching of fully opening up of China's banking sector, commercial bank reform is urgent. I believe that, with clear policy and development direction set by Central Committee and State Council and more favorable reform environment, commercial bank reform will proceed successfully through joint efforts by all staff in banking sector.