

Xiang Junbo: Medium-term strategy to strengthen financial stability and promote financial development

Speech by Mr Xiang Junbo, Deputy Governor of the People's Bank of China, at the Seventh Meeting of IIF Asian CEO Summit, Hong Kong, 26 October 2005.

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Ladies and Gentlemen,

It is my great pleasure to address the Seventh Meeting of IIF's Asian CEO Summit. It provides us with a good opportunity to exchange views about important issues relevant to Asia and the whole world. Today, I would like to introduce to you the People's Bank of China's medium-term strategy in strengthening financial stability and in promoting financial development.

Finance is the core of modern economy, and maintaining financial stability is the foundation for sound and stable economic development and long-term social security. Financial stability is an important agenda for all governments in the world. As China's economy and financial sector grow steadily, a stable financial system will hold great significance not only in China, but also in Asia and the world.

Over the past more than two decades, China's opening-up and reforms and socialist market economic development have achieved remarkable accomplishments and realized economic, political and social stability, creating favorable macro environment for financial stability. Chinese government paid high attention to financial stability. In 2003, Chinese government restructured financial management regime by establishing China Banking Regulatory Commission to supervise banking industry. At the same time, *the Law of the People's Republic of China on the People's Bank of China* was revised to confirm and strengthen the PBC's function in prevention and mitigation of financial risks and in safeguarding financial stability. The PBC and other government agencies carry out national guidelines and policies by close collaboration and collective efforts to proactively prevent and mitigate financial risks, promote financial reform, safeguard financial stability and advance financial development.

I. Financial stability situation in China

Since the opening-up and reform of the Chinese economy, China has established rather complete financial institutional system. As of the end 2004, China has 4 wholly state-owned commercial banks, 3 policy banks, 12 share-holding commercial banks, 112 city commercial banks, 681 city credit cooperatives, 32,854 rural credit cooperatives, 8 rural cooperative banks, 7 rural commercial banks, 211 foreign bank branches, 220 foreign bank representative offices, 4 financial asset management companies, 59 trust and investment companies, 74 finance companies, 12 financial leasing companies, 3 auto financing companies and a large number of postal savings institutions. In the securities industry, China has 131 securities companies, 43 fund management companies, 187 future brokerage companies and 111 securities -investment consulting agencies. In the insurance industry, China has 6 insurance groups and holding companies, 69 insurance companies, 4 insurance asset management companies, 1317 specialized insurance intermediaries and more than 110 thousand insurance intermediaries. According to the PBC statistics, at end-2004, the total financial assets reached RMB41.28 trillion yuan.

Thanks to close cooperation and joint efforts by the PBC and other government departments, financial risks emerged in the transition process of Chinese economic and financial development are properly controlled through improving socialist market economic system and financial deepening. Financial systems in China broadly remain stable with bright prospects.

1. **Political and economic environment is favorable.** Stable and favorable foreign, political, economic and financial policies produce sound international environment for financial stability. Timely and effective macro adjustment policies have helped lessen shocks of economic cyclical movements to financial stability. Healthy macro-economic development has created a favorable environment for financial system to remain stable. Sound monetary policy buttressed domestic currency stability and laid the foundation for financial system to develop steadily.
2. Financial Markets remained broadly stable. Money market developed rapidly and orderly so that its ability to allocate resources increased evidently. Bond market innovation and

development speeded up and market operation remained stable. Stock markets developed gradually in the process of reform and its direct financing function was basically realized. Foreign exchange market was further improved and deepened. Gold market started to develop and was gradually turned into an investment platform. Financial market developed rapidly in the process of innovation and financing structure further improved, creating a stable market environment for financial institutions sustainable and healthy development.

3. Financial risks accumulated in history were broadly resolved. Under the steering of the State Council, the PBC, the MOF, the financial supervisory bodies and local governments collaborated closely to advance risk disposal, restructuring and reform of the financial institutions, resolved effectively financial institutions' risks, protected investors' interests and raised public confidence in financial institutions.
4. Financial institutional reform achieved evident results and financial institutions remained broadly healthy and sound. Financial institutions endeavored to become modern financial enterprises by meeting the requirements such as on sufficient capital, strong internal control, safe operation, good services and profitability etc. Financial institutions' operational performance was broadly improved with enhanced assets quality, contained financial risks and strengthened corporate governance. In particular, banking industry's reform has achieved significant results. The share-holding reform of wholly state-owned commercial banks made a big stride. Both Bank of China and China Construction Bank's financial situation improved significantly, with main financial ratios already close to that of the international big commercial banks and modern corporate governance mechanism beginning to produce good results. The financial restructuring of the Industrial and Commercial Bank of China are basically finished and the ICBC will be restructured to become a share-holding company within this year. The pilot reform of rural credit cooperatives has extended to 29 provinces (region and municipalities), with improved operation and strengthened capital quality. Guidelines for restructuring of the securities companies have been clarified and preliminary results have been achieved in relevant reform areas. Insurance industry has made great progress in reform and development with the restructuring of the stated-owned insurance companies basically completed. At the same time, China continued to fulfill its WTO-entry commitments by further opening-up and reforming the financial industry.
5. Financial infrastructure and financial ecological environment were improved gradually. Modern payment and settlement system has been preliminarily established, and the building of financial legal system, financial institutions' corporate governance, accounting and auditing standards has achieved considerable progress. Financial safety network has been preliminarily established as well, and prudential supervision was becoming increasingly important. The PBC and the MOF have strengthened their coordination and information exchange with three supervisory commissions. The formation of financial stability coordination mechanism is underway, with insurance protection system and securities investors' protection system preliminarily established and deposit insurance system establishment initiated. At the same time, Chinese government strengthened legal enforcement and accelerated the establishment of credit registration system to improve social credit culture and financial ecological environment.

II. Concerns about financial system stability.

Finance is the core of modern economy and interlaced closely with economic operation. In the process of establishing socialist market economy as well as of reform financial globalization, the main concerns of Chinese government about financial stability are focused on the following ten aspects.

1. **Economic growth model transformation.** Currently, economic growth is highly dependent on investment and export and the development of different industries is unbalanced. Given changes in economic environment, industrial structural adjustments, deterioration of terms of trade, overheating in sectors like real estate industry, real economy's profitability and sustainable development may be affected, so as the sound operation of the financial institutions and financial markets.
2. **Coordination between direct and indirect financing.** At present, direct financing develops rather slowly in China compared with the development of indirect financing, in particular, bond market and stock markets development broadly lags behind, and business financing

highly depends on the banking system which results in a concentration of financial risks in the banking industry. Capital markets face many historical problems and institutional drawbacks and listed companies need to timely disclose true information, improve corporate governance and fully resolve the state shares problem while the securities companies all need to strengthen operation.

3. **Implicit fiscal deficits.** Implicit fiscal deficits arising from inadequate funding of the pension system and mounting local governments debts might be transferred to financial systems and affect financial stability.
4. **Control and deregulation of capital prices.** In the process of interest rates liberalization and the reform of the exchange rate regime, business, financial institutions, households and other market participants must adapt to the changes from a controlled to a deregulated environment and hedge interest rate risks and exchange rate risks. However, the financial markets are not adequately developed and require more financial derivatives and financial products for market participants to hedge financial risks.
5. **Improving financial institutions' corporate governance.** The corporate governance of financial institutions still has problems like insider control, insufficient information disclosure, deviated business targets, lack of clear and effective disciplines and market incentive which affect financial institutions' risk management capability and are likely to trigger credit risks and operational risks.
6. **Monitoring and supervision of risks from cross-sector financial businesses.** Cross-sector financial businesses contain cross-institutional, cross-markets and cross-regional risks which investors' are lack of full knowledge, financial institutions have not established effective risk prevention and internal control system as well, and supervision system requires to be further improved.
7. **Prevention of moral hazards in financial institutions' risks resolution.** In recent years, governments often underwrite individual claims when financial institutions are rescued or closed because of the incomplete investor protection mechanism and investors' lack of risk knowledge. Such a method doesn't help to enhance investors' risk awareness and market disciplines on financial institutions business operation, and it can even encourage financial institutions to irrationally expand and engage in vicious operational activities. It is an urgent task to maintain financial stability and at the same time to prevent moral hazard risks.
8. **Strengthening financial infrastructure.** The market-oriented operational mechanism for payment services are not soundly established and payment and settlement management skills require further improvement. Besides, financial legal system, accounting and auditing standards, information disclosure level, credit registration system requires further strengthening and financial safety networks need to be improved. Information exchange and coordination mechanism among the PBC, the MOF and financial supervisory authorities also needs to be cultivated.
9. **Improving financial ecological environment.** Credit culture is not well developed in China and needs to improve along with the social and economic development. There are still cases of law violation and improper law enforcement in China, which affects financial stability and even the social stability.
10. **The spillover effects of economic and financial globalization.** With the development of economic and financial globalization, financial stability is increasingly affected by international economic and financial situation and uncertainties such as rising oil prices, global interest rates increasing, US dollar depreciation, geographical conflicts etc. With the depth and scope of China's participation in international production, trade and capital movements gradually enlarged, uncertainties accompanied globalization gains are increased accordingly. Besides, because global financial system integration is strengthened, cross-border contagion effects of financial risks will be increased as well. Such kind of "spill-over" effects will bring many uncertainties for Chinese financial stability.

III. Medium-term strategy to strengthen financial stability and promote financial development

It is a systematic project to maintain financial stability, and therefore it involves many aspects. In line with the fundamental principle of maintaining stability by reform and development, the PBC will closely collaborate with other departments to strengthen macro financial control, properly deal with historical burdens, mitigate financial risks, optimize financial structure, promote financial institution reform, improve financial markets, strengthen financial infrastructure, improve financial ecological environment, establish appropriate a long-term financial stability mechanism to maintain financial stability and promote financial development.

(1) Improve macro financial control system to provide favorable environment for financial stability.

We will continue to adopt economic and legal instruments to strengthen and improve macro financial control system in order to promote steady and relatively fast economic development. The PBC will enhance the timeless, effectiveness and forward-looking aspects of monetary policy, smoothen monetary policy transmission and promote the market-oriented interest rates reform. We will promote RMB exchange rate regime reform in a sequenced manner to gradually establish the managed floating rate regime based on market supply and demand so as to maintain the RMB exchange rate basically stable at an adaptive and equilibrium level.

(2) Speed up financial reforms to increase financial institutions' competitiveness.

In the coming period, China will continue to reform the financial system, clarify ownership structure, improve corporate governance, transform operating mechanism, strengthen internal control so that commercial banks, securities companies and insurance companies could be transformed as modern financial enterprises with sufficient capital, strict internal control, safe operation, good services and profitability.

First, China will continue to conduct the share-holding reform of the wholly state-owned commercial banks, and deepen rural credit cooperatives reform, promote city commercial banks, city credit cooperatives and non-banking financial institutions to restructure and consolidate, encourage private funds to participate in the restructuring of urban credit cooperatives and city commercial banks, promote assets management companies market-oriented operation, restructure and consolidate securities companies and improve insurance companies reform so as to establish a multi-layer financial institutional system.

Second, efforts will be made to further improve corporate governance of the financial institutions and strengthen internal control system. We will promote financial institutions' ownership structure reform, establish incentives for the financial institutions to introduce strategic investors, board of directors, management and market participants and put in place risk management system and internal control system.

Third, financial innovation will be fostered. Financial institutions should enhance their financial innovation and strengthen their pricing capability. Commercial banks need to pay attention to developing their fee-based business; securities companies need to develop seller's business; insurance companies need to diversify investment channels and cultivate sustainable growth model. Supervisory authorities need to provide policy to support financial innovation.

(3) Optimize financing structure and improve capital markets.

Efforts will be made to promote capital markets reform and stable development. In particular, historical burdens will be properly dissolved and institution building will be strengthened. Bonds market will be further developed and pilot-program of credit securitization will be conducted, corporate bonds market will be developed, capital market structure will be improved and capital market instruments will be diversified. Besides, we will improve interactions among the money market, capital market and insurance market to maintain broad stability of financial operation and financial market.

(4) Strengthen financial risks monitoring and early warning.

Risks of banks, securities firms and insurance companies as well as the cross-sector, cross-country and cross-region risks will be closely monitored. Financial stability indicator system and early warning

system will be established to improve the monitoring and assessment of financial vulnerability and enhance monitoring and warning of financial risks. To strengthen the monitoring and prevention of systemic financial risks, the PBC will periodically issue Financial Stability Review from 2005 to evaluate the financial system risk profile in China.

(5) Accelerate the establishment of financial safety networks.

Financial safety networks include prudential financial supervision, central bank's lender of last resorts function, deposit insurance system, securities investors protection system and insurance protection system. Currently, we will focus on the establishment of deposit insurance system which covers all depository financial institutions. At the same time, we will collaborate with other departments to establish and improve the securities investors protection system and insurance protection system.

(6) Improve financial legal system and financial legal environment.

At present, the PBC is speeding up the relevant financial legislation work, which include Rules for Credit Registration and revision of the Enterprise Insolvency Law and the Criminal Law. In line with the principle of the Insolvency Law, the PBC will promote to stipulate Rules for Financial Institutions Insolvency to emphasize on the special feature of financial institutions. Furthermore, the PBC will make efforts to coordinate the revision of the Securities Law and draw up the Anti-money Laundering Law as well as study relevant legal issues related to financial institutions' market exit, deposit insurance, legislation of the financial-holding company law, asset securitization and trust investments etc. The PBC will endeavor to publish these laws and rules as soon as possible to improve law enforcement and at the same time, clean up the financial legal system in accordance with Chinese situation.

(7) Promote financial infrastructure and create favorable environment for financial industry.

The PBC will continue to promote the improvement of payment and settlement system and the establishment of credit registration system so as to increase public credit awareness and credit culture. The PBC will strengthen anti-money laundering work and expand international cooperation. Furthermore, the PBC will explore to establish financial supervision coordination mechanism among the PBC, the MOF and the supervisory authorities.

Currently, China is mapping out its 11th Five-year plan for National Economic and Social Development. I believe, with the fulfillment of scientific development concept, the improvement of macro economic management, acceleration of reform and opening-up, deepening of economic restructuring and transformation of growth model, Chinese financial system will be maintained stable and enjoy further development.

Thank you.