

Zhou Xiaochuan: Steadily advancing market-based interest rate reform

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It's my honor to attend Euromoney's Conference in China. First, I would like to express my thanks to the sponsors of this Conference including Bank of China, Euromoney Group and Hong Kong & Shanghai Banking Corporation. My thanks also go to the other parties that have provided support to the Conference. The theme of the Conference is "Making Financial Markets work", a very important topic. In China, one of the major means to promote the efficient operation of financial markets is to steadily advance market-based interest rate reform and to gradually establish benchmark yield curve.

I. Progress achieved in China's market-based interest rate reform and problems remained

The Chinese Communist Party and Government attach great importance to the market-based interest rate reform. In 1993, the 3rd Plenum of the 14th CPC National Congress pointed out that "the central bank shall promptly adjust benchmark interest rate according to changes in market supply and demand, and allow the commercial banks to flexibly set their own rate on loans and deposits within a specified range." The 5th Plenum of the 15th CPC National Congress in 2000 and the 4th Plenum of the 9th National People's Congress in 2001 called for "steady progress in market-based interest rate reform". In 2002, the 16th CPC National Congress adopted in its report the decision to "steadily advance market-based interest rate reform and optimize the allocation of financial resources". The Decision on Issues concerning improving the Socialist Market Economic System adopted by the 3rd plenum of the 16th CPC National congress further pointed out that "market-based interest rate reform should be steadily advanced to establish and improve the mechanism for determining interest rate based on market supply and demand. The central bank shall use monetary instruments to influence market interest rate."

While moving in the general direction of market-based interest rate reform, we need to clarify some concepts. Some people think that the objective of market-based interest rate reform is to let all interest rates determined by the market. This perception is incorrect. The interest rates that will be determined by the market include commercial rates but not the interest rates used by the central bank to conduct financial management.

In recent years, China's market-based interest rate reform has advanced steadily, with significant progress achieved in the deregulation of money market interest rate. First, market has been playing an increasingly important role in determining the types of interest rate in the money market, which now include inter-bank lending rate, bond repurchase rate, bill market discount rate, interest rate in the primary and secondary market of government bond and policy financial bond. Second, management of interest rate on loans and deposits has been streamlined. The previous practice of regulating most types of interest rate has been changed and commercial banks have been given greater flexibility in managing the interest rate. Third, the floating band of interest rate on loans to small and medium sized enterprises has been widened for three times, leading to improved risk management capability of the banks and enabling these enterprises to have easier access to bank credit. Fourth, management of interest rate on foreign currency has been relaxed. At present, there are only a few types of foreign currency interest rate that are still subject to the central bank management. Fifth, domestic commercial banks have introduced large amount time deposit business for domestic insurance companies, with the interest rate jointly determined by both sides.

Despite the above progress, China's market-based interest rate reform has lagged behind the overall economic reform and opening up. One of the major reasons is lack of proper understanding of the reform. For example, when talking about the level of interest rate, some people tend to think it is solely determined by the cost of fund, without giving due consideration to market supply and demand. This is similar to the improper understanding of the factors determining the price of goods in the early stage of reform. In addition, some people have not established the concept of risk premium when considering

the level of interest rate. The need for favourable interest rate policy to support the reform of small and medium-sized enterprises is also a factor affecting the level of interest rate.

II. Measures to push ahead with market-based interest rate reform

To steadily advance the market-based interest rate reform is a direction clearly defined by the Party and the government. As to the specific measure, they have been under frequent discussion by the Monetary Policy Committee and involve the following aspects.

First, further widening the floating band of lending rate. At present, different lending rate bands around the central bank's benchmark rate are applied to loans extended by different types of financial institutions and provided to enterprises of different size. The rural credit cooperatives in selected areas may set their lending rate within 90-200 percent of the central bank's benchmark rate. Other rural credit cooperatives may set their lending rate within 90-150 percent of the benchmark rate. For the commercial banks, the interest rate they charge on loans to the small and medium-sized enterprises shall be within 90-130 percent of the benchmark rate; that to the large enterprises shall be within 90-110 percent of the benchmark rate; and that to a few key enterprises may not exceed the benchmark rate. The current situation of supply and demand in the credit market and the risk management requirement of the commercial banks call for changes in the above policies. Such policies have also made it difficult for the small and medium-sized enterprises to obtain bank loans in the absence of guarantee or collaterals. In the next-stage reform, the floating band on lending rate will be further widened. In particular, the range above the benchmark rate will be further expanded to give the banks greater flexibility in managing their lending rate.

As to the range below the benchmark rate, I have mentioned earlier that the lending rate can be as low as 90 percent of the benchmark rate. Of course, some enterprises with very good credit standing will be able to get even lower rate. Nevertheless, they are encouraged to issue corporate bond, which will help promote the development of corporate bond market. The interest rate in corporate bond market shall be allowed to move in a wider range. We should let the market determine whether an enterprise can borrow at a lower rate.

Second, the interest rate on deposits shall be allowed to move downward against the benchmark rate. The practice of allowing a few rural credit cooperatives to set the deposit rate above the benchmark rate has its special background, and has raised some controversies.

In China, the 8% capital adequacy requirement set by the Basle Committee on Banking Supervision in its 1998 Capital Accord has not been strictly enforced in the regulation of financial institutions, and the Prompt Corrective Actions have not been adequately established. Some financial institutions with poor performance and inadequate capital and liquidity tend to attract deposits by offering high interest rate. The riskier a financial institution is, the more likely it is to offer high interest rate, resulting in deteriorating financial positions of these institutions.

Therefore, in the absence of strict enforcement of capital adequacy requirement and effective implementation of the Prompt Corrective Actions, we should be cautious in allowing the financial institutions to set deposit rate above the benchmark rate.

The previously adopted policy of allowing some rural credit cooperatives to set deposit rate above the benchmark rate had its special background. At that time, postal savings system attracted large amount of deposits from the rural area, but could not use these fund directly to serve the development of agriculture and rural area and the need of farmers. The rural credit cooperatives are in a disadvantageous position in competing for deposits, since the postal savings system not only has its own operational advantages but also enjoy favourable policies. To promote the development of rural financial services, we introduced the policy of allowing the rural credit cooperatives to set their deposit rate above the benchmark rate. Now we face some new issues. First, since August 2003, the interest rate policy for the newly increased postal savings deposit has been changed, thus alleviating the problem of rural deposit competition. Second, the increase in deposit interest rate has narrowed the interest spread, resulting in difficult financial situation of some of the rural credit cooperatives. Third, some county-level financial institutions that were not given the flexibility to set their deposit rate above benchmark rate complained that they were facing unfair competition from the rural credit cooperatives. Therefore, the policy of allowing the deposit interest rate to move upward against the benchmark rate need to be carefully examined and evaluated.

In China, almost no financial institutions offer below-benchmark interest rate on deposits. While in other countries, many banks set their deposit rate below the central bank's benchmark rate. One of the main reasons is that financial regulation in China has not strictly enforce the requirement in Basle Committee's Capital Accord, and the excessive expansion of the balance sheet of the deposit-taking institutions has not been effectively contained. China Banking Regulatory Commission is going to introduce stricter capital adequacy requirement. After such requirement is imposed, the banks that have inadequate capital and have difficulties in strengthening their capital base must reduce the growth of their risk assets. Without effectively lowering the risk weight of the assets, they will have to tighten their balance sheets. So they may offer lower interest rate on the deposits.

Third, further relaxing the regulation on interest rates. We need to consider whether it is necessary to regulate some interest rates or to set narrow floating bands on these interest rates.

III. Gradually establishing effective benchmark yield curve

Market-based interest rate reform will contribute importantly to the formation of effective benchmark yield curve. At present, there are insufficient varieties of debt instruments in the market, the maturity structure is inappropriate, and the yield of debt instrument has not been fully determined by the market. For example, there are relatively few types of short-term bond in the market, and the long-term yield seems to be too low. The measures we will adopt in the next stage include adding more types of government bond or replacing some bonds with other alternative debt instruments, so that there are sufficient products in the short-term, medium-term and long-term bond markets. With reduced administrative interventions and deepened market, an effective benchmark yield curve is expected to be set up, providing a useful base rate for the operation of the financial institutions and the financial market.

IV. Money market interest rate

We need to pay special attention to the interest rate in the money market. At present, interest rate in the money market in China is to a large extent determined by market forces, with active transactions conducted in the market. Major money market transactions, particularly inter-bank lending and government bond repurchase, have played an important role in the formation of interest rate. Participants in the money market need to increase their experience and improve their judgment. For example, some monetary policy instruments are mainly targeted for the short-term money market. Since last year, the main purpose of the central bank's operation in the short-term money market to absorb liquidity with some monetary policy instruments is to sterilize the increase in money supply from foreign exchange purchases. However, some market participants have not clearly identified the relationship between the RMB position resulted from foreign exchange purchases and the central bank's open market operations. Of course, this is partly due to the insufficient transparency of information, since only monthly data on changes in foreign exchange are available in the market. For years, the increase in money supply from foreign exchange purchases has been an important factor affecting the central banks decision as to whether to issue central bank bill and the volume of issue.

One point worth mentioning is that in China, the issue of stocks is an important factor affecting money market. Actual fund is required to purchase stocks in initial public offerings. This is a unique requirement in China rarely found in other countries. Large volume or successive issue of stocks will affect money market in the short run, with tightened market liquidity and large volatility in short-term interest rate. Nevertheless, China's money market is stable in general. Better understanding of both the money market and interest rate volatility is need.

V. The importance of market-based interest rate reform

First, market-based interest rate reform is crucial to the allocation of financial recourses. Optimizing resource allocation is an important function of the market. In the absence of sound allocation of financial resources, even a minor policy error will entail great loss on the overall economic efficiency.

Second, a special problem facing China is the large employment pressure. In China, about 10 million new jobs need to be created every year to absorb the increase in labor force, which include college graduates, migrant workers from the rural area, and urban laid-off workers. I believe many foreigners will be surprised at the figure of 10 million, which shows the severity of China's employment problem.

Recent years' statistics show that small and medium-sized enterprises have made the greatest contribution to the creation of new jobs. How to better serve these enterprises, in particular, how to use interest rate policy to support their development to enable them to obtain loans or financing from other sources, depends largely on the progress in market-based interest rate reform.

Finally, China is expected to open its banking sectors in all areas - including market access, the range of customers and RMB business - in 2006. Due to excessive regulation on interest rate, China's domestic financial institutions do not have sufficient capability in the pricing of financial products, particularly loan products. They need to accumulate more experience in financial product pricing so as to maintain their competitiveness in the international market.

Above is an overview of China's market-based interest rate reform. I welcome any comments. Thank you.