

Zhou Xiaochuan: Some considerations in the study of monetary policy transmission

Speech by Mr Zhou Xiaochuan, Governor of the People's Bank of China, Beijing, 13 April 2004.

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Distinguished guests, ladies and gentlemen,

This high-level seminar on China's Monetary Policy Transmission Mechanism jointly held by the People's Bank of China and the International Monetary Fund is an important and meaningful cooperation between the PBC and the IMF. First of all, on behalf of the People's Bank of China, I would like to express the warmest congratulations on the opening of this seminar and the most sincere welcome and appreciation to foreign experts headed by Mr. Lipschitz, Director of the IMF institute, and the Chinese experts and scholars present at this seminar. During the meeting, Mr. Marvin Goodfriend discussed the analysis framework for monetary policy transmission mechanism; Mr. Hervé Ferhani presented on the impact of banking soundness and competitiveness on monetary policy transmission mechanism; Mr. Lajos Bokros, Director of the World Bank financial services advisor/ Europe and Central Asia office and Prof. Bennett T. McCallum from Carnegie Mellon University spoke on the experience of post-transition and industrial countries respectively; and this afternoon, Prof. Noriyuki Takayama from Hitotsubashi University will talk about the impact of ageing and social securities system on monetary policy transmission from the Japanese experience. Their research and presentations are very helpful for us to learn the useful country experience and further improve the monetary policy transmission and adjustment mechanism. With respect to China's monetary policy transmission mechanism, I would like to add the following points:

I. The study of monetary policy transmission should be attentive to the micro foundation, and to the sensitivity, speed and effects of banks' and other financial institutions' response to monetary policy. Only with a sound micro foundation, could monetary policy transmission mechanism be improved.

In recent years, in order to establish a micro foundation sensitive to price signals, much importance has been attached to strengthening corporate governance and the role of shareholder value. Whether economic agencies at the micro level are profit-maximizing has direct impact on the monetary policy transmission and its effectiveness. If micro economic agencies are not profit maximizing, it is no surprise that price instruments of monetary policy hardly works.

With the deepening of the economic reform, it can be observed that financial institutions are gradually moving towards profit maximization, though still far from what would have been in a market economy. Some financial institutions, especially large ones, have not shed the bureaucracy-oriented mentality, a legacy of the centralized economy. In their business objectives, personal promotion is usually prioritized over profit indicators, which will definitely affect the transmission of price instruments of monetary policy.

In order to enhance the micro foundation, China has been strengthening financial supervision over the years. It should be noted that the choice of regulatory intensity and indicators has direct impact on monetary policy effectiveness. For instance, with increasing concern on the rise of non-performing loans (NPL), the regulatory authority required that NPL ratio be reduced to a certain level. This regulatory indicator played its role to the extent that commercial banks did reduce NPL ratios. However, in order to comply with the regulatory requirement of lower NPL ratio, some financial institutions increased lending in an attempt to inflate the denominator and grow out of the NPL problem. This exacerbated the excessive credit growth problem. At this point, some people started to realize that we should worry not only about the NPL ratios, but also the quantity of NPLs. Again, this was also an over-simplified perception. It was only after some time of market development, much experience and years of discussion, that consensus was finally reached in 2003 on the importance of capital adequacy. Only when agencies at the micro level put in place risk control and capital constraint, could monetary policy transmission mechanism work.

The Chinese financial community has always watched the evolution of the Basel Accord closely. As early as in 1994, the PBC initiated the regulatory indicators on commercial bank's capital in its circular 38 entitled "*Notification on Balance Sheet Management of Commercial Banks*", and required

that the ratio of monthly average capital of commercial banks to monthly average risk-weighted assets be no less than 8 percent, while the ratio of average core capital of commercial banks to monthly average risk-weighted assets be no less than 4 percent. The *Commercial Banking Act of 1995* also stipulated that capital adequacy ratio (CAR) of commercial banks be no less than 8 percent.

However, for an extended period of time, no regulatory actions were ever taken against banks with inadequate capital. Concession was even allowed in the calculation of CAR. Compromise was made in the loan asset classification and bad debt provisioning rules in 1997. In the absence of realistic classification and sufficient risk provisioning, CAR can hardly indicate the risk of the bank. These problems made it impossible for bank regulatory rules to rein in the excessive credit expansion of the commercial banks. The result was that bank rules were not fully implemented and capital ratio was notably inadequate.

In fact, the Basel Accord is a comprehensive regulatory and internal assessment system. Its essential indicator, capital adequacy ratio embraces earning objective while effectively containing the excessive expansion of the bank. The numerator of CAR indicates the capital adequacy of the bank and robustness of the buffer against shocks. The more capital, the more resilient a bank is against risks. Meanwhile, dynamics of capital depends on retained profit. When a bank calls for additional capital, the investors look at the earnings of the bank. An unprofitable bank can hardly attract external finance. In addition, expansion through merger and acquisition is also subject to capital constraint. The denominator of CAR assigns different risk weights to assets so as to drive banks towards less risky business and away from high risk business. Risky business must be supported by more capital. This effectively contains the excessive growth of risky assets. The Basel II initiated the so-called "internal rating base" (IRB), encouraging banks to identify asset risks through internal rating system. The risk weighting system encourages non-asset business, or commission-based business. The Accord will also boost asset securitization since securitization lowers risk level of assets thus lowers capital requirements. In a way, it encourages banks to shift, sterilize and lower risks by all means. In this sense, such an indicator is a combination of incentive and control mechanisms, while encouraging technical innovations to improve credit asset quality.

Nevertheless, a principal problem in applying CAR to Chinese banking institutions is that different banks bear different historical legacy, which is difficult to measure by a unified standard. This historical problem should be solved by more aggressive reforms before more stringent regulations could be applied and serve as the core objective to improve their corporate governance and business operation. In this spirit, in 2003, the China Banking Regulatory Commission initiated the 3-year plan for banks to comply with Basel II.

Some technical issues deserve attention, which, if not properly dealt with, may dampen the effectiveness of the policy. For instance, for banks with inadequate capital, the so-called "shadow calculation" may leave a lot of leeway. For banks with lower than 4 percent of capital adequacy ratio, strict regulatory measures have been taken. However, for banks with capital ratio sliding down from 8 percent to 4 percent, no adequate restrictions are imposed. In this respect the differentiated reserve requirement ratio to be applied from April 25 will help regulatory implementation. In sum, only when the micro foundation with well-defined business objectives and control mechanisms is in place, could monetary policy transmission work.

II. In a transition economy, policy-makers tend to rely on quantity measures and avoid price instruments. In fact, the experience of price reform shows that price mechanism is often more effective than expected.

Monetary policy transmission mechanism to a great extent determines the choice of instruments. In the monetary policy conduct, there have always been disputes on the pros and cons of price and quantity instruments. Currently, price instruments such as interest rate and exchange rate coexist with quantity instruments such as liquidity absorption and foreign exchange control.

For an extended period of time in China, quantity measures were preferred while price instruments were seldom used. This was the expediency given the constraints of the transmission mechanism as well as the result of the policy legacy from the demand economy mentality. A centrally planned economy emphasized quantity control. When demand and supply are out of balance, quantity indicators are often imposed to increase supply or contain demand. The same mentality, when applied to the financial sector, tends to tighten liquidity when there is inflationary pressure, and in the sequence of policy choice, price instruments are only considered after quantity control. Some believe

that in financial sector transition, the borrowers, e.g. the SOEs, and lenders, e.g. state-owned banks are not sensitive to price movements. However, empirical studies did not support this assumption. China has been gradually moving to focus on the use of price instruments. An example would be that when inflationary pressure emerged at the beginning of this year, the central bank adjusted its lending rate and rediscount rate.

As a matter of fact, the effects of and responsiveness to price instruments usually turn out far better than expected. Examples are abundant. It is foreseeable that with market liberalization of the economy, price mechanism will play a more prominent role and there will be more willingness to use price instruments. It should be noted that when the actual price is close to equilibrium, price is elastic and price instruments are more effective. Whereas if the actual price is too far from equilibrium, price may not longer be elastic and price instruments cease to be effective. This can be proved by empirical analysis.

III. The study of monetary policy transmission should also look at the game between macro adjustment and micro agencies.

The decision-making process and policy implementation have always been a game between macro adjustment and micro agencies. "When there is a policy, there are countermeasures to circumvent the policy" would be a vivid description of this game relation. Monetary policy transmission and its effectiveness are no exception. Any information structures and monetary policy conduct models will affect the monetary policy transmission. For instance, market can often find ways to preempt a monetary policy measure or sterilize its effects through ex post actions. Changes in the asset portfolio can help evade policy restrictions. An excellent example would be the textbook version of how micro agency could minimize the effects of official reserve requirement.

In a transition economy, political bargaining and lobbying for "exemption" should be guarded against. In the transition process, due to difference of regions and sectors, to a policy that would have been applicable across the board, there will be large number of applications for "exemption". In the financial sector, since quite a number of financial institutions have a variety of policy lendings as a historical legacy, any restrictive policy may arouse one-to-one bargaining and dampen the monetary policy effects. For instance, central bank lending was originally designed to provide short-term liquidity assistance, but evolved to be persistently abused for all sorts of reasons. When a change in central bank lending rate is called for, there will be bargaining for exemption. The floating lending rate recently adopted by the central bank was to curb the one-to-one bargaining behavior in principle. Otherwise, central bank lending rate as a monetary policy instrument will fail in the transmission.

IV. The study of monetary policy transmission mechanism should care about incentive mechanism.

For an extended period of time, no sufficient importance has been attached to incentives. The current situation in China is that banks with good or bad performance have little difference in terms of rewards. In order for policies to be effective, positive incentives must be put in place to break the old system of "eating from the same big pot", and "same reward for good and bad performers". The phenomena of the "subsidizing the lean by exploiting the strong" or "the fast oxen get whipped" should be guarded against. Distorted incentives will not only bring down a good bank, but also result in "adverse selection" and "moral hazards". There are ample examples in the financial sector. For instance, good performers in terms of earnings, tax payment and share-holder return are usually not positively rewarded, whereas financial institutions in distress are often the priority of re-capitalization and favorable NPL disposal policies. It is worth noting that with market developments, the capital market will promptly catch the differences among banks. With corporate restructuring and eventual public listing of the state-owned commercial banks, the market will gradually play the role of incentive mechanism, thus enhance the effectiveness of monetary policy transmission.

In this respect, we can learn a good deal from the experience of countries of more mature market economy. And prompt corrective action (PCA) is a valuable tool. Measures must be available to impose sufficient external pressure on financial institutions whose risk profile and asset quality worsen. These actions also carry the unmistakable messages that poor performance is not welcomed but restricted. A typical example would be the *Federal Depository Insurance Corporation Improvement Act (FDICIA) of 1991*. The main content of the act is capital adequacy categories and their corresponding corrective actions. Banks with capital adequacy ratio of 10 percent and more are defined as

adequately capitalized. When capital ratio slides to 8 percent, mandatory corrective actions such as “may not take trust deposits” is imposed. Banks of lower than 8 percent capital are “under capitalized” and the correction actions include “may not take trust deposits; may not make any capital distribution or pay a management fee; growth of total assets must be restricted; must submit capital restoration plan and prior approval is required to acquisitions, branching, and new lines of business and some discretionary actions”. Additional discretionary corrective actions may be imposed. For banks of lower than 6 percent capital, in addition to the above measures, “transactions with alliance must be restricted; interest rates paid on deposits, and bonuses and salary raises to senior executives officers must be restricted”. Banks with under 4 percent capital adequacy ratio are “critically undercapitalized”, and must be prohibited from paying interest on subordinated debts and activities must be restricted. If things do not improve within 4 quarters, they must be placed under receivership. These actions proved effective in containing the business expansion of risky institutions and prevent risk from worsening.

Currently, a large number of countries have adopted different PCA systems. We would say the differentiated reserve requirement ratio is an experiment to establish positive incentives under the given circumstances in China. In any country, because of the differences in the legal system and regulatory authority, agencies have different competence and tools at hand. Therefore, it often calls for a combination of forces and measures to implement such PCAs. Currently in China, the incentive system is vulnerable. Reform will be accelerated to solve the historical problem and lay the level field for competition. Only when incentive system is established and improved to guard against “reverse selection” and “moral hazards”, could the effectiveness of monetary policy be ultimately assured.

V. The study of monetary policy transmission mechanism should also consider the impact of ageing and social security system on the effects of monetary policy.

The current financial situation is characterized by fast growth of money supply and credit but muted CPI growth and high investment ratio. In 2003, investment ratio increased by 6 percentage points and M2-GDP ratio was very high. This should draw our attention. An optimal economic structure would have a higher consumption-GDP ratio. Final consumption is an important signal for future investment. Without a clear signal from rising final consumption, the future return and sustainability of investment are doubtful. To address this problem, it was suggested that consumer credit be increased, together with a number of supporting measures in pricing consumer credit, financing support and regulations. However, in this process, it is important to keep a balance between establishing social security system and encouraging credit consumption.

Some analysis shows that consumption in China is greatly constrained by two factors. One, inadequate social security system, especially the unfounded pension and health care system dampened consumer confidence. On top of it is the concern over the education expense for children. In the transition to market economy, some services that used to be public goods gradually turn to operate under the rule of market. Meanwhile, no social security system is put in place. This deterred consumption, increased prudent savings and affected consumer confidence. It is encouraging news that Liaoning Province initiated the pilot programme on social security system reform. The intensity of the reform is probably not enough and more in-depth research is needed. The second constraint is the demographic structure. China will gradually move to an ageing society. The social security system is still largely built on a pay-as-you-go basis, which effectively makes the young generation save more to account for the surging claims on the pension system. Under these circumstances, efforts to encourage consumer credit need to look at the inter-generation consumption behavior. If the young generation takes advantage of consumer credit while the share of aged population in the society increases, the sustainability of the PAYG system will be threatened, so will the future payments of the already under-funded pension system. From this standpoint, careful consideration must be given to establishing and improving the social security system where the central bank’s concern is established from a macro adjustment perspective. Moreover, any deficiency in the social security system may dampen the transmission of monetary policy intended to encourage consumption, and make such a monetary policy move impotent.

A broader view reveals that another big threat to monetary policy and financial stability is fiscal deficit. Excessive and rolling government securities also affect the effectiveness of monetary policy transmission. The current deficit in China is not large but implicit fiscal deficits are more difficult to deal with. Economic growth may help reduce the NPLs evolved from policy credit, implicit deficits of the under-funded social security system is more problematic. If no solution is found for the social security

issue, implicit fiscal deficits will hamper the monetary policy transmission and thus dampen the desired effects of monetary policy measures.