

Zhou Xiaochuan: Exclusive Interview with the *People's Daily*

Mr Zhou Xiaochuan, Governor of the People's Bank of China, recently had an interview with a reporter of the *People's Daily*.

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Reporter: On monetary policy in 2004, people said that although the central bank had taken very effective measures, it had tightened money supply too much. How do you comment on this?

Zhou: There is a time lag between the supply of money and the changes in economic activities. The higher-than-desired level of money supply in 2003 had its special background. The new leadership of the central government was formed in March 2003, followed by the outbreak of the war on Iraq and the SARS epidemic. These uncertainties prevented us from adopting a tight monetary policy stance. We had to carefully watch the situation to cope with the adverse impact brought by these events. After initial progress was achieved in the fight against SARS, we began to take measures to control money and credit growth. Nevertheless, given that all sectors of the economy wanted to make up for the slack from the SARS epidemic through expanded economic activities, those control measures were only moderate in nature. Against such a background, money supply in 2003 was unduly high, with the effects lingering into 2004. Money supply was tightened somewhat in 2004. The average growth rates of broad money (M2) and narrow money (M1) during 2003 and 2004 were 17 percent and 16.3 percent respectively, slightly higher than the average growth rate for the previous five years which is 15 percent. To judge whether money supply at a particular point of time is appropriate, we have to take into account the time lag effect as well as the interest rate in the money market.

Reporter: What do you think of the credit structure?

Zhou: With aggregate money supply being broadly appropriate, certain problems in the structure are inevitable to some extent. We require the commercial banks to differentiate credit policies to different sectors and improve their credit services to the small- and medium-sized enterprises. At the same time, we should note that with changing market circumstances, demands of the enterprises are also changing. While strengthening and improving window guidance, the central bank should also take measures to promote the reform of the commercial banks to better resolve the structural problems.

Lack of fund, particularly of working capital faced by some regions and enterprises is related to over-investment and excessively large inventories. Some enterprises have used their working capital to finance the investment projects. Moreover, working capital of some enterprises has been adversely affected by the pile-up of inventories. Statistics show that the stock of raw materials of 5000 enterprises increased by about 37.3 percent, 25 percentage points higher over end-2003.

Reporter: The central bank will continue to pursue sound monetary policy in 2005. What does "sound" mean? What are the issues that deserve special attention in formulating and implementing monetary policy in 2005?

Zhou: Briefly speaking, sound monetary policy aims at preventing inflation and systemic financial risks.

At present, the inflationary pressures have not been fundamentally alleviated. Higher prices of water, electricity, fuel and urban transportation services may push up CPI. Continued increase of prices of production materials will gradually feed through to CPI with some time lag. The prices of oil and certain important raw materials in the international market will also affect the development of domestic prices. In addition, the increase of household disposable income and consumer demand will lead to higher CPI. All these deserve our close attention.

To implement the sound monetary policy, we will take steps in the following five areas. First, strengthening the forward-looking approach so that we will be able to judge economic and financial development more accurately. Second, further improving the indirect management tools and flexibly applying the mix of various monetary policy instruments to ensure steady and appropriate growth of money and credit. Third, encouraging the financial institutions to improve their credit structure to enable the prices to play a larger role in promoting balanced economic aggregates and structural adjustment. Fourth, closely monitoring external economic and financial development to promote balanced international payments. Fifth, appropriately dealing with the market exit of some financial institutions to maintain the stability of the financial system.

Reporter: Just now you mentioned the role of the prices. We can clearly recall that on October 29, 2004, the central bank announced its decision to raise the interest rate, a step that arrested the world attention. Many people predicted that China would from then on enter into a period of repeatedly but moderately raising the interest rate. Will the central bank again issue the news attracting the world attention as it did last year? At present, the increase of prices seems to exceed the deposit interest rate. In addition, interest tax is imposed on the deposits. So the real interest rate on deposits seems to be negative. Will you take measures to address the “negative interest rate”?

Zhou: China is in the transition from a planned economy to market economic system, therefore its economic development does not display clear cycles as the matured economies do. In the matured market economies, due to the obvious cycles in economic growth, the adjustment of interest rate also show a periodic feature, that is, raising the interest rate in one period and cutting the rate in another. The pattern of economic cycles in China is not yet that stable, so it's not appropriate to say that we have entered a certain period. The central bank's decision on raising the interest rate will be based on the close monitoring of the changing economic and financial situation and timely analysis of the development of macroeconomic indices.

With regard to the “negative interest rate”, we shall understand that interest rate policy is not meant to ensure that the real interest rate is positive at any particular point of time. Instead, it depends on various factors.

First, the month-on-month CPI in China is significantly affected by seasonal factors. It may be high in one month and much lower in another. As regards the year-on-year CPI, it should not be used as the sole basis for judging whether the real interest rate is at an appropriate level, since the base figure of the same period of the previous year may contain some abnormal factors. Therefore, we should base our judgment on careful analysis and forecast.

Second, the saving rate in China is very high. Large amount of savings have been channeled to investment projects, leading to overheating in some sectors. The Premier's report on the work of the government pointed out that steps will be taken to boost domestic demand by expanding consumption. High interest rate on deposit will adversely affect the efforts to increase consumer demand.

Third, investment can be financed by savings through many channels, including the banking system, capital market and direct investment. In China, an excessively large share of financing is made through the banking system, while that made through the capital market and direct funding is relatively low. So the asset-liability ratio or debt to equity ratio of the enterprises is unduly high. We will take measures to promote the funding of investment through channels out of the banking system.

In sum, whether the interest rate of deposit is positive or negative is not the only consideration in formulating the interest rate policy. There are various factors that need to be considered in setting an appropriate interest rate level.

Reporter: On March 16, 2005, the central bank announced its decision to modify the policy on individual housing loans. The new policy prescribes that preferential interest rate is no longer applied to the housing loans, and in the cities where the housing prices have been going up sharply, the minimum down payment may be raised to 30 percent of the total payment. This decision has aroused strong response from the public. What are the considerations behind this policy change?

Zhou: The excessively rapid increase of housing prices, if not duly contained, will bring risks to the market and adversely affect the individuals that plan to purchase or rent houses. Various policies are involved in the management of housing prices. Monetary policy is targeted at economic aggregates. Therefore, we cannot expect that monetary policy alone can fairly address concerns of every participant in the economy.

By changing the housing loan policy, the central bank intends to promote a reasonable expectation among consumers on the prices of funds. The individual housing loans are medium- and long-term loans with floating interest rate. The interest rate is adjusted annually in line with changes in economic situation. It is wrong to think that housing loan rate should always be kept low regardless of the development of housing prices and the general price level. In the past, the interest rate of individual housing loans is called “preferential interest rate”, which may lead to a misperception that the rate is always “preferential” no matter how economic condition changes. Some people have not adequately assessed the risks involved. For example, the prices of the houses they have bought are too high relative to their income, resulting in heavy debt burden. And some people have purchased excessively large and luxury houses. All these indicate that consumers should properly understand the repayment

burden and risks resulting from changes in the interest rate. The minor revision of housing loan interest rate policy is aimed at promoting risk awareness of the consumers.

The policy change has more important implications for the banks. China's housing reform started in the late 1990s, and was basically completed in recent years. Housing loan is a new business for most banks. Compared with traditional loans, housing loan proved to be a good asset in the banks' total loan portfolios, so the banks have been actively engaging in this business. However, potential risks and problems may exist in China's housing loan market. First, with only a few years' development, the housing loan market in China has not accumulated sufficient data that reflect default rate in the long and medium term. Second, the default rate may go up when economic activities become weaker. Therefore, we should not be over-optimistic about the prospect of housing market development. Strict measures should be adopted to regulate the market. By modifying the housing loan policy, we intend to promote greater risk awareness of the commercial banks. They are encouraged to draw up their own strategies to develop the housing loan business based on careful consideration of various factors including relevant costs and probability of default in the long and medium term.

Moreover, the development of housing prices differs substantially across the country. They have been rising in most cities. In some cities, the rise has been sharp or extremely sharp, while in others the rise has been moderate. Therefore, it is desirable to adopt differentiated policies. The bank associations have been given discretion to set the interest rate on housing loans. As to the ratio of minimum down payment, the commercial banks are encouraged to make their own decision in light of the local situation, window guidance of the central bank, self-disciplinary mechanism set by the bank associations and regulatory requirement of relevant authorities.

Reporter: Will the central bank adopt new policies to prevent further rise of the housing prices?

Zhou: International experiences show that the authorities mainly rely on the benchmark rate policy to regulate housing prices. After the housing loan policy was revised, only the loans based on housing provident fund bear preferential interest rate, while the interest rate of commercial housing loan has been raised to the same level as that of other types of loans. If the benchmark rate is to be adjusted in the future, it will also affect the housing prices.

Interest rate policy is targeted at many economic variables, including economic growth, employment, consumer and producer prices, asset prices, etc. Housing prices constitute only part of the asset prices. If most of the variables are moving in the same direction, we will of course use the interest rate policy. However, when these variables move in opposite directions, it is not easy to select the key variable at which to target the interest rate policy

Reporter: With regard to the reform of the state-owned commercial banks, some people described the progress in financial restructuring as "physical changes" and the improvement in corporate governance as "chemical changes". There have emerged some cases since the Bank of China and the China Construction Bank started their joint-stock reform. People say that this indicates the reform has not produced chemical changes in these two banks. What's your comment on this? Will these cases affect the public listing of the Bank of China and China Construction Bank and the joint-stock reform of the Industrial and Commercial Bank of China and the Agricultural Bank of China?

Zhou: The so-called "chemical changes" have already occurred in the Bank of China and the China Construction Bank. First, they have already established and gradually improved the basic framework of corporate governance. Second, they have made great efforts to strengthen internal control and risk management. Third, the personnel management system and incentive mechanisms of these two banks have improved. Fourth, their credit culture is improving. And lastly, they have placed greater emphasis on protecting the shareholders' interests.

In general, these two banks have made substantial progress in improving their corporate governance, but certain problems remain. Financial restructuring can be completed within a relatively short period of time, while the improvement in corporate governance will have to take longer time. As for the non-performing loans, it is quite normal for the commercial banks to have some non-performing assets since they are engaged in many risky businesses. As long as the amount of incremental non-performing loans of a given year is managed within a normal range and can be covered by the bad loan provisioning of that year, there's not much to worry. Otherwise the non-performing assets may erode the banks' capital, putting the banks in an unhealthy situation.

With regard to the cases that happened in some banks, serious lessons will be drawn so as to improve the future work. I believe that these cases will not have a substantial impact on the overall reform process of the state-owned commercial banks. The reform has been carried out in a pragmatic and

step-by-step manner. On the one hand, reform will be strengthened with the lessons drawn from these cases. On the other hand, the cases themselves indicate that the old systems and mechanisms are still playing a negative role, calling for greater reform efforts.

Reporter: In addressing a question from the media at the NPC and CPPCC press conference, you said that it won't take too long for the Bank of China and the China Construction Bank to get listed. Could you further explain what "not too long" means. Is there a timetable for the reform the Industrial and Commercial Bank of China and the Agricultural Bank of China?

Zhou: As to when and where the Bank of China and China Construction Bank will get listed, this depends on the decision of the boards of directors of these two banks. It also depends on whether there is a suitable window for listing operation in the capital market as well as on the opinions of their financial advisors, major underwriters and accounting firms. By saying "not too long", I mean that these two banks have basically met the requirement according to the major criteria for public listing in the capital market.

Efforts will also be made to push ahead with the reform of the Industrial and Commercial Bank of China and the Agricultural Bank of China. The office of the leading group for the pilot joint-stock reform of the state-owned commercial banks has already submitted to the State Council the overall plan for the financial restructuring of the Industrial and Commercial Bank. The reform will be carried out in accordance with the arrangement of the State Council when conditions mature. The Agricultural Bank of China is encouraged to strengthen its internal control and risk management to improve its profitability and asset quality so as to pave the way for the joint-stock reform.

Reporter: The market-based interest rate reform is an important element of last year's financial reform. The central bank has recently published a special report on the market-based interest rate reform. What is your conception on the market-based interest rate reform in the future?

Zhou: It was clearly pointed out at the Third Plenum of the 16th CPC National Congress that steps would be taken to steadily advance the market-based interest rate reform and improve the interest rate formation mechanism based on market supply and demand, and the central bank would guide the movement of market interest rates by applying various monetary policy instruments.

In recent years, the central bank has been making steady efforts to advance the market-based interest rate reform. Two important measures were adopted in 2004. First, the band of interest rate on loans of the financial institutions was widened on January 1, 2004. Second, the upper limit on loan rate and lower limit on deposit rate were removed on October 29, 2004. At present, there are only two control measures for interest rate, one is the ceiling imposed on RMB deposit rate and the other is the floor set for RMB lending rate.

With the above two steps taken, the near-term goal for the reform of the interest rate system can be considered as basically realized and there will be no further reform measures in this regard in the near future. Of course, the commercial banks still need to make sustained efforts to enhance their ability to properly assess risk and set prices.

The upper limit on loan interest rate and lower limit on deposit rate will be maintained for a relatively long period of time before consideration can be given to remove them. This is because such reform involves the consideration of many factors including the order of market competition and the amount of interest rate spread. If the financial and capital constraints of the banks are not strong enough, removing these two limits is likely to result in improper competition in the market.

Reporter: Recently, there has been an international chorus for the revaluation of the RMB so as to reduce the huge trade deficits of some countries with China and to fix the global economic imbalance. There have also been capital inflows to China speculating that the value of RMB will appreciate. So I would like to ask whether the RMB will be revaluated? If yes, when?

Zhou: In setting the exchange rate policy, we will mainly take into consideration of China's domestic economic situation and balance of payments, rather than the bilateral trade deficits or surpluses with some individual countries.

Regarding China's international balance of payments, our current account is in moderate surplus. Of course, we need to reform the mechanism for determining the RMB exchange rate so that we can maintain financial stability in the medium- and long term as we continue to integrate with the world economy.

We will make active and steady efforts to push ahead with the reform of the RMB exchange rate regime on a well-planned and step-by-step basis. Relevant policy measures will only be taken at proper time. Given that China is playing an increasingly important role in the global economy, we will assume a responsible attitude and take into consideration the impact of RMB exchange rate reform on the regional and global economy.

Judging from China's current balance of payments, our task in the future is mainly centered on improving the mechanism for determining the RMB exchange rate rather than simply adjusting the rate.

Reporter: Since last year, you have mentioned on many occasions the notion of "financial ecology". It seems to be an entirely new concept. Could you further explain it?

Zhou: "Financial ecology" does not refer to the internal operation of the financial institutions. Instead, it refers to the external environment, or the basic conditions for financial operations. I am not the first to use this concept.

First, the legal framework, including the laws and regulations that protect the interests of investors and depositors, the accounting standards and the bankruptcy law, is a key component of financial ecology.

Second, financial ecology also involves the market system, including the intermediary system. Many intermediary services are not provided by the financial institutions themselves. The intermediaries, including the lawyer's offices, accounting firms and rating agencies play a very important role in the financial services. Weakness in these sectors will adversely affect financial operation and the development of the social credit system.

In addition, since the non-performing loans of the banks are closely related to the creditworthiness of their clients, the reform of the corporate sector constitutes another important part of the efforts to improve financial ecology. Insufficient progress in the reform of the enterprises would make them more vulnerable to financial problems, thus leading to higher NPL ratio of the banks.

Ecology is a systemic concept, so concerted efforts from all sections of the society are needed to improve financial ecology. First, efforts should be made to improve the legislation and law enforcing system. Bankruptcy law is of utmost importance. With well-developed bankruptcy law, the lenders will be able to resort to legal procedures to protect their rights. Second, the reform of the corporate sector including the state-owned enterprises should be accelerated. Third, steps need to be taken to establish and improve the social credit system and strengthen the collection of credit data. Fourth, the accounting, auditing and information disclosure standards should be improved. Fifth, the intermediary agencies need to improve their services.

Improvement in financial ecology is also a kind of "chemical changes" that you mentioned just now. It is not a "chemical change" within the financial institutions. Instead, it is a change from both inside and outside. A relatively long period of time is needed for such changes to take place.