

Wu Xiaoling: Improving monetary policy transmission, creating a sound financial environment

Speech by Ms Wu Xiaoling, Deputy Governor of the People's Bank of China, at the Annual Conference of China Economic Forecast, Analysis and Outlook, Beijing, 20 March 2005.

* * *

In the first two months of 2005, the economy ran smoothly as the supply of money and credit grew steadily. By the end of February, M2 increased by 13.9 percent yoy; the RMB loans went up by 13.4 percent with newly issued mid- and long-term loans accounting for 46.7 percent, or 4.5 percentage higher yoy, but 13.8 percentage points lower than that of last year as a whole, indicating some structural change.

During January and February, the fixed investment in the urban areas increased by 24.5 percent yoy. Real estate investment grew by 27 percent, lower than that of the same period last year, but still at a rather high level. New starts continued to grow and projects under construction were of large scale.

In January and February, the CPI went up by 2.9 percent. According to the statistics of the NBS, the PPI jumped by 7.2 percent yoy. With prices of raw materials, labor and land trending upward and their downstream impacts growing, the inflation pressure is on the rise, even though inflation is still seen as can be controlled within 4 percent for the year.

The People's Bank of China (PBC) will do its best to maintain a stable growth of money and credit through using a range of monetary policy tools.

In 2005, the PBC will improve monetary policy transmission to increase the effectiveness while strengthening the preemptive and scientific approach in conducting monetary policy. Being an important part of the monetary policy transmission process, the commercial banks shall enhance promptness in responding to macro-developments and contribute to financial stability when maximizing profits and controlling risk.

I. The commercial banks shall respond to macro-developments promptly

A. Generally speaking, legislation and macro-policies aim at maintaining fair competition and efficient allocation of resources, reflecting the overall interests of the whole society. Under this framework, a positive interaction is formed among the legislative bodies, macro-adjustment departments and the public, which would also contribute to cushioning big shocks to the economic and social development.

Policy circumvention may in some cases reflect the reactions of micro-entities to the deficiencies in macro-policies. However, with the goals of national economic and social reform becoming clear, and with market mechanism, government administrative capacity, macro-policies transparency being improved and more channels reflecting problems in the economy, in coordinating macro-policies our aim is to make the commercial banks pay more attention to macro-policies. We should also enhance the effectiveness of monetary policy through better transparency and stronger credibility of the central bank.

B. Commercial banks shall pay more attention to various legislations and incorporate state laws, regulations and supervisory requirements to their internal controls, guided by the business philosophy of maximize profits within the legal framework.

- Most financial risks stem from malpractice;
- Legal risks and regime risks are greater than operational risks;
- Legal department and auditing department should become two of the most important departments of commercial banks.

C. Commercial banks shall put more emphasis on national industrial policy and credit policy in conducting industrial analysis, allocating loans, seeking profitable opportunities and avoiding risks.

The sustainability of China's economy is restrained by limited supply of primary energy, land and water. In building a well-being society, the government advocates scientific development approach.

Industrial policies will definitely be oriented to energy-efficiency. Commercial banks should keep this in mind while lending in order to avoid future losses.

In industrial analysis commercial banks can also consider outside sources, such as credit policy guidance of the central bank and research of consulting firms.

II. The commercial banks shall improve risk pricing ability while implementing differentiating lending policy

A. It is essential for macroeconomic adjustment that commercial banks enhance loan-pricing ability and control risks using economic capital in their efforts to improve credit structure.

Loan pricing requires proper risk identification and measurement that rely heavily on accumulation of historical data. In transitional period, it is a practical choice for commercial banks taken into consideration changes in industrial policy, trends in sectoral development and the advantages and disadvantages of businesses in decisions concerning asset pricing and capital allocation.

B. It is crucial to cultivating potential customers and generating profits that the commercial banks to take full advantage of risk pricing and differentiate customers.

Although mature clients provide banks with stable sources of profit, with the development of the capital market, good businesses obtain financing by tapping corporate bond market and issuing commercial papers in a way to lower their costs. As a result, banks cannot avoid competing for a handful of good customers unless they turn to find potential customers among a sea of small and medium businesses.

Small- and medium-sized businesses are an important engine for social economic development and provide a crucial source of jobs. The sound operational requirements of banks have made it difficult for them to extend credit to these businesses at their starting stage. As they grow and expand, banks can come in to help by charging higher risk premium and providing financial advice. As competition intensifies, to expand market is not only required by economic development but also meets banks own interests. As serving the society and return its kindness is the responsibility of all businesses, and the reason of the success of age-old brands, it should become the aim of financial sector too.

III. Efforts should be made to lay the foundation of monetary policy transmission through promoting interest rate liberalization, financial innovation, and formation of a government bond yield curve.

The yield curve of government securities provides a benchmark for pricing of financial products. At present, the term structure of government securities cannot form a complete fixed income product yield curve. PBC's issuing of central bank bills of one-month, 3-month, half-year and one-year terms takes place of the absence of short-term treasury bills. Even though central bank bills and treasury bonds are of same risk category, the segmentation of treasury market hampers the formation of a complete yield curve. In order to form a benchmark yield curve, management of securities issuance should be replaced by management of outstanding debt, and improvement in securities registration is required as well.

B. For the financial products and costs of funds to reflect changing market conditions, further efforts are needed to promote market-oriented interest rates.

Progress achieved by the PBC in moving toward market oriented interest rates in 2004 included removal lending rate ceiling and deposit rate floor. In the meantime, the PBC still controls the interest rate spread of deposit and lending and a number of specific interest rates. This is because spread income still dominates commercial banks' income and their internal controls are still weak. The aim of interest rate liberalization is to eventually let the central bank control the benchmark rate and leave the discretion of spreads to commercial banks.

The interest rate of excess reserves was lowered to guide the money market rate.

C. Financial innovation of commercial banks should be encouraged to create more instruments for asset and liability management and increase their adaptability to macro-adjustments.

The discretion of financial innovation shall be left to the commercial banks as the PBC proceeds with interest rate reform that creates conditions for them to price their products. Efforts shall be added to promote CDs, financial bills, subordinated bonds and asset-backed-securities, and issuing and trading of corporate financing bills and corporate bonds.