

China Financial Outlook

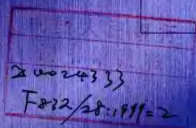
2009



THE PEOPLE'S BANK OF CHINA

2009

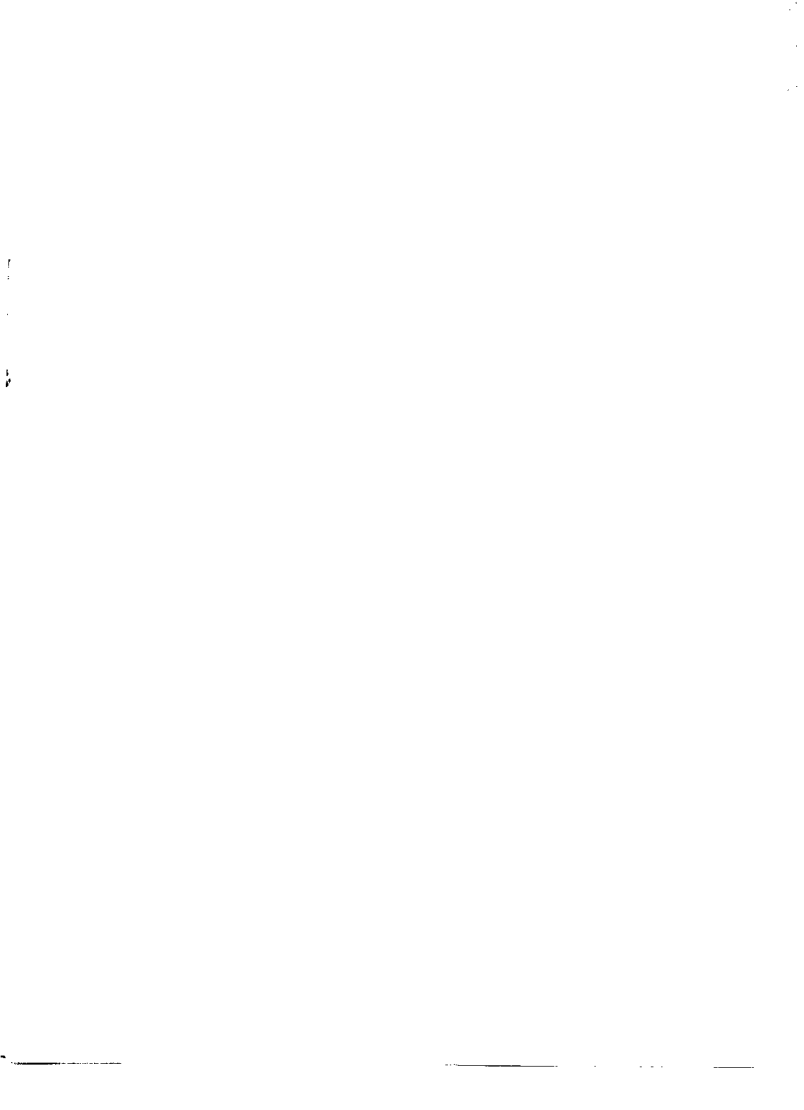
China Financial Outlook



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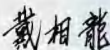
The year 1998 was very unusual for China in its two decades of reform and opening-up. China weathered both the shocks of the Asian financial crisis and the severe flooding. The economy maintained a favorable growth momentum, the renminbi exchange rate kept stable and financial reform and opening progressed steadily. Work in the financial sector was pursued with vigor.

The Chinese financial sector developed steadily and soundly in the course of reform. Based on the needs of a socialist market economy, a framework of financial institutions, markets, monetary control and supervision systems has been basically set up. While making endeavors to prevent and resolve financial risks, the PBC implemented a series of measures to appropriately increase money supply and strengthen foreign exchange administration, which contributed to the realization of the macroeconomic targets.

Financial reform took critical steps forward. Credit ceilings for the state commercial banks were eliminated. The required reserves system was reformed. Floating range for interest rates was widened. The transition to indirect monetary control was basically completed. The PBC established nine inter-province (autonomous regions and municipalities) regional branches and eliminated its provincial branches, smoothly completing the reform of its management system. Meanwhile, through the establishment of Financial Commission of the Central Party Committee and the Party Committee for Financial Institutions, a unified party leadership for the financial sector has been enhanced.

Financial supervision of the central bank was further strengthened. At the PBC headquarters, supervision departments were reorganized according to the classification of financial institutions. Consolidated supervision was introduced for domestic and overseas financial institutions, for local and foreign currency business, and for on- and off-balance sheet operations. Risks of some financial institutions were resolved through merger, acquisition, restructuring, takeover and closure. These actions contributed importantly to maintaining social stability and preventing the spread of risks.

In 1999, the tasks of the Chinese financial sector remain formidable. Positive conditions for accomplishing the work agenda include further unfolding of the effect of the policy measures initiated last year to expand domestic demand, relative balance of macroeconomic aggregates and ample foreign exchange reserves and strategic goods such as grain. On the negative side, however, the impact of the Asian financial crisis is lingering. Global economic growth is slowing down. Domestically, the problem of fiscal imbalance is acute; market demand remains weak; and employment pressures are growing. These difficulties present severe challenges to the Chinese financial sector in its effort to accomplish this year's work. Under these circumstances, the PBC is determined to continue and deepen financial reform, improve financial service, implement sound monetary policy, strengthen supervision to prevent and resolve financial risks and facilitate a sustained, fast and healthy economic development. The bank will strive for achievements in reform and development as it welcomes the forthcoming 50th anniversary of the People's Republic of China.



Dai Xianglong
Governor
The People's Bank of China

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Outlook



**OVERVIEW
OF THE
ECONOMY**



MONETARY POLICY OUTLOOK

In 1998, the People's Bank of China (PBC) implemented a series of macroeconomic adjustment and reform measures, which contributed importantly to alleviating external shocks and supporting the expansion of domestic demand. For the Chinese economy, external environment remains severe for 1999. The PBC will adopt a sound monetary policy, steering it to the needs of increasing domestic demand. A variety of monetary policy tools will be used in a flexible manner with a view to facilitate an appropriate growth of money supply.

REVIEW OF THE 1998 MONETARY POLICY

The Chinese economy suffered fairly severe external shocks in 1998. The focus of macroeconomic policy shifted from increasing effective supply and restraining the expansion of aggregate demand to boosting domestic demand and adjusting the structure of supply. In line with this shift, monetary policy turned from tackling inflation to preventing deflation. The choice of monetary policy instruments in 1998 showed new characteristics and the transmission of monetary policy changed notably

Monetary Policy Targets were Basically Achieved

The macroeconomic targets determined by the government at the beginning of 1998 were: economic growth of 8 percent, inflation under 3 percent and stability of the renminbi exchange rate. Monetary policy targets set by the PBC were: growth of broad money (M_2) at 16-18 percent, narrow money (M_1) at 17 percent, and stable renminbi exchange rate. To achieve these targets, the People's Bank of China implemented a series of policy measures

The outcome for 1998 was as follows. The year-end balance of monetary base was RMB3007.54 billion yuan, an increase of 1 percent. The balance of lending by financial institutions was RMB 8652.41 billion yuan, up 15.5 percent. Among this, RMB6844.21 billion yuan was lent by the state banks, an increase of RMB910.04 billion yuan realizing their annual guidance plan of increasing credit by RMB900-1000 billion yuan. The balance of deposits of financial institutions was RMB9568.76 billion yuan, an increase of 16.1 percent. Among this, RMB3248.66 billion yuan was enterprise deposits which grew by 13.4 percent. The balance of household deposits was RMB5340.75 billion yuan, growing by 17.1 percent. Broad money (M_2) grew by 15.3 percent, and narrow money (M_1) by 11.9 percent. Net cash increase was RMB 102.65 billion yuan. Foreign exchange reserves amounted to US\$145 billion, an increase of US\$5.1 billion than the previous year. The exchange rate of the renminbi was at 8.2789 yuan to the US dollar, which represented a 9 basis point appreciation from the end of 1997. Judging from the above indicators, monetary policy targets set at the beginning of the year were basically achieved.

Real GDP grew by 7.8 percent and the retail price index declined by 2.6 percent, basically meeting the macroeconomic targets.

A CHRONOLOGY OF MONETARY POLICY OPERATIONS IN 1998

January	Credit ceilings for the state commercial banks were eliminated.
February	The Notice on Increasing Credit, Strengthening Credit Management, Promoting the Development of Agriculture and Rural Economy was issued. The 1998 guidance plan for credit was finalized. The amount of the plan was 900 billion yuan, 81 billion more than 1997.
March	Interest rates on loans and deposits were lowered. The required reserves ratio and the interest rate on required reserves were lowered. The mechanism for the discount and rediscount rates were reformed. Off-budget deposits and institutional deposits were classified as sources of funds of financial institutions.
April	The Notice on Increasing Credit, Support Housing Construction and Consumption was issued. The plan for the state fixed assets investment loans was issued, and the amount of the plan was increased to 370 billion yuan from 270 billion yuan at the beginning of the year.
May	It was announced that foreign banks were permitted to enter the inter-bank market. The Procedures of Personal Housing Loans, and The Guidance for Improving Financial Services to Support the Development of the National Economy were issued. Open market operations were resumed. The plan for fixed assets investment loans of the State Development Bank was increased
June	The following documents were issued: Supplementary Notice on Further Support to Loss-making State Industrial Enterprises for Their Production of Marketable and Profitable Products; Notice on Strengthening the Management and Promoting the Development of Commercial Bills; Decision on Further Improving Financial Services for Small and Medium-sized Enterprises; Notice on Satisfying the Reasonable Financing Needs of Grain, Cotton and Edible Oil-Procuring and Storing Enterprises for Their Side-line Businesses
July	The interest rates on loans and deposits, on central bank lending and export credit were lowered for the second time. Decision on Further Support for the Development of Foreign Trade was issued.
August	Urgent notice was issued to financial institutions to give full support to the resumption of production for the flood-hit areas.
September	Policy financial bonds were issued to the public by the State Development Bank. Foreign exchange administration was strengthened to strike on illegal activities and maintain the stability of the renminbi exchange rate.
October	The interest rate on US-dollar deposits of financial institutions was lowered for the third time. The interest rate floating range for loans to small and medium-sized enterprises was increased.
November	Rules on Inter-bank Trading of Bonds (provisional), and Settlement Rules for Inter-bank Trading of Bonds (provisional) were issued.
December	Insurance companies were permitted to enter the national inter-bank market. The Notice on Terminating Foreign Exchange Swap Activities was issued, and foreign exchange swap activities of foreign-funded enterprises were terminated from Dec. 1. The interest rates on loans and deposits, on required reserves and central bank lending were lowered for the third time

Monetary Policy Operations Showed New Characteristics

Major reforms were implemented in the monetary and credit control system

Credit ceilings were eliminated and the assets-liabilities ratio management and risk management were fully adopted. As the economic and financial reform deepened and the money and capital markets developed, transmission of monetary policy merely through controlling total credit of the state commercial banks became much less effective. While broad money became a better measurement of the aggregate supply of funds than total credit, narrow money showed more advantages than working capital loans in gauging liquidity conditions of enterprises. The elimination of credit ceilings was also consistent with the requirements of autonomous management of the state commercial banks. Starting from 1994, the PBC has been using money supply as the intermediate target instead of total credit. Meanwhile, it has experimented with the use of indirect monetary control instruments such as the required reserves ratio, interest rates, rediscount and open market operations. Rich experience has been drawn from these experiments and conditions have been prepared for the elimination of credit ceilings.

The required reserves ratio was lowered and the reserves system was reformed. Before the consolidation of required reserve and excess reserve accounts and the 5 percentage points reduction in the required reserves ratio on March 21, 1998, the system was still not satisfactory despite many reform attempts earlier. It had several shortcomings. First of all, a required reserves ratio of 13 percent plus an excess reserves ratio of 5-7 percent added up to a reserves ratio of about 20 percent, which was excessively high. And such reserves had actually become important sources of funds for credit allocations of the People's Bank of China. Meanwhile, required reserves accounts and excess reserves accounts were separate, and the former could not be used for the clearing and settlement among financial institutions. In addition, interest rate arbitrage was evident when the interest rate on required reserves was excessively high. The purpose of the reform measures introduced in March was to tackle these problems. The 5 percentage points reduction in required reserves ratio enabled financial institutions to have RMB57 billion yuan additional funds available in the year. The interest rate on required reserves was lowered by a fairly large margin, thus weakening the arbitrage motivation of financial institutions.

Open market operations was developed. In the second half of 1998, the amount of the base money that the PBC injected through open market operations reached RMB70.1 billion yuan.

Expanded the floating band for interest rates on loans to small enterprises. The upper band was increased from 10 percent to 20 percent and the lower band remained at 10 percent for lending by the commercial banks and urban credit cooperatives. For lending by rural credit cooperatives, the upper band was expanded from 40 percent to 50 percent. The changes provided fresh incentives for financial institutions to lend to small enterprises.

Commercial banks were encouraged to improve the management of credit funds. In line with the needs to expand domestic demand, the central bank urged the commercial banks to give certain credit discretion to their branches and to lower the interest rate on deposits of branches with the headquarters. The purpose was to enable branches at all levels to make lending decisions on the basis of asset quality and the needs of local economic development, thus meeting the reasonable financing needs of enterprises for their production and operations.

The central bank lowered the interest rates on three occasions and pushed forward the interest rate system reform In less than 9 months, there were three consecutive reductions of interest

rates on loans and deposits (Figure 1-1). The interest rate structure was further rationalized, and the interest rate system reform was carried forward. First of all, the interest rate on required reserves was lowered for three times, leading to an accumulated reduction of 4.32 percentage points. The central bank lending rates were also lowered for three times and the accumulated reduction of rates for 20-day, 3-month, 6-month and 12-month lending were 3.96, 3.96, 4.05 and 4.23 percentage points respectively. The accumulated reduction of the rediscount rate was about 4.46 percentage points. The deposit and loan rates of financial institutions were reduced by 1.15 and 2.22 percentage points on average. Meanwhile, the rediscount rate was designated as a benchmark rate. In addition, the interest rate on renminbi export credit was adjusted. The above monetary operations had obvious financial effects: interest payment of enterprises was reduced by more than RMB60 billion yuan and the interest payment of government debt was slashed by RMB30-40 billion yuan. They also helped change enterprise and household expectations and stimulate investment and consumption.

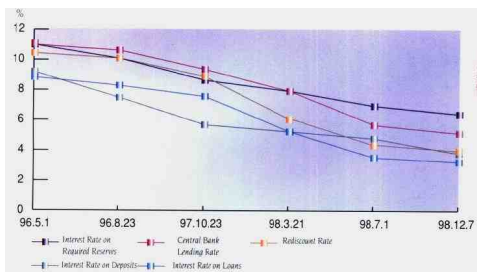


Figure 1-1 Six Reductions of Rates on Deposits and Loans (12-month rates)

Unbalanced growth of credit and money supply The growth of loans and money supply showed a "V" curve. In 1998, annualized growth of loans of financial institutions declined month by month from 16.1 percent in January to the bottom of 15.2 percent in May, and picked up from June (Figure 1-2). The growth of M_2 , M_1 and M_0 followed a similar course except that it reached the bottom in June and began to pick up in July (Figure 1-3). This pattern was in distinct contrast with that of 1996 and 1997. This difference could be explained basically by inadequate economic policy coordination in the first half of the year and the extended time lag of policies due to government restructuring. The effective policy mix achieved in the second half of the year led to a general increase in the above indicators. The proportion of the incremental deposits and loans of the state commercial banks against that of all financial institutions rose slightly. In 1998, the state banks had an excessive proportion in total loans. The state banks' share of total incremental loans reached 78.59 percent, 3.5 percentage points higher than the previous year, and their deposits proportion reached 75.41 percent, 5 percentage points higher than the previous year. The proportion of both loans and deposits of small and medium-sized financial institutions against that of all financial institutions declined.

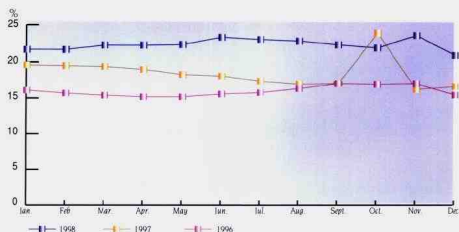


Figure 1-2 Monthly Growth of Loans of Financial Institutions

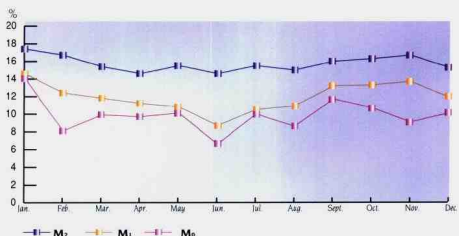


Figure 1-3 Annualized Monthly Money Supply Growth (%)

The structure of base money growth changed and money multiplier showed a trend of rise

Before 1994, base money growth mainly consisted of central bank lending to the state banks. After the foreign exchange system reform in 1994, the renminbi injection through foreign exchange purchase replaced central bank lending as the main source of base money growth.

In 1998, the supply of base money had major structural changes (Table 1-1). First, the supply of base money through foreign exchange purchase was no longer important. Second, after the reform of the grain marketing system, the growth of lending to the policy banks slowed down and accounted for 33 percent of base money growth in 1998 as compared with 53 percent in 1997. Third, lending to the state commercial banks once again became the main channel of base money supply with the proportion of its growth in the total growth of base money rising to 59 percent from negative 54 percent in 1997.

The money multiplier rose in 1998 (Figure 1-4). The broad money multiplier in China has in general shown a trend of slow rise, and has moved up and down within the neighborhood of 3 for the past few years. In 1998, affected by factors such as the reform of the required reserves system and capital replenishment of the state commercial banks, the money multiplier increased to some degree.

Table 1-1 Structural Changes of Base Money (1995-1998)

RMB100 million yuan. %

Main channel of base money supply	1995		1996		1997		1998 (Jan.-Nov.)*	
	growth amount	proportion%	growth amount	proportion%	growth amount	proportion%	growth amount	proportion%
Base money	3640	100	6147	100	3805	100	-1067	100
Foreign exchange purchase	2303	64	2765	45	3027	87	371	42
Lending to the four state banks	-2932	-79	1317	21	-2059	-54	632	59
Lending to the policy banks	3716	103	1647	27	2031	53	352	33

*Excluding the amounts resulting from the required reserves system reform and accounts transfer of the Agricultural Development Bank of China.

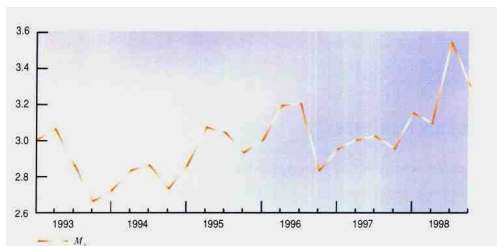


Figure 1-4 Change of the M_2 Multiplier

Window guidance played an important role As a selective monetary policy instrument, window guidance is merely of a suggestive and guidance nature. It has no direct influence on base money or the money multiplier, and acceptance by the commercial banks is optional. However, monetary operations in 1998 actually changed the contents of window guidance. First, credit policy became an important basis and subject for window guidance. Second, the amount and speed of extending credit became an important target of window guidance.

Monetary and fiscal policies were closely coordinated In the second half of 1998, the Chinese government decided to adopt a more aggressive fiscal policy. Long-term government debt in the amount of RMB100 billion yuan was issued to the state commercial banks. The banks in turn put together a matching loan program of RMB100 billion yuan mainly for infrastructure construction. Such a "lax-lax" monetary and fiscal policy mix through issuing long-term government debt ear-marked for infrastructure construction sectors was the first such experiment in 1990s. The effects of this policy mix were also felt at the intermediate and micro levels. Export tax rebate rate was raised and the interest rate of export credit was lowered. "Monitored account loans" were combined with cooperation agreements between the banking and trade sectors. Housing construction fees were adjusted in line with conditions of

housing credit. In particular, part of the proceeds from the RMB100 billion government debt issue was allocated as the capital for various projects, thus increasing the capacity for bank loans. Furthermore, the three interest rate reductions of the PBC created more room for government financing by cutting the cost, reducing or even eliminating the possible "crowding out effects" of increased government spending.

Monetary policy transmission mechanism changed Whether the instruments such as adjusting money and credit supply and interest rates will have direct or indirect influence on intermediate and final demands, and the degree of such influence, are all determined by performance of the real economy and its capacity to "absorb". First, because of stronger risk awareness and harder budget constraint of commercial banks and enterprises, strong expansion impulse of banks and enterprises (or government) is not normal any more. The transmission of monetary policy mainly relies on the "back-wheel drive" mechanism of the central bank. Second, household expectations is playing a significant role. In 1998, lower income expectations of households together with reforms in the housing, medical and social welfare system reinforced the cautiousness of the general public, repressing the normal growth of current consumption expenditures. The effect of monetary policy in stimulating consumption was constrained to some degree.

MONETARY POLICY FOR 1999

Macroeconomic Environment and the Government Targets

In 1999, the government's macroeconomic adjustment measures to increase domestic demand will gradually take effect. Meanwhile, external environment will remain unfavourable. Based on its judgement of the domestic and external situation, the government has decided to adopt an aggressive fiscal policy and a sound monetary policy in 1999 in order to expand domestic demand and stimulate economic growth. For 1999, the government macroeconomic targets will be an economic growth of 7 percent, retail price and consumer price increase below 2 percent and 4 percent respectively.

According to macroeconomic conditions and the above targets, the PBC has decided on the 1999 monetary policy targets as follows. The guidance lending plan for the state banks will be RMB1000 billion yuan, an increase of 14.6 percent or RMB90 billion more than the increase of 1998. Loans of all financial institutions will increase by RMB1355 billion yuan, an increase of 15.5 percent. Broad money (M_2) will grow by 14-15 percent while narrow money (M_1) by about 14 percent. Cash increase is planned to be RMB150 billion yuan, 47.3 billion more than 1998. The level of the state foreign exchange reserves and the renminbi exchange rate will remain stable.

Monetary Policy Stance

Monetary policy must be tuned closely to the performance of the economy as has been fully proved by the experience over the last decade (Table 1-2). The decision to adopt a sound monetary policy for 1999 is a response to the very severe economic situation. The implications of such a policy stance are to maintain a necessary growth of base money, appropriately increase money supply, avoid deflation and support the aggressive fiscal policy with a view to facilitating domestic demand expansion and thus economic growth.

Table 1-2 Macroeconomic Performance and Monetary Policy Stance

Economic performance	Monetary policy stance
1984 Economy overheated	Tight monetary policy adopted in 1985
1986 Economy slowed down	"Stability-based accommodative" monetary policy adopted in 1986
	"Tight-flexible" monetary policy adopted in 1987
Around 1992 Economy overheated again	Financial orders rectified and appropriately tight monetary policy adopted in the second half of 1993
1996 Economy achieved "soft landing"	Operations of monetary policy adjusted after May, 1996
1998 Increasing domestic demand, insuring the growth target to be realized	Monetary policy to appropriately increase money supply adopted in 1998

In 1999, the basic tune of monetary policy is to increase money supply appropriately. In terms of the real growth of money, the 1999 target is about the same as that of 1998. It is not a slow growth when compared with the declining trend in the past few years (Figure 1-5). In 1993 and 1994, the growth of money of all the three categories was above 20 percent. However, it began to decelerate in 1995 and all dropped below 16 percent in 1998. The declining inertia will be further felt in the course of 1999.

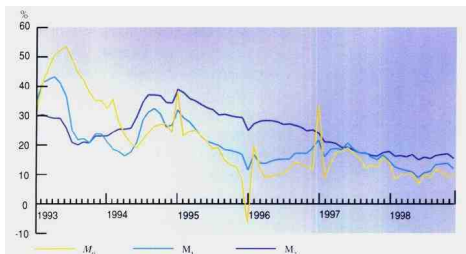


Figure 1-5 Annual Growth Trend of Money Supply

The deceleration of money supply growth in the past few years reflected both the effect of the appropriately tight monetary policy and other factors weakening the demand for money. First, monetization of the economy has past its peak and will further slow down in 1999. The demand for money resulted from such process will weaken accordingly. Second, the use of commercial credit by industrial and commercial enterprises is growing fast, also reducing the demand for money to some degree. In addition, the weakening of the declining trend of the velocity of money in 1998 will in turn reduce the pressure for monetary growth in 1999.

New Issues for Monetary Policy Operations

There will be many new issues for monetary policy operations in 1999, which should be adequately recognized.

How to respond to the changes in the transmission mechanism of monetary policy

Monetary policy intentions of the central bank can only become effective through activities of banks and other financial institutions. With the elimination of credit ceilings for the state commercial banks in 1998, window guidance is becoming an important way for transmitting monetary policy intentions. However, the central bank still has to learn how to use window guidance or "moral persuasion" in a balanced way so that it can fully play its role on the one hand and does not affect normal operations of the commercial banks on the other.

Another new issue brought up by the changes in the monetary policy transmission mechanism is how to choose and develop channels for base money injection. Increasing base money is an important aspect of increasing money supply. The channels for increasing base money changed in 1998 with foreign exchange purchase no longer being the main channel. It will be even more so in 1999. Monetary growth will be directly affected if no proper channel is found for base money injection.

Still another new issue is to prevent small and medium-sized financial institutions from being left out of the monetary policy transmission process. In 1998, the state banks regained dominance in credit activities. Accordingly, window guidance of the central bank was directed mainly to these banks resulting in an incomplete transmission of monetary policy. This phenomenon, if allowed to remain in 1999, will adversely affect the conduct of monetary policy.

How to strike a balance between preventing financial risks and increasing bank credit

Banks and financial institutions must increase credit in order to facilitate strong economic growth. However, non-performing loans (NPLs) and thus financial risks tend to increase if the quality of credit is neglected in the process. On the other hand, if banks allow quality concerns undermine their efforts for actively pursuing lending opportunities, macroeconomic adjustment and economic growth will be

