China's Monetary Policy: Retrospect and Prospect

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I. Brief Review of China's Monetary Policy Pursued during the 9th Five-Year Plan Period

During the 8th Five-Year Plan Period (1991—1995), China achieved an average annual economic growth rate of 12 percent, with a tremendous success. Yet at the same time it also experienced serious inflation, with the residents consumer price index rising at an annual average rate of 12.9 percent, and even reaching a peak of 24.1 percent in 1994. In view of this problem, in the Proposal on the 9th Five-Year Plan for National Economic and Social Development and the Long-Range Objectives to the Year 2010, the Central Committee of the Communist Party of China (CPC) specified in 1995 that curbing inflation was the primary task for macro-economic adjustment during the 9th Five-Year Plan period (1996—2000). They called for a substantial drop in the excessively high inflation rate, and stressed the importance of pursuing a moderately tight fiscal and monetary policies. In accordance with the requirements of the CPC Central Committee, during the late 8th Five-Year Plan period and the early 9th Five-Year Plan period, the People's Bank of China (PBC) adopted a variety of monetary policies to exercise strict controls over the total currency credits. The increase in broad money hit 34.5 percent in 1994, but it began to fall year by year after 1995, dropping to 17.3 percent in 1997. Moreover, the retail price and the consumer price plunged to 0.8 percent and 2.8 percent respectively in 1997. Yet China still maintained an 8.8 percent economic growth rate that year. The moderately tight monetary policy played a significant role in curtailing inflation.

In 1998, in the face of the adverse impact of the Asian financial crisis and the drastic change in the supply-demand relation on the domestic market, the CPC Central Committee and the State Council made an important decision to expand domestic demand. In implementing the principle of the central authorities, the PBC tried to give full scope to the role of the monetary policy, by making a comprehensive use of various types of monetary policy instruments, and appropriately increased money supply. These measures included the reduction of interest rates for seven times, the downward adjustment of the deposit reserve ratio twice, the expansion of the open market operations, the vigorous adjustment of the credit policy and the expansion of the commercial banks credit scopes. These ensured a moderate increase in money supply and loans. In 1998 and 1999, the broad money supply shot up 15.3 percent and 14.7 percent respectively, and loans extended by financial institutions surged to 1.1
trillion yuan and 1.08 trillion yuan respectively. The increased money supply and loans were basically compatible with economic growth. The monetary policy contributed to warding off deflation and ensuring sustained and rapid growth of the national economy.

Meanwhile, efforts were made to promote the reform of the monetary policy mechanism and the monetary policy instruments. Marked primarily by decontrolling management of the loan scale and the expansion of the open market operations, within three years the regulatory way of the monetary policy was realized by shifting from direct control to indirect control. In 1998, 192 billion yuan of base money was issued via open market operations, accounting for 52 percent of the increased amount of base money that year. In 2000, more than 300 billion yuan of net base money was withdrawn via open market operations. This practice played a major role in controlling the issue of base money and money supply. Open market operations have now become a principal instrument of the routine operation of the central bank to pursue its monetary policy.

Moreover, efforts were made to reform the deposit reserve system and the mechanism for forming the rediscount rate, decontrol the rediscount rate, to realize the market-oriented issuance of financial bonds of policy-based banks and national debts, to deregulate interest rates on foreign currency loans, and to reform the system of interest rates on foreign currency deposits. Work was also done to increase the floating range of interest rates on RMB loans extended to small and medium-sized enterprises, and improve the re-lending administration procedures, to perfect a series of rules, regulations and systems regarding management of money markets, all of which led to a great change in the monetary policy's transmission mechanism.

II. The Objective of Monetary Policy for the Next Five Years

The objective of China's monetary policy is to maintain the stability of the currency value to advance economic growth. This provision is based on drawing on the experience of monetary policies worldwide. Meanwhile, it also reflects the historical summary of the experience of China's monetary policy. It takes as primary goal the maintenance of the stability of the RMB value, and takes the stability of the currency value as the means to promote economic growth. During the 10th Five-Year Plan period we must unswervingly adhere to this basic provision on this objective of the monetary policy.

Maintaining the stability of the RMB currency value means internally retaining the stability of the general price index and it means externally retaining the stability of RMB's real and effective exchange rates. We are of the view that the stability of the general price index means that the range of price fluctuations is controlled within the limits of the general public expectations. In line with China's national conditions, the range of the rise of less than 3 percent in the price level should be regarded as price stability. The stability of real and effective exchange rates is considered as a
prerequisite for a country to maintain an international balance of payments. The supply-demand relation on the foreign currency market experiences daily changes. In particular, in China, a country whose foreign currency market mechanism is far from perfect, permitting RMB exchange rates to fluctuate freely every day along with the change of supply-demand relation is detrimental to operations of real economy. The operation of the central bank on the foreign currency open market takes it as the objective to iron out the drastic fluctuation in short-term nominal exchange rates and maintain the basic stability of the long-term real exchange rates. This practice is probably appropriate.

In accordance with the Proposal on the 10th Five-Year Plan for National Economic and Social Development adopted at the Fifth Plenary Session of the 15th Party Central Committee, China's gross national product is projected to double again by 2010, namely, growing at an annual average growth rate of 7.2 percent. This goal is entirely likely to be achieved. During the 1978—1999 period China's economy grew at an annual average growth rate of 9.6 percent. This 21-year period was one which saw a price increase of within 3 percent, and the GNP growth rates hit about 9 percent. For example, the retail price inched up 1.9 percent in 1982, while the economic growth rate was 9.1 percent. The retail price edged up 1.5 percent in 1983, while the economy grew 10.9 percent. The retail price increased 2.9 percent in 1991, whereas the economy increased 9.2 percent. The consumer price gained 2.8 percent (the retail price edged up 0.8 percent) in 1997, while the economy grew 8.8 percent. China is a large country, whose domestic market has much leeway, and enjoys an enormous potential in the expansion of supply and demand. Provided that the system and policies are correct, China will enjoy an enormous economic growth potential. Of course, during the late 9th Five-Year Plan period, because of great changes that occurred in a host of factors on the domestic and foreign markets, the structural contradiction and the contradiction of inadequate effective social demand became evident, resulting in a sustained drop in the economic growth rate. Despite an important turn for the better that was achieved in 2000, the foundation was not solid. Great efforts still need to be made to maintain sustained and rapid economic growth in the next five years.

An analysis of various factors in the next five years such as the economic structure and market demand indicates that with great efforts, the goal of an annual 7—8 percent economic growth rate can be achieved. At the same time, the currency value will be kept stable and the annual inflation rate will be kept within 3 percent. According to the projection based on the experience in money supply and economic growth since China initiated its reform and opening-up drive, and by taking into account the factor of the slowdown the velocity of money, money supply in the next five years should not exceed 14 percent annually. Compared to the annual increase of 17 percent in money supply during the 9th Five-Year Plan period, the rise in nominal money supply in the coming five years will be lowered. But this does not mean a tighter monetary policy regulation than during the 9th Five-Year Plan period. This is because, with the development of the money markets, particularly the capital markets,
the velocity of money will accelerate, enterprises will obtain more funds from direct financing channels and the funding environment for economic growth is expected to be much better.

III. Monetary Policy and Principle to Be Pursued in the Next Five Years

The monetary policy to be pursued in the next five years should be designed to ward off deflation and inflation as well. This should be our cardinal principle. It is imperative to pay special attention to correctly handling the relation between warding off financial risks and promoting economic growth. It is also imperative to maintain an appropriate increase in money supply in order to advance the sustained, rapid and sound development of the national economy, and improve the loan quality in order to ensure the steady operation of the financial sectors.

It is appropriate at this juncture to comment on the issue of the prevention of deflation. The fundamental reason for deflation is inadequate aggregate demand. First it is essential to examine consumer demand. Since China initiated its reform and opening-up drive, consumption has always served as the first important driving force behind development. Since 1997, however, consumer demand has shown a tendency toward a sustained decline. A major reason is the decrease in the incomes of rural residents who constitute the overwhelming majority of China's population. After China joins the WTO, more foreign farm products will be likely to break into the domestic market, compelling farmers to face even more fierce competition in increasing their incomes. After the domestic market for manufactured goods is opened widely, a considerable number of Chinese industries will face intense competition from foreign products. As a result, the pressure of urban employment is likely to mount further and the income gap is expected to widen further. Therefore there will be a greater uncertainty as to whether consumer demand will rebound rapidly in the next few years.

Another consideration is that of investment demand. Since 1994, the investment increment in fixed assets by whole society has shown the downward tendency. A major reason is that the reform of the investment and financing systems has lagged behind, the mechanism under which savings deposits are converted into investments is still not perfected and investment funding sources are insufficient. In regard to the buyers market, the anticipated rates of return on investments have fallen, thus dampening investors initiative. We predict that in the next five years it will still take time to digest the existing low-level surplus. Investments in the high-tech industry with the most promising market development prospects require a process from pioneering work to a certain scale. State-owned and collective enterprises have a low capability to accumulate funds on their own. Non-governmental capital is limited. The capital market, especially the corporate bond market is far from perfect and the direct financing channel remains clogged. Over the past two years increased fiscal investments have played a certain role in jump-starting the economy, but there exist a number of problems in the sustainability of such investments. Before the fundamental
reform of the investment and financing systems is completed, it will still be difficult
to maintain rapid growth of investments.

Finally imports and exports need to be examined. A preliminary analysis shows that
after China becomes a WTO member state, it will report a substantial increase in
imports and an increase in exports, whose increase is likely to be smaller than that of
the increase in imports. As China has entered the debt serving peak, the amount of
profits from foreign direct investments remitted out of the country is expected to rise
year by year, yet a deficit in the non-trade account has existed. If imports continue to
exceed exports in the next few years, it is not unlikely that a deficit will emerge in
China's current account under the balance of payments. If a deficit in the current
account does emerge, China's economic growth will have to be spurred by relying
primarily on domestic demand, that is, relying on domestic consumption and
investment growth. So, it is a crucial problem to attaining the goal of sustained growth
of the national economy whether China will be able to achieve moderate growth of
domestic demand, especially investment growth in the next few years in the course of
the structural adjustment. The shadow of deflation will always linger before the
structural contradiction and the problems of inadequate aggregate demand will not be
resolved from the root.

In the meantime, there is also an accumulation of the latent pressure of inflation. Credit has been concentrated mainly in banks since China initiated its reform and
opening-up policy 20 years ago. The financing system with bank credit as the
mainstay has compelled enterprises to rely heavily on bank loans, resulting in the
rapid growth of loans. During the 1978—1999 period, loans extended by financial
institutions rose at an annual average rate of 20.4 percent. Loans have given rise to
savings deposits, which have annually increased 23.5 percent on average. Of the
broad money supply (M2), deposits account for 90 percent. During the 17-year period
from 1981 to 1999, M2 grew at an annual average growth rate of 26.4 percent.
Deposits are actually liabilities of commercial banks, which take in deposits to extend
loans. For various reasons, some loans have become bad debts, leading to the
shrinkage of banks assets. Yet banks may not repudiate a single cent of liabilities in
the form of deposits and also have to pay interest without any bad debts. Quasi-money
in M2 can become real money in a given condition to form realistic demand on the
market. Therefore, the ratio of M2 to the nominal GNP is usually regarded as an index
to measure inflationary pressure. In 1998, this ratio stood at 0.5 in India, 0.67 in the
United States, 0.6 in the Republic of Korea, 1.2 in Japan, and 1.31 in China (rising to
1.46 in 1999). M2 is expected to climb 15 percent in China in 2000, while the
nominal GNP is projected to grow 8 percent. The ratio of M2 to the nominal GNP still
shows the tendency toward increase, which is expected to continue in the next few
years. From this it can be seen that the latent inflationary pressure continues to
accumulate. After joining the WTO, China will face an even greater test in
maintaining its independence of monetary policy, while new uncertainties affecting
macro-financial stability will continue to increase. At present, Chinese financial
institutions as a whole are low in any competitive edge, and are imperfect in the
governance of their internal structure. The quality of their employees and their technological means cannot meet the requirements posed by the development of a modern economy and fierce international competition. China has a fragile micro-financial foundation. Thus, it constitutes an arduous task to maintain financial stability, and ward off and eliminate financial risks. All this will eventually be related to inflation. In considering China's national conditions, the implementation of monetary policy, particularly in opting for medium-term objectives, it is necessary to be on full alert against inflation.

IV. Monetary Policy Measures over the Next Five Years

In the last three years, relying on the rapidly-growing inter-bank bond market, the monetary policy instrument has experienced a fundamental change, which finds expression chiefly in the fact that the open market operations have become the most important monetary policy instrument. It is precisely on this basis that monetary policy regulation has realized the shift from direct control to indirect control. But as the development of instruments in the money market and intermediate agencies in the money market lags behind, relatively speaking, the scale of the money market is comparatively small. The indirect regulatory instruments for the monetary policy, especially the interest rates remain a low elasticity, and the monetary policy's transmission mechanism, as a whole, has a host of impediments. This has adversely impacted on the effectiveness of the monetary policy and the efficiency of the operation of the financial sectors as a whole.

Therefore, it is imperative to make energetic efforts over the next five years to perfect the monetary policy's transmission mechanism. Work should be done to further promote the development and perfection of the money market, bond market and commercial bill market, bring into full play the role of market interest rates in guiding the orientation of the flow of funds. It is necessary to further expand open market operations and improve the efficiency in operating the monetary policy. It is necessary, according to the needs of the economic structural adjustment, to promptly adjust the credit policy and exhibit the initiative of commercial banks in making credit innovations. It is imperative to make a success in coordination between the fiscal policy and the policy on balance of payments, in order to enhance the overall efficiency of financial macro-control.

Whether the objective of the monetary policy can become a reality will depend, to a large extent, on the mutual link and promotion between the money market and the capital market. According to the table of the flow fund of the PBC, in the enterprises financing structure during the 1992—1998 period, loans extended by financial institutions made up 70 percent; the utilization of foreign funds accounted for 27 percent, whereas funds raised via the stock market and the bond market made up less than 4 percent. In the next few years, efforts should be made to expand the capital market to increase the ratio of direct financing by enterprises through issuing stocks, bonds and establishment of funds. Meanwhile, it is necessary to encourage various
types of investors to obtain capital fund from the non-open equity market. The goal is that during the latter period of the 10th Five-Year Plan, the ratio of direct financing by enterprises will rapidly increase to 20 percent from less than 4 percent at present.