

PBC's Five Areas of Focus

An Interview with The Honorable Zhou Xiaochuan,
Governor, The People's Bank of China, Beijing



The Hon. Zhou Xiaochuan

EDITORS' NOTE Zhou Xiaochuan graduated from Beijing Chemical Engineering Institute and received his Ph.D from Tsinghua University, and subsequently served as assistant minister of foreign trade (December 1986 to December 1989) and a member of the State Economic System Restructuring Committee (November 1986 to September 1991). He became vice president of the Bank of China in September 1991 and was appointed to the State Administration of Foreign Exchange in October 1995. From October 1996 to February 1998, Zhou was deputy governor of the People's Bank of China and administrator of the State Administration of Foreign Exchange. He became president of the China Construction Bank in February 1998 and chairman of the China Securities Regulatory Commission in February 2000. Zhou assumed his current post in December 2002.

DEPARTMENT BRIEF Established in 1948, the People's Bank of China (PBC) is the central bank of the People's Republic of China. As a member of the State Council and a government department responsible for macroeconomic management, the People's Bank of China formulates and implements monetary policy, safeguards financial stability and provides financial services under the guidance of the State Council.

What will the PBC focus its efforts on in the near future?

In the first half of 2005, China's economy maintained steady and rapid growth. The excessively rapid growth of investment was contained, consumer demand increased markedly, price indices moderated steadily, and great improvements were made in the fiscal revenue and the income of urban and rural residents. In the first half of 2005, GDP grew by 9.5 percent and the CPI (consumer price index) increased by 2.3 percent on a year-on-year basis; the growth of money and credit was appropriate, and the financial sector performed soundly.

In line with the central government's overall plan to strengthen and improve macroeconomic management, the PBC will continue to pursue sound monetary policy and strengthen the market-based means to control economic aggregates and promote structural adjustment. Efforts will be focused on five areas. First, the PBC will take concrete steps to improve its forecast of economic and financial trends. Second, the indirect management tools will be further improved and the mix of monetary policy instruments will be flexibly used to ensure the steady and appropriate growth of money and credit. Third, by encouraging the commercial banks to improve their credit structure, the PBC will seek to strengthen the role of prices in promoting balanced supply and demand and structural adjustment. Fourth, external economic and financial development will be closely monitored to promote a payments equilibrium. Fifth, issues related to market exit of the financial institutions will be properly handled to maintain the stability of the financial system.

What are the crucial issues in the reform of the state-owned commercial banks, and how do you feel about the practice of transforming their operating system through public listing?

The Chinese government attaches great importance to the reform of the state-owned commercial banks. In September 2003, the State Council decided to set up a leading group for the pilot joint-stock reform of the wholly state-owned

commercial banks. In December 2003, the Central Huijin Co. Ltd., established with the approval of the State Council and acted on behalf of the government, injected foreign exchange of \$22.5 billion respectively to the Bank of China and the China Construction Bank. The pilot joint-stock reform was carried out in these two banks, and they established joint-stock companies on August 26 and September 21, 2004, respectively. Modern corporate governance has taken shape in these two banks. In April 2005, the Central Huijin Co. Ltd., acting on behalf on the government, recapitalized the Industrial and Commercial Bank of China with \$15 billion. By the end of June 2005, financial restructuring of the Industrial and Commercial Bank of China was basically completed, and the preparatory work for establishing a joint-stock company is currently underway.

In the past, the state-owned banks were regarded as part of the government and they operated similar to government offices. The key of banking reform is to establish reform incentives within the banks and to create an external environment for the banks to operate on a commercial basis.

In pushing ahead with the joint-stock reform in line with internationally accepted practices for listed companies regarding information disclosure, supervision requirement, accounting standards, and corporate governance, we have made concrete progress in addressing the external problems and establishing internal reform incentives. Other relevant reforms have also been accelerated. Nevertheless, completion of the listing procedures does not mean that the reform is finished. The banks will be subject to market oversight with higher standards after they are listed. So public listing is really an important step in advancing the banking reform. We will continue to make efforts in this area.

The central bank recently published a special report on the market-based interest rate reform, which has attracted broad attention. What is your thinking about the market-based interest rate reform in the future?

The market-based interest rate

reform constitutes an important part of China's efforts to build a socialist market economy, under which the market plays a major role in resource allocation. It is also the key to the indirect management of the financial system and a prerequisite to transforming the operating mechanism of the financial institutions and enhancing their competitiveness. Moreover, market-based interest rates will help improve the RMB exchange rate.

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 rates on loans of the financial institutions was widened on January 1, 2004. Second, the upper limit on loan rates and lower limit on deposit rates were removed on October 29, 2004. At present, there are only two control measures for interest rates: the ceiling on the RMB deposit rate and the floor for the RMB lending rate.

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

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

What are the main features of the new RMB exchange rate regime, which was put in place in July 2005?

Foreign exchange control has been gradually relaxed, the foreign exchange market further developed, more market instruments introduced to facilitate transactions, and concrete progress achieved on financial reforms on various fronts. Macroeconomic management has yielded manifest results with the economy continuing to grow in a steady and relatively fast manner, and the world economy has developed stably in conjunction with a solid appreciation of the U.S. dollar. These factors have created a favorable environment for the reform of the RMB exchange rate regime and laid a solid foundation to ensure its success. Therefore, it is a relatively good time to reform the RMB exchange rate regime.

To establish and improve the socialist market economic system in China and enable the market to fully play its role in resource allocation, China reformed the exchange rate regime by moving into a managed floating exchange rate regime based on market supply and demand with

reference to a basket of currencies. The RMB is no longer pegged to the U.S. dollar. Instead, the RMB exchange rate will be determined based on a basket of certain major currencies with assigned weights, selected in line with China's external sector development. At the same time, proper measures could be taken to manage and adjust the RMB exchange rate based on market supply and demand and according to the domestic and international economic and financial developments with reference to the exchange rate indices of the basket currencies, as an effort to keep the RMB exchange rate stable at an adaptive and equilibrium level. Of course, the managed floating exchange rate regime must also be based on another important factor – market supply and demand.

The selection of the basket currencies and the determination of the weights must consider the currencies of China's trading partners in current account transactions. The current situation in China shows that trade in goods and services dominates current account balance. Therefore, the shares of trade are the major considerations in the determination of the currency components of the basket. China's major trading partners are the United States, Europe, Japan, and Korea, so naturally those currencies are major parts of the basket. In addition, China also trades significantly with Singapore, Malaysia, Russia, Australia, Canada, and Thailand, and those currencies are also important in determining the RMB exchange rate.

What reforms has the PBC undertaken to speed up the development of the inter-bank foreign exchange market?

To further improve the socialist market economy, enhance the role of the market in determining the exchange rate, and provide more risk-management instruments for banks and enterprises, the PBC has recently launched a number of measures to promote the development of the inter-bank foreign exchange market. First, more institutions will be allowed to participate in the inter-bank foreign exchange spot market. Non-bank financial institutions and non-financial enterprises will be allowed to enter into the market based on their true demands. Second, additional trading modes will be adopted. A price-query system will be introduced to the inter-bank foreign exchange market, where entities can trade via bilateral credit authorization and settlement. This trading system will be first adopted in forward transaction. Third, more trading instruments will be introduced. Qualified participants can deal with forward transactions and those with registration for more than six months will be allowed to deal with swaps that combine spot and forward transactions or different forward transactions.

These measures are important to strengthening the foreign exchange market infrastructure, improving the RMB

exchange rate regime and to having the inter-bank foreign exchange market play a fundamental role in resource allocation. The measures are also of great significance in facilitating domestic economic entities to manage exchange-rate risks, expanding the coverage of banking services, and developing the domestic derivatives market for RMB trading against foreign currencies. While accelerating steps to develop the inter-bank foreign exchange market, the PBC will strengthen its supervision and management over the market to ensure its sound performance and keep the RMB exchange rate basically stable at an adaptive and equilibrium level.

What are the impacts of the reform of the exchange rate regime on the domestic enterprises, commercial banks, and China's economy?

In the short term, the reform of the RMB exchange rate regime can have an impact on economic growth and employment. Broadly speaking, the benefits of the reform outweigh the associated costs. The reform has set higher standards for domestic enterprises and commercial banks to improve their market operation. We will guide the enterprises to strengthen restructuring to absorb impacts smoothly throughout the reform period. Banking institutions and foreign exchange administration agencies should further improve financial services to provide strong support for the development of the enterprises. The enterprises should also accelerate restructuring and transform operating mechanisms to improve adaptability to the reform of the exchange rate regime and to the movements of the exchange rates.

Do you think the 2-percent RMB exchange rate revaluation is too small?

We consider it a proper adjustment. It was determined considering the size of trade surplus and the needs for restructuring China's foreign trade, while at the same time taking into account the resilience of the domestic enterprises to absorb the risks and their real local currency costs of export earnings. The exchange rate is adjusted not to achieve an absolute trade balance with the United States, but to pursue an overall foreign trade balance, and the 2-percent revaluation satisfies the need for a broad trade balance in goods and services. Also, the adjustment is conducive to maintaining the steady growth momentum of the macro-economy, consolidating the achievements of macroeconomic management, and ensuring a steady operation of financial markets. Moreover, the reform is focused not on the quantitative adjustment of the RMB exchange rate, such as the level of revaluation and the size of the exchange rate band, but on the improvement of the RMB exchange rate regime. The PBC will make adjustments to the RMB exchange rate band when necessary, according to market developments and economic and financial situations. 