International Financial Forum—November 16, 2008

# Monetary Policy and Financial System Reform in China


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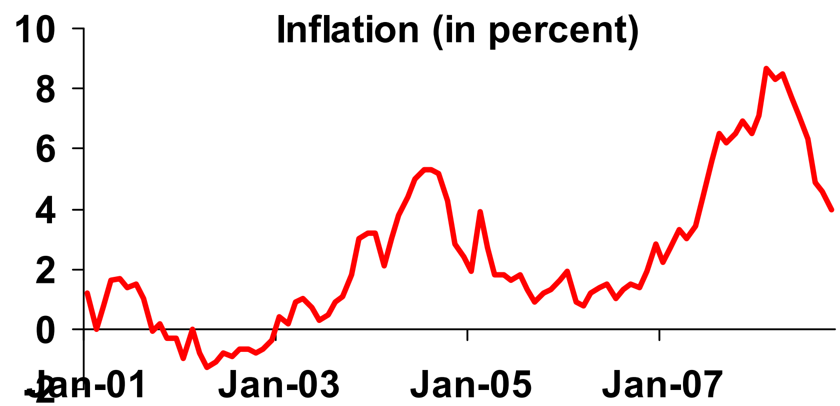
# Interest rates are being lowered across the globe.

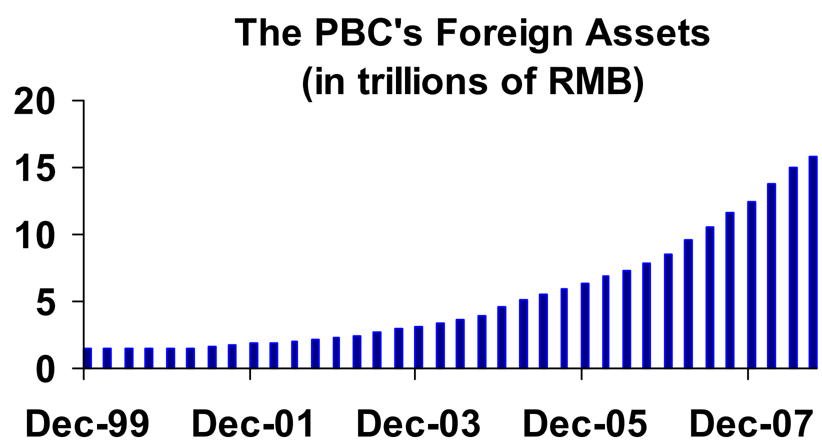
| | Policy rate | | 1-month LIBOR/SHIBOR | |
|---|---|---|---|---|
| | Nov 2007 | Nov 2008 | Nov 2007 | Nov 2008 |
| US | 4.50 | 1.00 | 4.7 | 1.4 |
| Euro area | 4.00 | 3.25 | 4.1 | 3.9 |
| Japan | 0.75 | 0.50 | 0.6 | 0.8 |
| UK | 5.75 | 3.00 | 5.9 | 3.8 |
| China | 3.60 | 2.16 | 5.5 | 2.9 |

# China has more room to ease its monetary stance in the short run.

- Inflation is declining rapidly
  - Driven by food prices
  - Nonfood prices low and stable

- Constraint: continued fx inflows



# Does monetary policy have a role in the current slowdown?

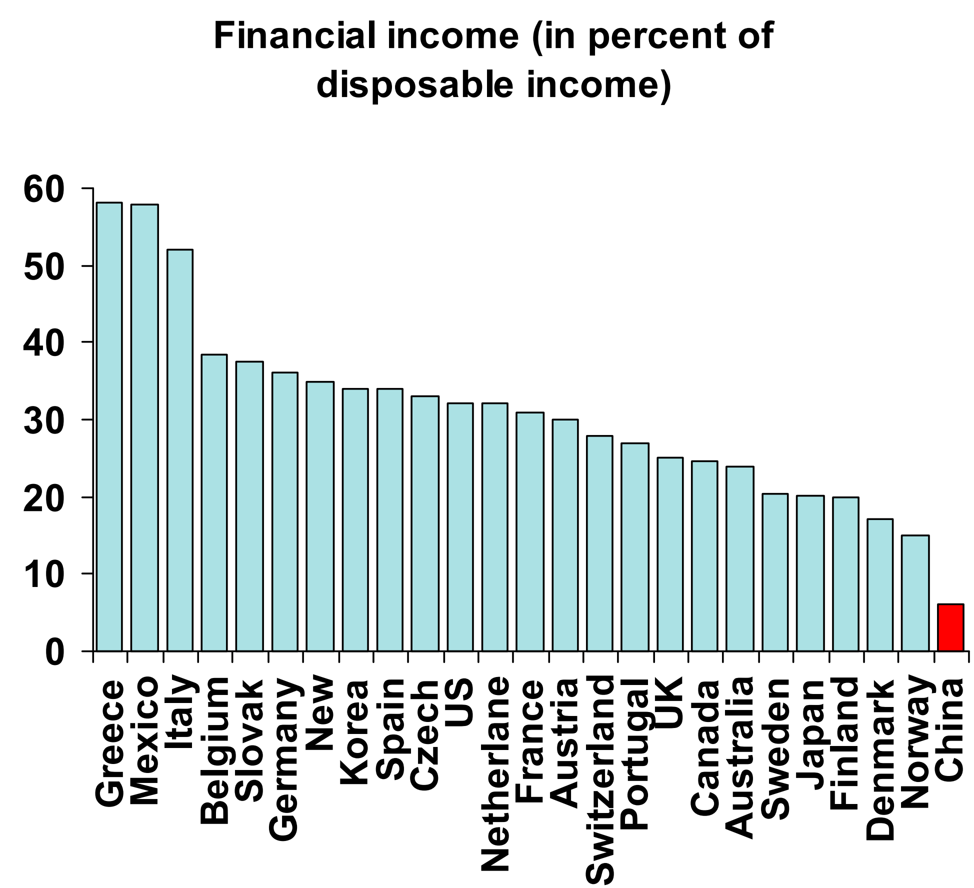
- Is lowering the rates like pushing a string?
  - Yes: With improved governance, banks are reluctant to lend
  - No: Investment demand is strong in a number of areas (urban FAI excluding real estate grew 20 percent (y/y) in real terms in October)

- Measures to improve effectiveness
  - Improving conditions for lending to SMEs, which have been traditionally credit constrained
  - Easing conditions for mortgages

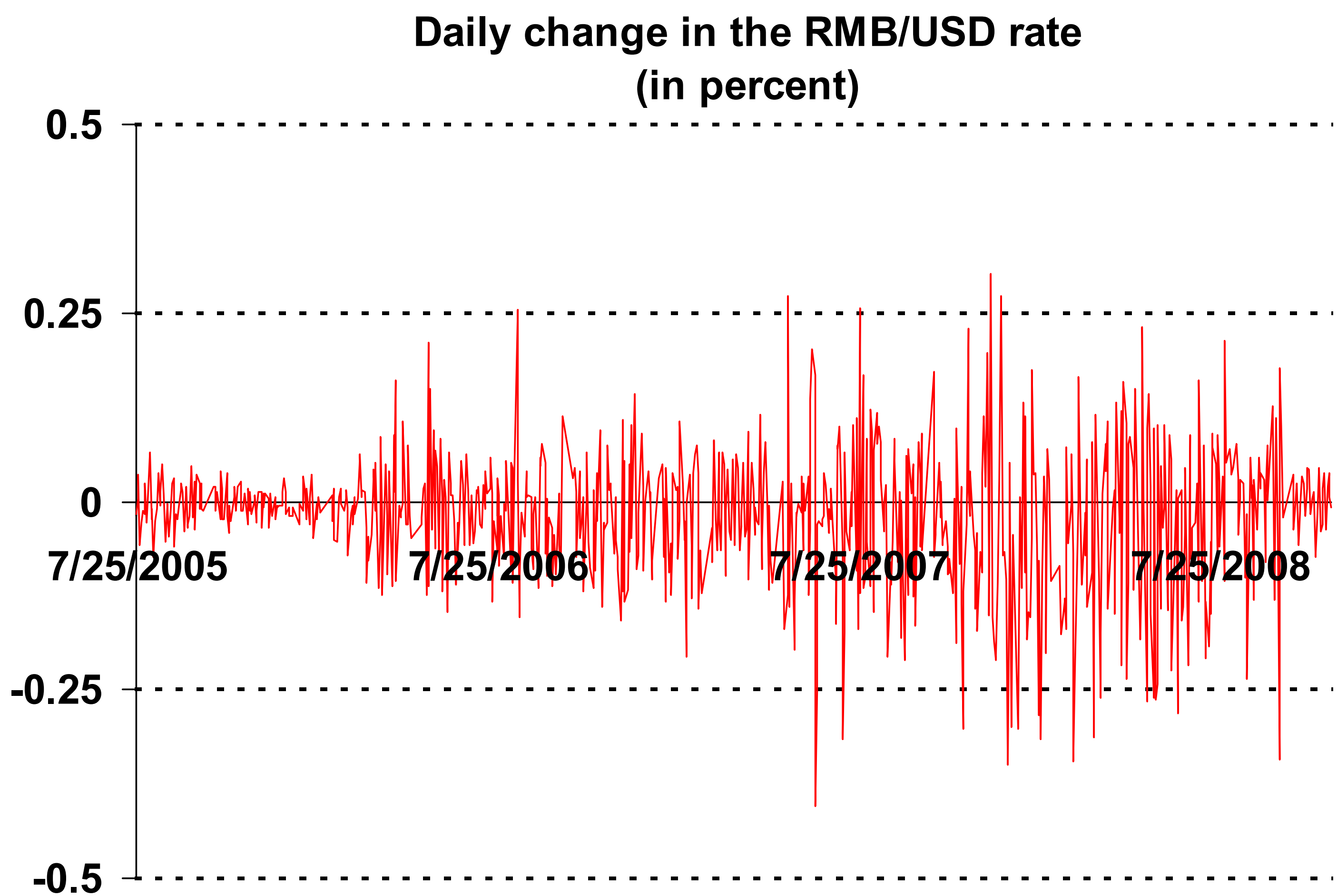
- Need to support the fiscal impulse package

# Lending rates should be lowered more than deposit rates.

- Deposit rates are main source of financial income for households
  - Financial income as share of disposable income one of the lowest in the world
  - Higher rates should boost consumption
- Banks enjoy a wide interest margin
  - Little incentive to develop the capacity to price risk
  - The ability of smaller banks to compete for deposits has been limited
  - Margins will not be competed away
- Deposit rate ceilings should be eliminated in the period ahead



# More exchange rate flexibility is needed.



# Efforts to deepen the capital markets should continue.

- Bond markets are small (market cap less than 50 percent of GDP, compared with 150 percent for the world)
- Deepening bond and equity markets
  - will provide firms with alternative sources of financing
  - should reduce the need for large corporate savings
- Efforts to switch fully to a disclosure-based system should continue.
- The PBC promulgated a regulation that allowed companies to issue commercial paper with up to 5-year maturity.

# More can be found at www.imf.org