FINANCIAL AND MONETARY REFORM IN CHINA

Brookings Institution
November 3, 2011

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Progress

Institutions

- Splitting out the regulatory functions into CBRC, CSRC, CIRC
- Strengthening regulatory oversight and supervisory practices
- Moving toward international standards in a range of areas

The Banks

- Stripping out bad loans from the banks
- Strategic foreign investors to improve internal practices
- Move to international accounting standards
- Listing on foreign exchanges

Progress

Markets

- Developing corporate bond markets
- Creating a range of futures, swap, and options markets
- Establishing interbank corporate bond market with NAFMII oversight
- Deepening equity markets, increasing liquidity, tackling nontraded shares

Monetary Operations

- Building out central bank bond market
- Establishing SHIBOR reference curve
- Creating interbank and repo markets
- Building a well-functioning foreign currency market

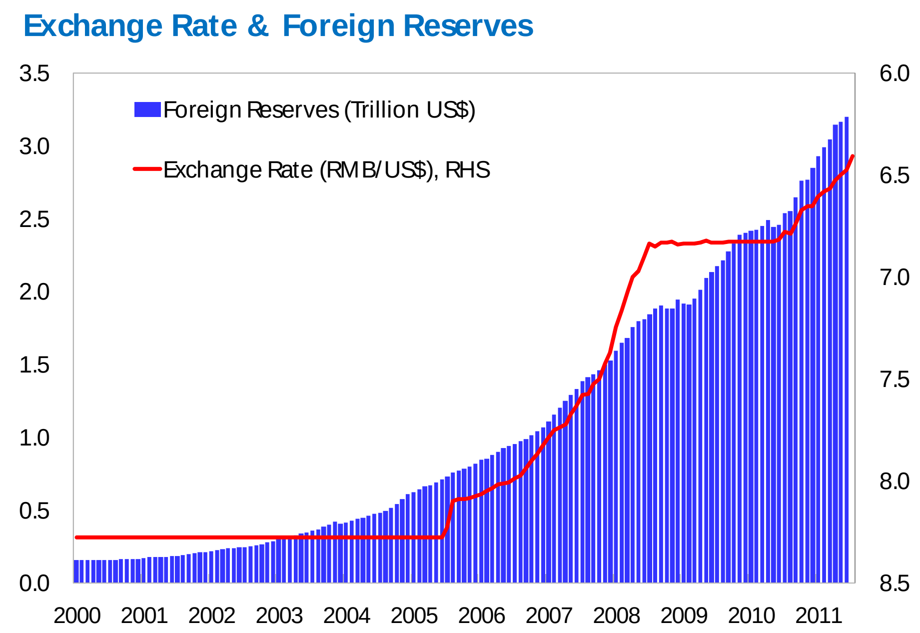
But There's More To Be Done

- It is a long list but I want to focus on a subset

1. A stronger exchange rate
2. Rethinking the monetary framework
3. Improved regulation and supervision
4. Market development
5. Liberalizing interest rates
6. Opening up the capital account

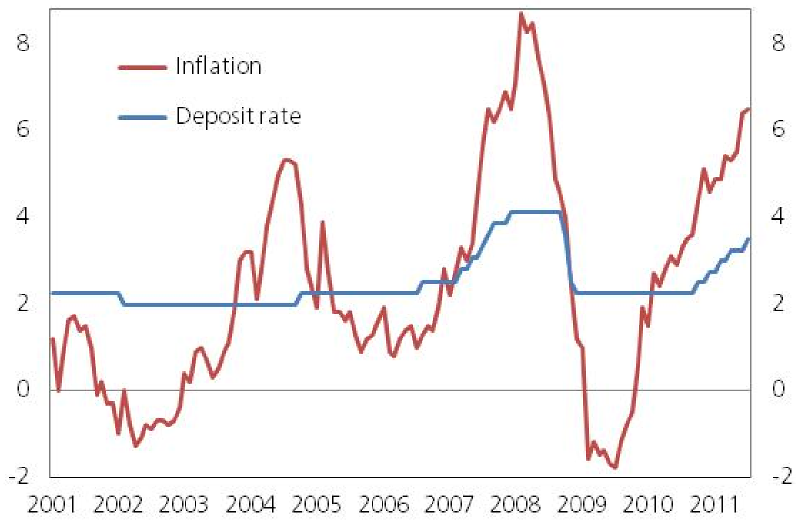
1. A Stronger Exchange Rate

- There is a need for currency appreciation to…
  - Reduce the scale of BOP inflows
  - Lower FX intervention
  - Have the flexibility to use reserve requirements not merely as a sterilization tool
  - Greater scope for an independent monetary policy



2. Rethinking The Monetary Framework

- Absorb the excess liquidity in the financial system and move to a point where interest rates clear the credit market, not quantity controls
- Shift to a framework that establishes clear objectives on growth, inflation, and financial stability and deploys a combination of monetary and macro-prudential tools to achieve these objectives
- A greater reliance on indirect instruments as intermediate targets (perhaps the 7-day repo)
- Operational autonomy for the central bank



3. Improving Regulation and Supervision

Regulation and Supervision

- Establish a coordinating regulatory body (Financial Stability Committee)
- Operational autonomy for regulatory agencies
- Increased staffing and funding
- Effective enforcement and resolution powers
- Tackle data quality and collection
- Continued progress in regular stress testing

Crisis Management Framework

- Procedures for intervention and orderly exit of weak institutions
- Clear definition of the scope of fiscal support
- Deposit insurance scheme
- Limits on emergency liquidity support to solvent banks facing short-term liquidity problems
- Standing facilities should operate automatically with common conditions to provide liquidity support to all domestically incorporated institutions

4. Market Development

Financial Markets

Bonds

- Bond issuance strategy of government
- Increase connectivity between markets
- Disclosure-based listing

Money Markets

- Increase repo market liquidity
- Remove tax and regulatory hurdles
- Interest rate hedging tools

Equities

- Legacy issues related to nontradable, A and B shares
- Expand free float of shares of public companies

Non-bank Intermediation

Insurance

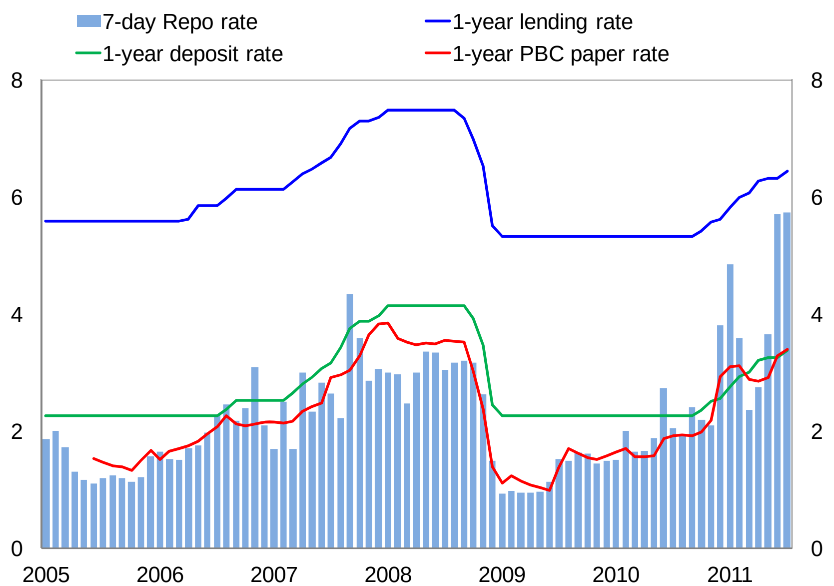
- Consolidation
- More comprehensive risk-based capital requirements
- Clearer voluntary exit rules
- Asset allocation limits
- Stronger actuarial oversight

Mutual Funds

- Expand scope of investments to lower-rated fixed income products and medium-term notes
- Assess the regulatory approach

5. Liberalizing Interest Rates

- Once liquidity has been absorbed and monetary policy is conducted by indirect instruments, then the PBC can move to liberalize interest rates
- Raise deposit rate ceiling first, making the loan rate floor more binding
- Need to ensure banks do not "over-compete", eroding their margins and creating financial stability risks
- Will also need to calibrate monetary policy as interest rate regulations become less binding in order to prevent a surge in credit



6. Opening Up The Capital Account

- It would be extremely risky to begin opening to international flows before addressing distortions in the domestic system
- Can make some progress along the way in opening up to outward flows and longer-term inward flows
- QDII and QFII are ideal tools for this
- Shorter term portfolio flows will have to wait for progress on currency and liberalizing interest rates
- Renminbi internationalization can be a part of this process but will move on a separate track