*The overall outlook for moderate US growth with steady inflation has not changed. However, European growth appears to be losing momentum and while deflationary pressures are easing in Japan the economy remains weak.*

*The third quarter output figures showed most OECD economies slowing more than expected, causing inventories to pile up, and the net trade and investment components – the major impetus of growth in the past few quarters – growing at a much decelerated pace. The deflators indicated benign inflation. In response, monetary policies were by and large accommodative. With the exception of Japan, the G7 countries eased their benchmark interest rates during the December quarter. Adding to the moderating growth picture was the unanimous restraint in fiscal policies. This was especially true in Continental Europe where the EMU convergence criteria on the control of budget deficit and gross national debt were actively affirmed during intergovernmental conferences.*

*China appears to have largely met the 1995 economic targets. Recent modest and selective credit growth suggests that the authorities are comfortable with the slowdown. After the announcement of a series of tax reforms in 1996, the government also announced sweeping tariff cuts at the APEC meeting. The financial sector reforms will continue apace.*

## OECD Economies

US real GDP grew an annualised 4.2% on the old fixed-weighted basis and 3.2% on the new chain-weighted basis (see Box 1) in the September quarter, stronger than expected. Inventories built up during the March and June quarters were run down, moderating the rise in output. Stronger residential investment, net exports and government expenditure contributed importantly to growth.

The third quarter pace of expansion was unsustainable; most estimates of trend annual potential output growth for US are between 2% and 2.5% and capacity utilisation, while declining, was still above its long-term average and unemployment remained low. It was therefore not surprising that there was some slowdown in activity in the December quarter, as reflected in subsequent weak industrial production and retail sales numbers, job reports, and the National Association of Purchasing Managers surveys.

The interpretation of the US economy in recent months has been complicated by delays to the release of economic statistics and some temporary factors suppressing activity. Extreme weather conditions on the east coast were an important factor in employment falling in January, pushing the unemployment rate up to 5.8%. Budget negotiations continued through the December quarter and beyond, leading to two partial shutdowns of federal offices and fears of a default on US Treasury securities. Agreement had still not been reached in mid-February. As a result, federal government spending has been lower, directly lowering GDP. The impasse is also likely to be one cause of the deterioration seen in indices of consumer sentiment. This was in turn reflected in weak Christmas sales.

Output was weak in other G7 economies in the September quarter (Chart 1). Japan's real GDP growth weakened to an annualised 0.6% from 2.6% in the June quarter. Growth was supported by private consumption, government investment and inventory accumulation, while exports and business investment were both down on the quarter. Record low interest rates and the 14.2 trillion yen fiscal stimulation package introduced in September provided the main impetus. The drop in net exports was the major source of weakness.

## Box 1: The new chain-weighted GDP index in the US

The US Department of Commerce replaced the long standing 'fixed weighted' real GDP figures with 'chain-weighted' GDP figures when the GDP data were benchmarked on 1 December 1995.

Under the 'fixed-weighted' approach, the value of real GDP is calculated by summing up all output weighted by the prices prevailing in the base year. In the past, the US Department of Commerce shifted the base period every five years, the latest of which was 1987.

Under the new 'chain-weighted' approach, real GDP calculation is no longer based on the price weights of the base year. Instead, the Fisher ideal quantity index[1] is employed to calculate the real GDP growth from one year to another. The annual change of real GDP of a particular year is obtained by the geometric mean of the volume of output weighted by two different prices, one of which uses current year prices and the other, prices of the previous year. For the most recent estimates, only the annual prices for the latest available year will be used as weights and the measures will then be re-calculated at a later stage when the current year prices become available.

### An illustration

The following table illustrates how the use of different weighting methods leads to different GDP growth rates. Suppose a hypothetical closed economy produces only computers (whose price has been dropping) and rice. In the fixed-weighted GDP using 1987 as the base period, the real GDP growth in 1988 and 1989 will be 15.0% and 17.4% respectively but the chain-weighted approach shows slower growth as it recognises the effect of lower computer prices on their share of expenditure.

| | 1987 | | 1988 | | 1989 | |
|---|---|---|---|---|---|---|
| | **Price** | **Qty** | **Price** | **Qty** | **Price** | **Qty** |
| Computer | $10000 | 10 | $8000 | 12 | $6000 | 15 |
| Rice | $20 | 5000 | $22 | 5500 | $25 | 6000 |
| Fixed-weighted annual GDP growth (%) | | | | 15.0 | | 17.4 |
| Chain-weighted annual GDP growth (%) | | | | 14.6 | | 15.3 |

### Why change?

Real GDP measures the change in output after removing the effect of changes in prices. In the fixed-weighted method, this is done by valuing all outputs at the base year prices (i.e. the 1987 prices in the above example). It works well only when the relative prices of different outputs vary little over time. Problems arise when these changes in relative prices become more pronounced. In our example, the price of computers fell by 40% while the price of rice rose by 25% between 1987 and 1989. For this reason, the fixed-weighted approach gives computers a greater weight than they would have had if computers were valued at 1988 and 1989 prices—the chain-weighted method.[2]

Another disadvantage of using the fixed-weighted method is the periodic shift in the base year so as to update the changes in price weights. In the US, the shift occurred every five years. The problem is when the base year is changed, the entire history of the GDP series also needs to be changed. The more frequent the change in the base year, the more would be the distortion in the past business cycles. With the new chain-weighted measures, the GDP estimates will allow for changes in relative prices as they occur and a periodic shift in base year is not necessary.

1 The Fisher's ideal index number is $I = \{(\Sigma P_{t-1}Q_t / \Sigma P_{t-1}Q_{t-1}) \times (\Sigma P_t Q_t / \Sigma P_t Q_{t-1})\}^{1/2}$, where $P_t$ and $P_{t-1}$ are the prices at periods t and t-1 respectively whereas $Q_t$ and $Q_{t-1}$ are the output quantities during the respective periods.

2 It has been suggested that GDP in the US may be understated because computer prices and software expenditure are not well measured but this is a separate issue.

### Chain-weighted growth is slower, so is the economy weaker?

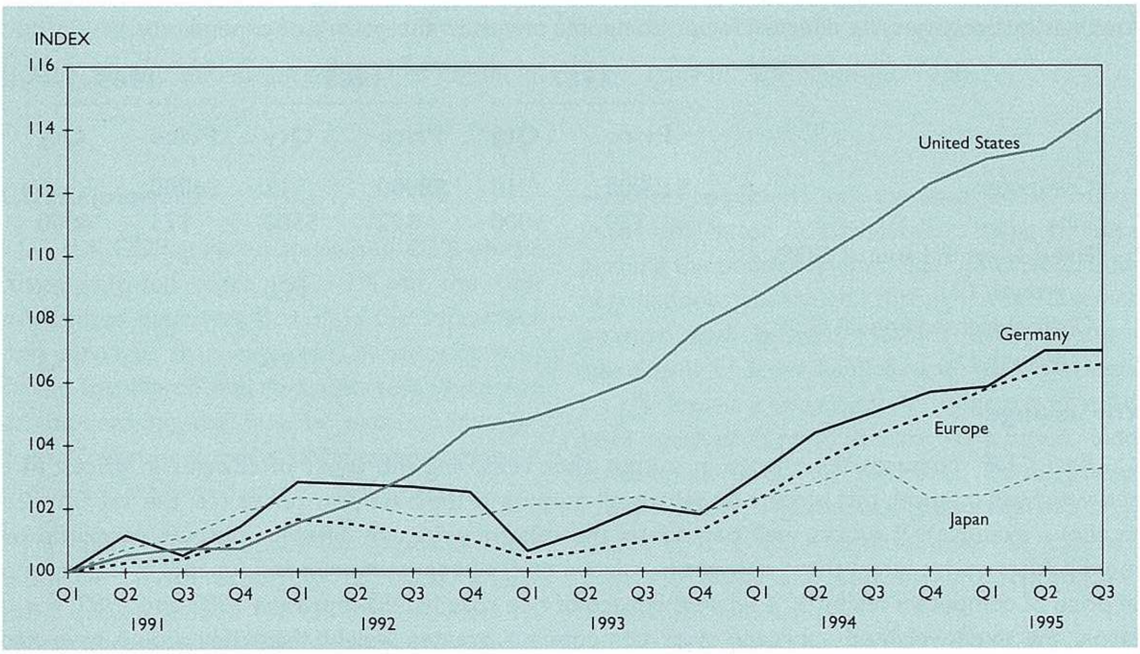
The new chain-weighted GDP index in the US exhibits slower growth over recent years than the previous GDP figures indicate. It showed a 3.0% annualised rise in real GDP for the September quarter of 1995 (up-dated to 3.2% during the first revision) instead of the fixed-weighted 4.2%. The new index shows growth in the US fluctuates around a lower mean in recent years but it does not alter the shape of the business cycle. The new data will leave the economy just as close to full capacity as the old figures, though the markets will need to grow accustomed to quarterly growth rates that fluctuate around a lower average gain.

### When and how?

The US Department of Commerce has been publishing the chain-weighted measures as one of the alternative measures in the regular presentation to supplement the fixed-weighted measures in the Survey of Current Business since May 1993. However, it was not until November 1995 that the US Department of Commerce and most of the media shifted their focus to the former.

Source: 'Survey of Current Business', US Department of Commerce, March 1993.

Chart 1
**Real GDP (March 1991=100)**

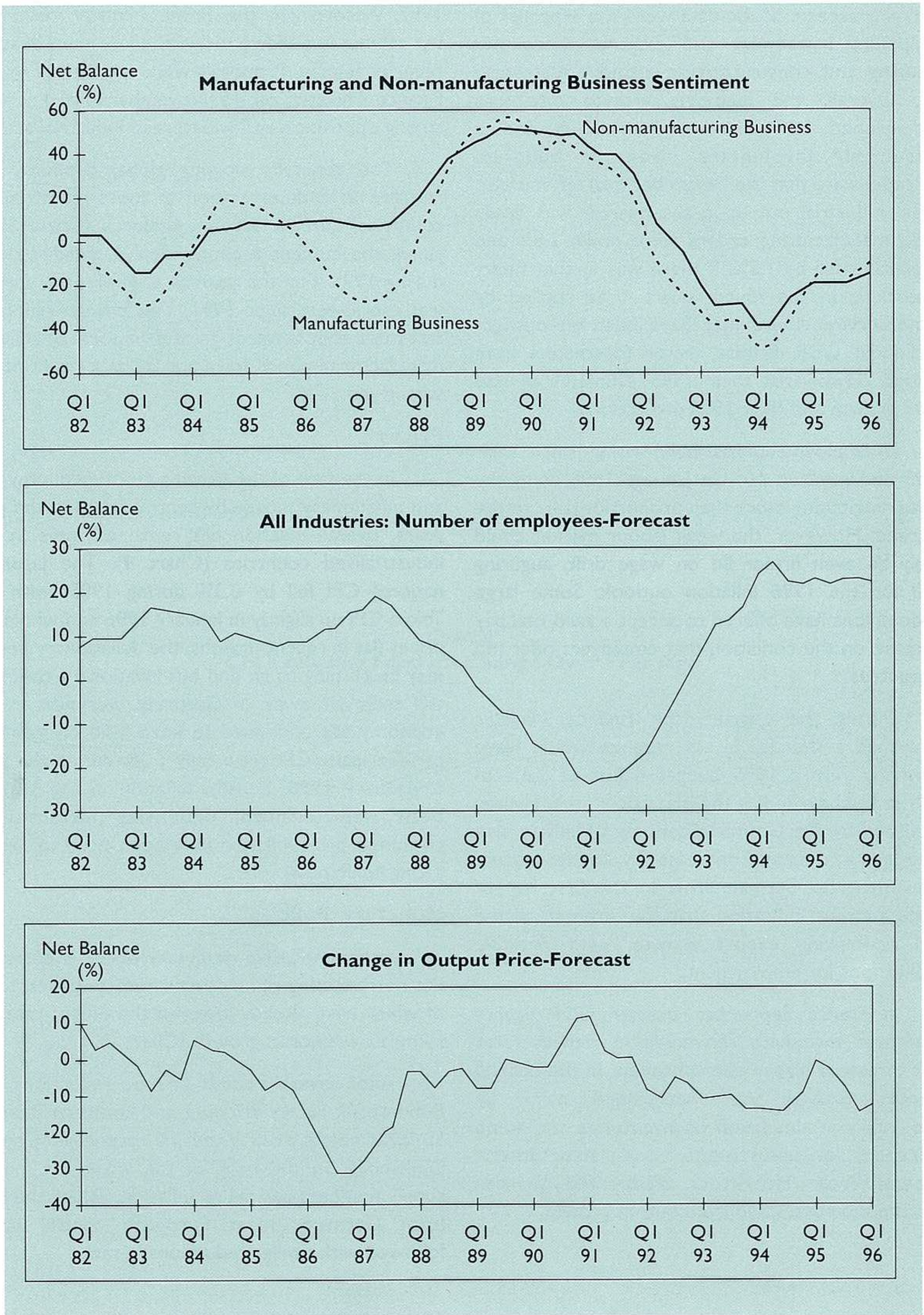



The Bank of Japan's November Tankan survey pointed to a mild improvement in business conditions (Chart 2). The modicum of change showed that the economy remained sluggish; business confidence remains near or below the low points observed in the two previous cycles.

Although industrial production rose solidly during the December quarter it remains well below its 1991 peak, suggesting substantial unused capacity. The jobless rate reached an historic high of 3.4% in November and December, with 2.2 million unemployed.

During the December quarter, the Japanese authorities approved the new economic plan for the years 1996 through 2000. Other than the continuation of 'structural reforms' involving deregulation, there are as yet few details and solid policy commitments to achieve the target growth rate.

Chart 2
**Japan Tankan Survey**




Source: Datastream

The German economy did not grow in the September quarter, bringing the annual growth rate down to 1.9% from 2.5%. The two most worrying aspects of the data were the slippages of equipment investment and exports. Consumer spending and construction investment were also flat. Overall, the quarterly growth rate was underpinned by government spending and a presumably involuntary inventory build-up. Indications are that the December quarter was also weak; industrial output in the quarter was down 1.4%, manufacturing orders were down 2.8% and retail sales fell by 1.5%. If there was further heavy destocking in the fourth quarter, as implied by some surveys, there may have been an outright decline in GDP. Private sector forecasters have revised downwards their 1995 estimates of real GDP growth and their 1996 projections.

Unemployment has been rising since mid-1995 and reached 10% in January 1996, with the East contributing more than proportionately to the uptrend. However, the weak labour market could imply an even firmer lid on wage drift, auguring well for the 1996 inflation outlook. Some large trade unions have offered to accept a zero real pay increase on the condition that employers offer job guarantees.

During the quarter, the Finance Minister confirmed a shortfall in tax revenue would leave Germany with a 1995 budget deficit of 3.6% of GDP, a level exceeding the Maastricht limit. Figures published by the German Economics Ministry also revealed a dramatic increase in foreign direct investment by German firms in the first half of 1995, another indication that the strength of the DM is hurting export growth, with negative implications for employment.

In France September quarter GDP figures confirmed the sharp slowdown in growth rates that threatens higher unemployment in the coming months. Growth was underpinned mainly by involuntary accumulation of inventories and some increase in investment, and government expenditures. However, trade and private consumption detracted from output growth.

The September budget for 1996 projected a central government deficit of FFr290 billion, still in excess of the Maastricht requirement of 3% in 1997. Accordingly, the Prime Minister reshuffled the cabinet in a bid to tackle the key issue of social security reform. Proposals were announced by the Finance Minister on 15 November but met with strong opposition and widespread industrial action.

The generally slowing global economy has resulted in a deterioration in most industrialised countries' current account balances (Chart 3). In Japan, the current account surplus trended down during 1995. For the year as a whole, the surplus was the lowest since 1991. This change reflects a structural shift towards greater imports of cheaper manufactured goods from abroad as a result of the strong yen.

### Prices

In the face of the slowing global economy and anti-inflationary moves by central banks in the past years, overall inflation has remained tame in the industrialised countries (Chart 4). The Japanese national CPI fell by 0.3% during 1995; with the Tokyo CPI up slightly in January 1996 and wholesale prices flat in recent months, the deflationary period may be coming to an end but inflationary concerns still seem far away. In Germany, weakness in the economy has continued to keep a lid on inflation; pan-Germany CPI grew only 1.5% during the year to January 1996. Equally, inflation in the US has been well-contained; underlying measures of consumer price inflation have been close to 3% for a long while now.

### Monetary Policies

Accommodative monetary policy is currently the norm among the industrialised countries, most of which have already lowered the official rates to stimulate economic growth (Chart 5).

After several rounds of repo reductions, the Bundesbank cut its discount and Lombard rates by 50 basis points, to 3% and 5% respectively, on 14 December on the back of the weak M3 money supply numbers and falling inflation. Taking the lead from Germany, most European central banks followed with similar reductions in rates.

Chart 3:
**Current Account Balance**

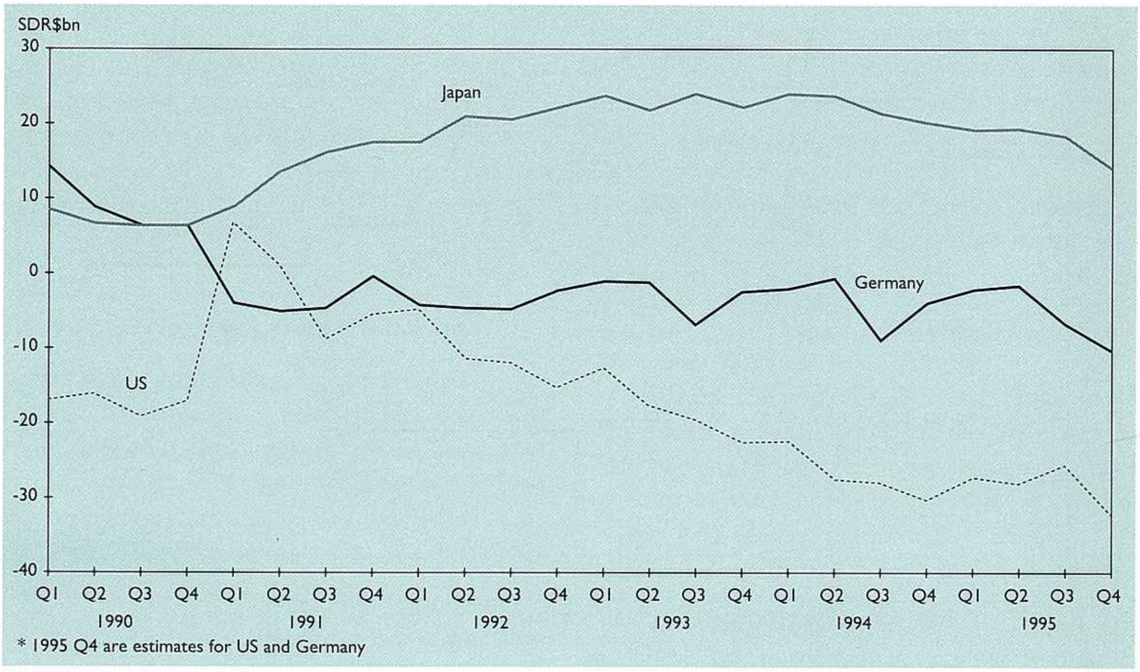



Chart 4:
**CPI Excluding Food - % Change Over Year Ago**

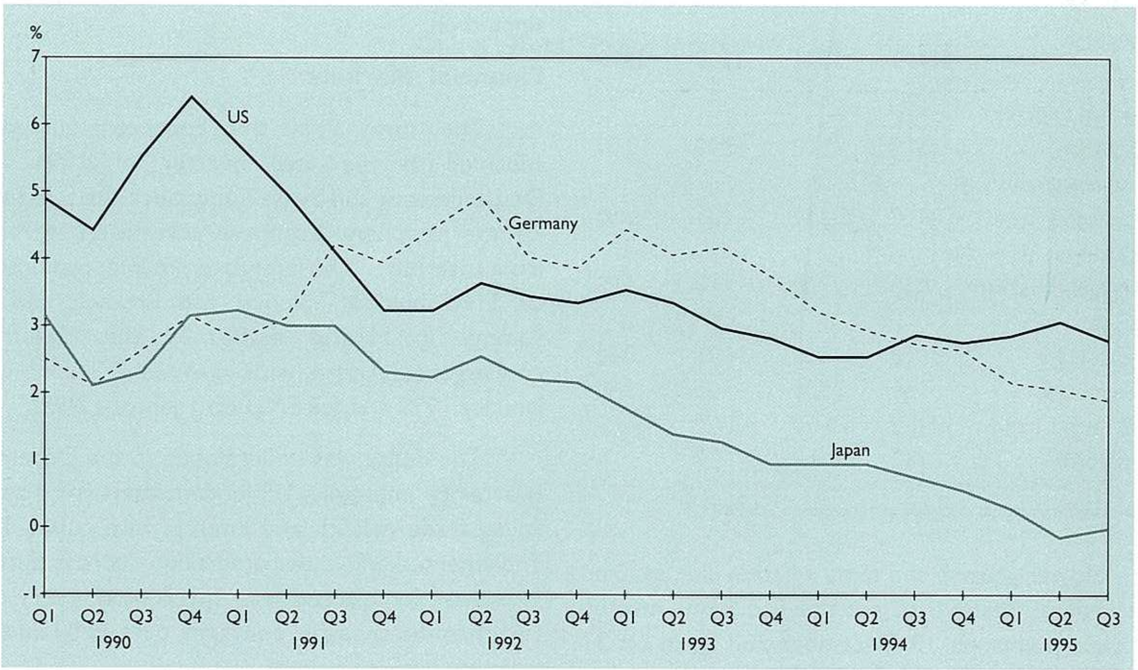
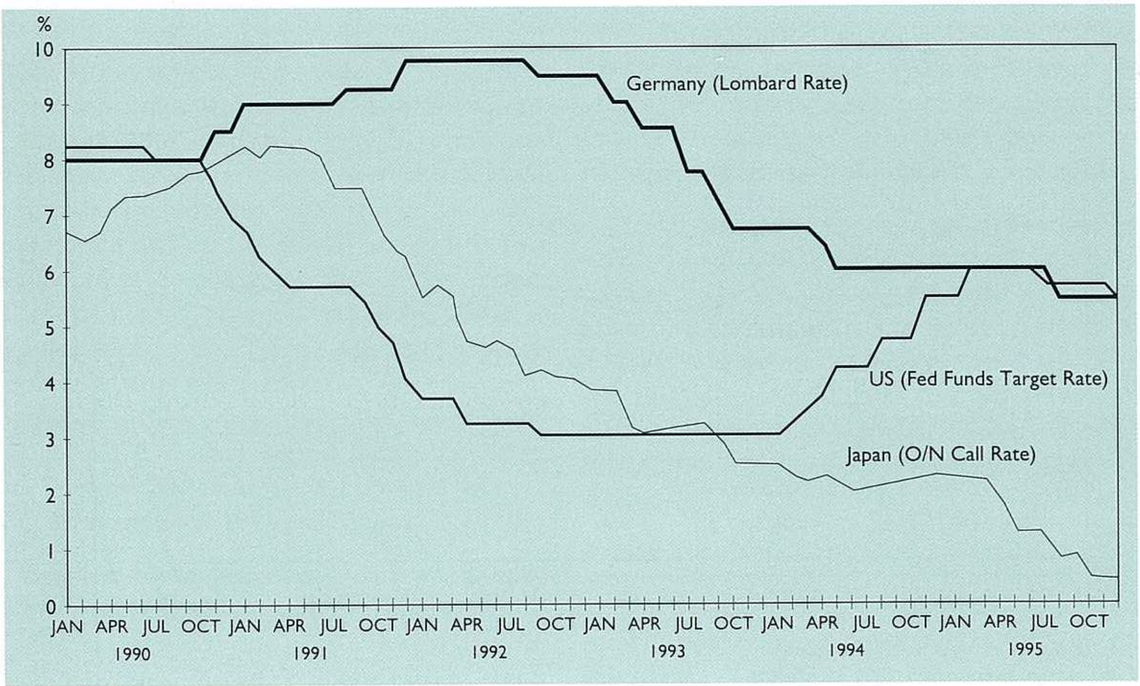


Chart 5

**G3 Official Rates**




The Bundesbank widened the M3 growth target for 1996 to 4-7% from 4-6% in 1995. It calculates the M3 target as follows:

| % | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|
| Medium term price inflation | 2.00 | 2.00 | 2.00 | 2.00 |
| Assumed production potential | 3.00 | 2.50 | 2.75 | 2.50 |
| Adjustment for decline in money velocity | 0.50 | 1.00 | 1.00 | 1.00 |
| Adjustment for past M3* | 0.00 | –0.50 | –0.75 | 0.00 |
| Central rate | 5.50 | 5.00 | 5.00 | 5.50 |
| **M3 target band** | 4.5-6.5 | 4.0-6.0 | 4.0-6.0 | 4.0-7.0 |
| **Outcome** | 8.2 | 4.9 | 2.7 | – |

* Due to the change in definition of M3 between 1994 & 1995

Slower growth and tame inflation also enabled the Federal Reserve to cut the Fed funds rate by 25 basis points on 19 December and again on 31 January, lowering it to 5.25%. The discount rate was also lowered in January, to 5%. The Bank of Japan has kept the Official Discount Rate – now at an historic low of 0.5% – unchanged since September, and continued with generous open market injections to prevent the overnight call rate from climbing above the 0.4-0.5% target in place since then.

## Financial Markets

The turmoil in the European currencies subsided in the final quarter of 1995. The Deustchemark and Swiss franc, once the safe haven for the peripheral European currencies, retreated from their highs. The intergovernmental conferences on EMU held in Valencia and Brussels and the summit in Madrid reaffirmed the Maastricht convergence criteria with irrevocable linking on 1 January 1999 and full EMU on 1 January 2002.[3]

The dollar was underpinned in the December quarter by improving US fundamentals (such as the falling trade deficit), and interest rate cuts – both implemented and anticipated alike – across Europe. However, its uptrend was interrupted, every now and then, by sporadic concerns over EMU and the Japanese banking system.

The combination of slow growth, low inflation and falling interest rates helped create a positive environment for worldwide debt markets. In January

3 For more information see Box on pages 52-54 in the November issue of the *Quarterly Bulletin*.

the US 10-year Treasury yield reached its lowest level since late 1993 while German yields were on a downward trajectory for most of 1995. Equity markets rose in sympathy. In particular, the Dow hit 69 new highs in 1995, matching the record set in 1925 and 1964, and rose further in early 1996. Major European and Asian bourses also recorded decent advances in stock indices during 1995 and have been buoyant since then.

## China

### Economic performance and inflation

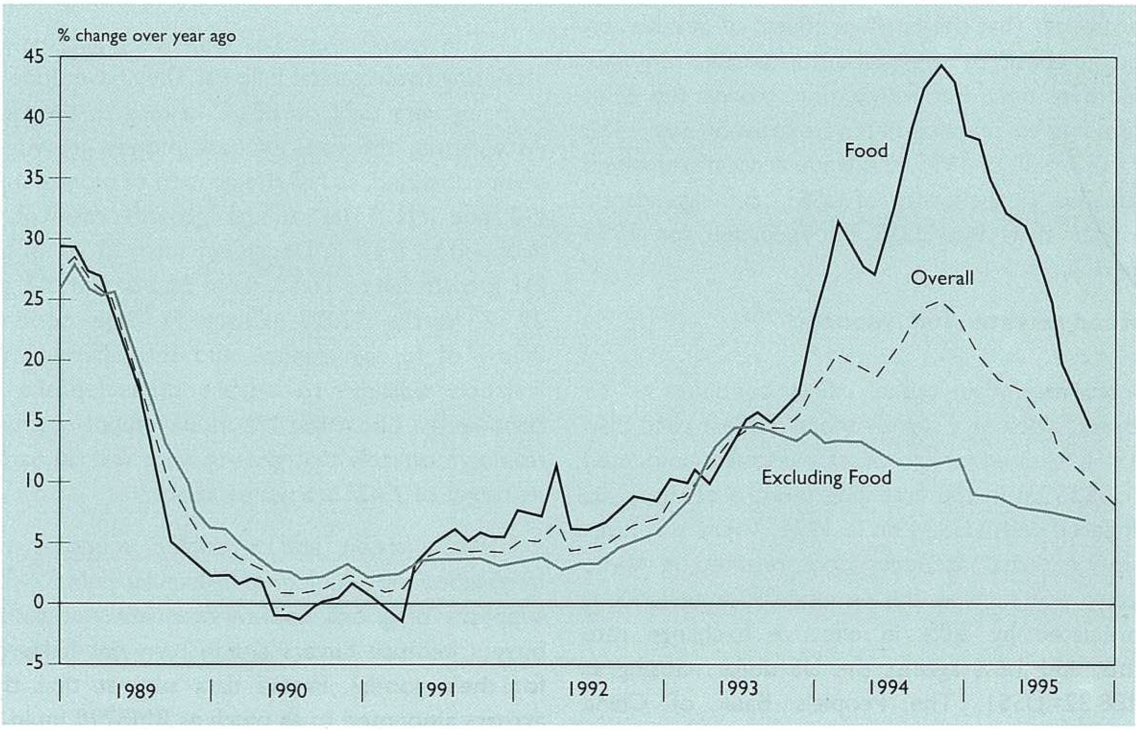
The tight credit policy implemented since July 1993 has been bearing fruit. Latest economic indicators, on balance, suggest that China is on track for a soft landing. There has been a significant easing in inflation, a gradual slowdown in economic growth, a robust trade balance, and a healthy foreign exchange reserves position.

The government succeeded in bringing inflation down to the target of 15% set for 1995; the retail price index increased 14.8% in 1995, down sharply from a rise of 21.7% in 1994. The decline in headline inflation continues to come from the general softening in food prices. In addition to price controls and subsidies which have served to restrain inflationary pressures temporarily, government credit and budgetary policies have recently been more supportive of agriculture, and there has been an improvement in food supply. While the fall in core inflation has been less pronounced (the retail price index excluding food grew an annual 7% in September based on our estimates), it also looks likely to head lower (Chart 6).

Real GDP slowed for three consecutive quarters in 1995, to 10.2% from 11.8% in 1994. The official growth target for the year was 8-9%. Also pointing to a cooler, more sustainable economy is industrial output, which slowed to 13.2% growth in the first eleven months of 1995 from 1994's 17.5%.

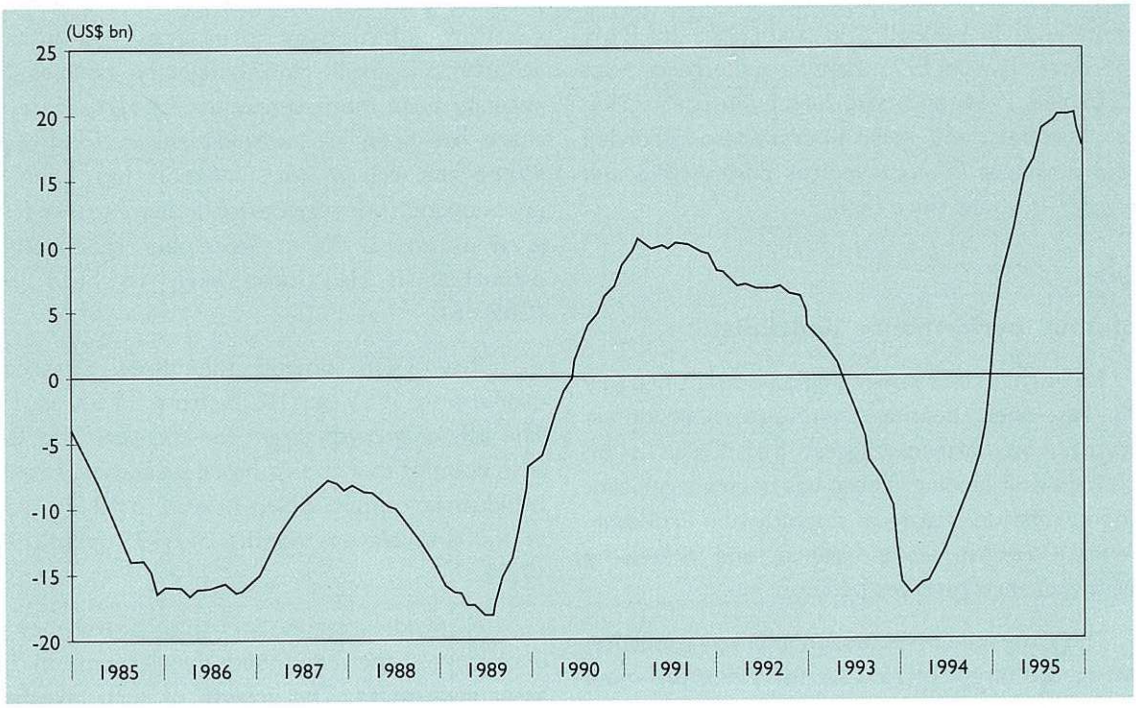
A major reason for this slowing of the economy is the continued deceleration in fixed asset investment. The growth of such investment has been sharply reduced from nearly 60% in 1993 to 19% in 1995. In addition, export growth

Chart 6
**China : Retail Price Index**




Source: China Monthly Statistics

Chart 7
**Trade Balance (12-month cumulative)**




Source: Datastream

declined over the course of the year with exports lower in November and December 1995 than in the corresponding months of 1994. The slowdown was partly due to the reduction of export rebates and the fact that the positive effects of devaluation brought about by the unification of the renminbi faded over time. But with export growth (up 23%) continuing to outpace import expansion (up 14%) for the whole of 1995, the trade account remained in surplus, in the order of US$17 bn, significantly stronger than the US$5 bn recorded for 1994 (Chart 7).

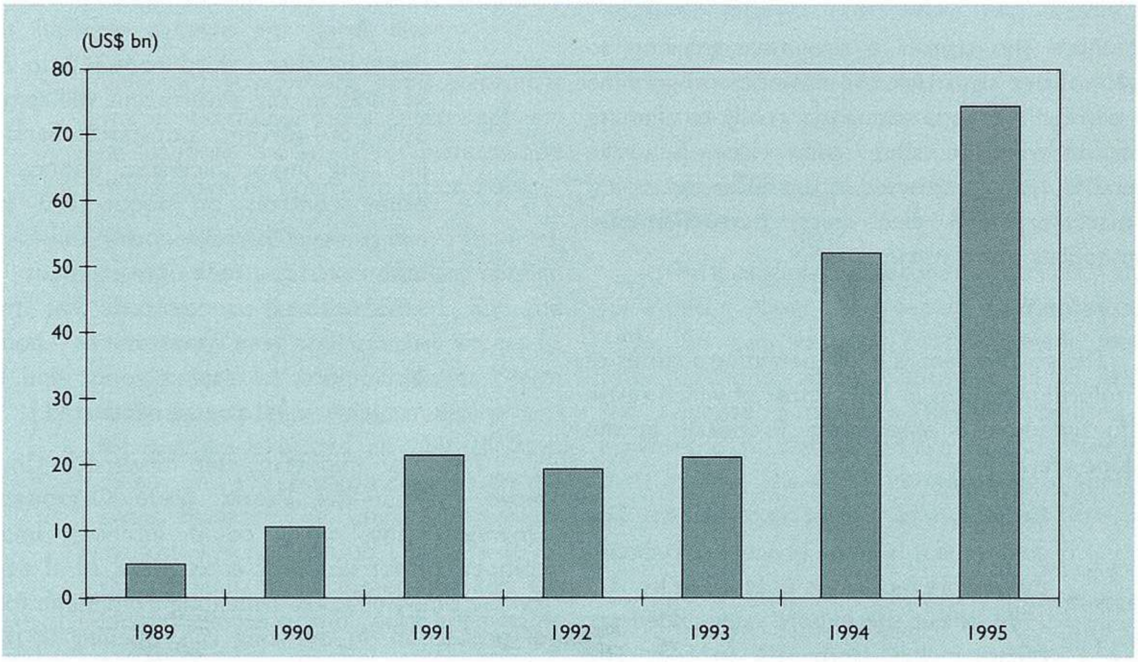
## Exchange rate and money

Furthermore, capital inflow continues to be buoyant, albeit at a slightly more modest pace than in 1994. Realised foreign direct investment amounted to US$26 bn in the first nine months of the year, compared with US$34 bn in 1994. These surpluses in the external accounts have resulted in some upward pressure on the renminbi. During 1995, it appreciated by 2.0% in effective exchange rate terms, and 1.6% against the US dollar, closing at RMB8.32=US$1. The People's Bank of China (PBoC) has chosen to keep the exchange rate stable around RMB8.3=US$1 by further accumulating reserves, which have more than trebled over the past three years to US$74 bn at end 1995 (Chart 8).

The government has been very successful in sterilising these capital inflows. They have done this by being very tight on PBoC lending to the banks. As a result, the pace of base money growth has been contained, as has the growth of money supply M0 and M1. The annual growth rate of M0 dropped to 8.4% in December from 21.1% in June, M1 growth fell to 16.8% from 21.2%, and M2 grew 29.5% versus 32.8% (Chart 9). The continued inflow of foreign capital, and the offering of an 'inflation subsidy' to attract time deposits will continue to boost the M2 money supply numbers, making it unlikely that growth here will fall back to its target of 23-25% anytime soon.

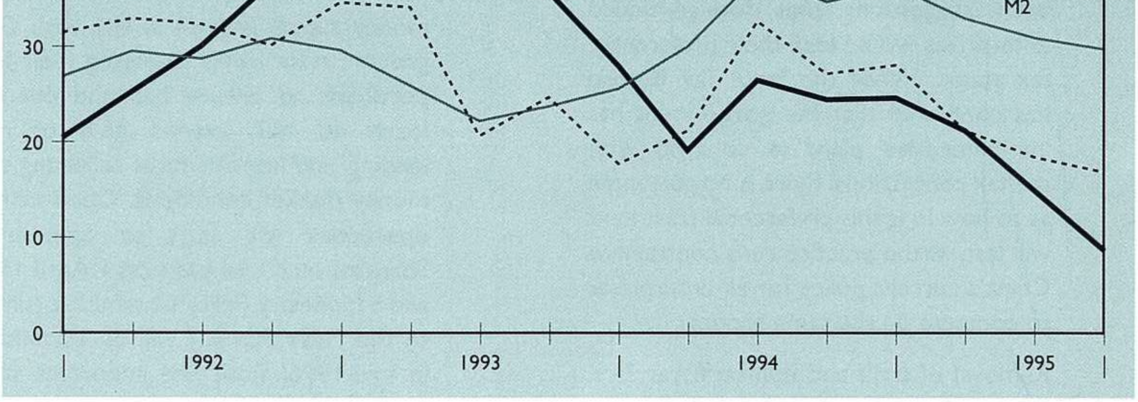
Tight credit and a cooler economy have heightened the problem of 'triangular debts' (where suppliers of goods and services are not paid by buyers because buyers are in turn not being paid for their goods). Partial data suggest that these arrears amounted to as much as RMB720 bn in July, and its share in money supply (M2) has remained

Chart 8:
**China: Foreign Exchange Reserves**




Source: IMF International Financial Statistics.

Chart 9
**China : Money Supply Growth**




Source: China Financial Outlook 1995.

around 13%. This has created a vicious cycle of indebtedness between enterprises that threatens to bring healthy enterprises down with sick ones.

With the macro environment starting to show positive signs that the austerity programme has worked, China is easing marginally to alleviate pressures on the state enterprises. Selective relaxation may be directed at the 'pillar industries' – machinery and electronics, petrochemicals, automobiles and construction.

### Tax reforms

The government is implementating a series of tax reform measures in 1996, most of which relate to foreign funded enterprises. Proposals in the pipeline are:

- Reduction in export tax rebates. The government is in the process of reducing the export incentives enacted in January 1994. It cut the export value-added tax rebate in July, from 17% to 14%. The second round of reductions occurred in January 1996 and took the rebate levels further down to 9%. The strong export performance of 1995 has greatly increased the financial obligations of the programme, and there are concerns over fraudulent claims.

- Unification of corporate income tax rate of domestic and foreign-funded companies. The existing rate for domestic enterprises is 33% and the concessionary rate applicable for foreign-funded enterprises is 15%. Recently, there have been suggestions that foreign-funded enterprises would lose their preferential tax status. While the State Tax Bureau has confirmed that the government has 'no immediate' plans to do away with the tax concessions, there is no guarantee as to how long this preferential treatment will last, as the practice runs contrary to China's current policy for all enterprises to compete on the same footing.

- Removal of tariff and non-tariff barriers. At the November Asia-Pacific Economic Cooperation summit, China announced a new round of unilateral trade liberalisation measures. Effective 1 April 1996, China will slash tariffs on more than 4,000 import items (roughly two-thirds of custom categories). The cut will bring the average nominal tariff down by over a third from 36% to 23%. In addition, the government will remove 30% of current non-tariff barriers, including import licences, quotas, and other controls on about 170 tariff categories. (To make up for the loss of tax revenues, the government has simultaneously announced that many exemptions from import duties – notably on imports of capital goods and raw materials – will also be eliminated.)

This is an important step forward in China's move to join the World Trade Organisation. However, the move could intensify import competition for domestic enterprises, all of which, for the time being, are benefiting from some forms of protection. In the long run, opening up to a more competitive environment will encourage greater efficiency and the development of better technologies and higher quality products. This in turn should make China more competitive in the global market place.

### Financial sector reform

During the period of the Ninth Five-Year Plan (1996-2000), there will be four key aspects for financial sector reform (this is placed in historical context in Box 2). They are:

- The PBoC will largely be responsible for monetary policy. Governor Dai Xianglong has explained this will entail: keeping money supply growth in line with GDP growth, state banks managing their loan portfolios to ensure bad and overdue loans do not exceed 15% of new lending, and interest rates reflecting true money market conditions. Open market operations will start to operate in Shanghai on a trial basis on 1 April 1996, and a Monetary Policy Committee (similar to the Fed's FOMC) will be established in mid-1996. Both are important steps towards a conventional monetary policy system.

- Specialised state-owned banks will become state-owned commercial banks.

Bank lending and borrowing will be based purely on commercial decisions rather than the previous administrative ones.

- Voluntary government bond placement will be extended, more enterprises will be listed on the securities markets and markets will be opened in other cities.
- The foreign exchange administration will be reformed and a standardised foreign exchange market established. For the time being, not everyone has access to the domestic interbank market for foreign exchange; foreign funded enterprises, for one, are excluded, as they still have to buy and sell foreign exchange on the swap markets. A unified interbank market, which began on 1 January 1996, should lead to a bigger market for foreign exchange and more predictable exchange rates.

## Impact on Hong Kong

Monetary tightening in China and rising domestic interest rates were two factors that trimmed growth in the Hong Kong economy in 1995. Compounded by worries over triangular debts and China's latest tax moves, the Hang Seng China Enterprise Index fell to a low of 685 on 16 November 1995, and closed the year 29% below the 1994 level.

The changing macroeconomic backdrop argues for a better economic prospect for Hong Kong in 1996, for two reasons. First, domestic interest rates have followed down those in the US. Second, the Chinese authorities have recognised the downtrend in inflation and are softening marginally their stance. The China connection can therefore be expected to be mildly positive for Hong Kong.

– Prepared by the External Department

## Box 2: Synopsis of China Financial Sector Reform from 1978

| 1978-1984 | 1984-1988 | 1988-1991 | 1991-1995 | Continuing and possible future action |
|---|---|---|---|---|
| **I. First Phase: Re-establishment of the Banking System** | **II. Second Phase: Diversification and Innovation** | **III. Third Phase: Rectification and Recentralisation** | **IV. Fourth Phase: Commercialisation and Expansion** | **V. Consolidation and Rationalisation** |
| Dec 78 Third Plenum of the Central Committee of the Communist Party broke the legacy of the Cultural Revolution and focused the party's work on economic development. Market-oriented reforms were adopted to achieve substantial gains in output on a sustained basis. | Sep 83 A directive of the State Council formally established the PBoC as the country's central bank by removing its commercial banking activities. | Early 88 Amid inflationary pressures, a rectification programme was introduced: stabilisation was given higher priority than structural reforms, and administrative measures were used to supplement nascent indirect instruments of macroeconomic control. | Oct 92 Fourteenth National People's Congress endorsed senior leader Deng Xiaoping's view of establishing a "socialist market economy".<br><br>Mar 92 Third Plenum of the Fourteenth Central Committee approved a comprehensive reform strategy where financial reforms were the key to strengthen the capability for market-oriented macroeconomic management. | The Fifth Plenary Session of the Fourteenth Central Committee of the Communist Party endorsed the Ninth Five-Year Plan (1996-2000) which focuses more on quality than on speed of economic growth. |
| **Exchange System** | | | | |
| 1981 Until 1981, numerous exchange rates were used for trade transactions between foreign trade corporations and domestic enterprises, depending on the items traded. In January 1981, a single exchange rate was established for internal settlement of trade transactions.<br><br>An experimental trading system was established by the Bank of China (BoC) in a few cities where domestic enterprises were permitted to sell foreign exchange to other domestic enterprises at the internal settlement rate. | 1985 The use of the settlement rate was discontinued and the exchange rate was unified. All transactions were to be done at the official rate set by the State Administration of Exchange Control (SAEC).<br><br>1986 Dual exchange system was reintroduced in 1986: official rate with de facto peg to the US dollar; more flexible rate determined on foreign exchange adjustment centres at which retention quotas were traded.<br><br>Chinese enterprises and foreign investment corporations in Special Economic Zones were permitted to transact foreign exchange at freely negotiated rates (retention quota system). | 1988 The right to trade in retention quota was extended to all domestic entities engaged in foreign trade. Those who were permitted to retain foreign exchange earnings were also permitted to transact retention quotas in the swap centres. By October 1988, 80 swaps centres were established.<br><br>1988-89 Official rate used in foreign exchange plan, for surrender and purchases with retention quotas.<br><br>1989 The SAEC issued regulations on priority access to foreign exchange traded in swap centres.<br><br>Official rate devalued in December, by 21%.<br><br>1990 Official rate devalued a further 9% in November. | 1991 The PBoC started selling to importers the quotas it had bought at the market rate through the swap market at the prevailing swap market rate.<br><br>1993 The State Council decided that the SAEC should function under the guidance of the PBoC. The SAEC issued regulations on licensing, capital, operations, controls, and risk limits for foreign exchange operations.<br><br>1994 The official and swap rates were unified at around RMB8.7 = US$1.<br><br>The China Foreign Exchange Trading System (CFETS) became operational, creating an integrated system of foreign exchange trading centralised in Shanghai. | Opening of the interbank market to foreign-funded enterprises and the abolition of the swap market on 1 January 1996. This should lead to a bigger market for foreign exchange and more predictable exchange rates.<br><br>Convertibility of the renminbi in respect of current account transactions. |

| 1978-1984 | 1984-1988 | 1988-1991 | 1991-1995 | Continuing and possible future action |
|---|---|---|---|---|
| **Banking System** | | | | |
| 1979 Shift of budgetary grants to bank lending.<br><br>Three specialised banks were established to operate in specific sectors of the economy. They were Bank of China (BoC), People's Construction Bank of China (PCBC), and Agricultural Bank of China (ABC).<br><br>A network of rural credit cooperatives (RCCs) was set up under the supervision of the Agricultural Bank.<br><br>Early 1980s The first non-bank financial institutions (NBFIs) started to operate, many at the provincial level, particularly in the coastal regions. | 1985 A fourth specialised bank, the Industrial and Commercial Bank of China (ICBC), was established to take over commercial activities that were removed from the PBoC.<br><br>1986 Provisional regulations entrusted the PBoC with responsibility to conduct monetary policy, and regulate and supervise the financial system as well as the money and capital markets.<br><br>All banks were allowed to engage in foreign exchange transactions.<br><br>Opening of Urban Credit Cooperatives (UCCs), insurance companies, leasing companies, and establishment of Trust and Investment companies (TICs) and securities houses. | 1988 Reorganisation of the TIC sector; the number of TICs was reduced significantly through mergers and absorptions. | 1992 End of the rectification programme. The authorities announced their intention to accelerate the process of reform. Gradually more commercial banks, mostly of regional scope, were licensed.<br><br>1994 Establishment of three policy banks (Agricultural Development Bank of China, Export-Import Bank of China, and State Development Bank).<br><br>1995 Enactment of Commercial Banking Law. | Strengthening of an independent macroeconomic and supervisory role of PBoC as central bank.<br><br>Gradual increase in autonomy of banks. |
| **Financial Markets** | | | | |
| 1981 The government resumed the issuance of government securities through compulsory sales to enterprises and individuals.<br><br>1982 Private enterprises were allowed to issue shares. | 1983 ABC established interbank market followed by other banks.<br><br>1984 The first information centres appeared in some major cities, thereby introducing the concept of an interbank market. Local enterprises were allowed to issue corporate bonds with the prior approval of the PBoC. These bonds were allowed to pay interest rates up to 40% higher that bank deposits.<br><br>1985 SOEs were permitted to issue shares carrying no ownership rights. Banks were permitted, upon approval from PBoC, to issue bonds. The interest rate was set 2 percentage points above deposit rates of similar maturities.<br><br>1986 Secondary market trading in government securities was allowed on an experimental basis.<br><br>1987 The Government began to diversify its debt instruments with the issuance of key construction bonds and special state bonds to households and state enterprises. | 1988 The State Council officially approved trading in government securities. Gradually trading was extended from 7 to 63 cities and other securities were added to the list (bonds, shares, non-government securities). Fiscal bonds were sold for the first time to financial institutions.<br><br>1989 Foundation of the Stock Exchange Executive Council (SEEC).<br><br>1990 Rising inflation urged the government to issue "price-indexed bonds". The PBoC established the Quotation Centre for government securities. Official opening of the Shanghai Securities Exchange in December.<br><br>1991 Official opening of the Shenzhen Stock Exchange in May. Issue of treasury bonds for households via an experimental underwriting syndicate. | 1993 The quotation Centre was transformed into the National Electronic Trading System (NETS).<br><br>1994 Issue of paperless Treasury bills through an underwriting syndicate. Establishment of Provisional Securities System (PSS), planned to be the infrastructure for payment and settlement related to open market operations. | Continue extension of voluntary government bond placement, and more extensive listing of enterprises on the securities markets and opening markets in other cities.<br><br>Development of interbank and money markets and of new financial instruments.<br><br>Enactment of Securities Law. |

| 1978-1984 | 1984-1988 | 1988-1991 | 1991-1995 | Continuing and possible future action |
|---|---|---|---|---|
| **Monetary Policy**<br><br>Monetary policy was dominated by the credit plan and the cash plan. Interest rates set by the PBoC under the authority of the State Council. | 1984 Reserve requirements were introduced; different rates applied according to the type of deposits (20 to 40%).<br><br>1985 Reserve requirements were reduced and made uniform at 10%.<br><br>1986 Banks were allowed to adjust loan rates within a 10% margin above the administered rate. Credit quota became more indicative.<br><br>1987 Reserve requirements raised to 12%. | 1988 Under the rectification programme, ratio of reserve requirements raised to 13%.<br><br>1989 Introduction of guidelines on "excess reserve requirements" (in a range of 5-7% of domestic currency deposits) in light of high liquidity and inflation threat. Reversal of the 1986 measure allowing banks to adjust loan rates above the administered rate. Credit quota became again mandatory.<br><br>1990 Interest rates were reduced in three steps through to 1991. Banks were again allowed to adjust loan rates within specified margins. PBoC regulated interbank rates and promulgated new measures to regulate interbank markets. | 1993 Interest rates were raised again in May and July. Banks and NBFIs were ordered to recall all loans on the interbank market granted to finance real estate or securities. The PBoC issued new guidelines on interbank activities.<br><br>1994 Decision to extend the bulk of PBoC credit at the PBoC headquarter level, instead of the previous practice of extending credit at the branch level.<br><br>Discontinuation of PBoC overdraft or direct loans to the government. Calling back of some PBoC loans extended to the State Commercial Banks and other financial institutions.<br><br>Use of special deposits to absorb excess liquidity in the system. Introduction of assets/liabilities management guidelines for all banks and replacing credit quota by a loan to deposit ratio for the UCCs and TICs.<br><br>1995 Compliance with the excess reserve guidelines on a consolidated bank-wide level, while monitoring remained at the branch level. Plans were prepared to liberalise interest rates and to develop an integrated interbank market. Enactment of Central Bank Law. | Introduction of open market operations, initially through issuance of short-term PBoC bills, then short-term Treasury securities. The PBoC has been experimenting and plans to start open market operations on a trial basis in Shanghai sometime in 1996.<br><br>Setting up of a Monetary Policy Committee (similar to the Fed's FOMC) in mid-1996.<br><br>Gradual increase in reliance on interest rates, determined through market forces. |

Sources: China at the Threshold of a Market Economy (IMF, 1993). China Financial Outlook (PBoC, 1995), and updated by HKMA.