



Chapter I

Macroeconomic Environment

In 2006, the world economy maintained its strong momentum with a stable international financial market. Meanwhile China's economy continued its steady growth with performance improved and overall price level subdued. Economic conditions, both international and domestic, favoured financial stability.

Economic and Financial Environment

In 2006, the world economy and financial markets demonstrated the following features: Firstly, rapid economic growth. World economy grew at 5.4%, with major economies like the US, Eurozone and Japan growing at 3.3%, 2.6% and 2.2% respectively. Emerging markets recorded 7.9% of growth. The global growth has also become less reliant on the US economy. Secondly, higher productivity and output eased inflation pressure, which resulted from low interest rates and excess liquidity in recent years. The pressure has been mitigated as emerging markets have begun to bring productivity and production gains to the global economic and financial system. Thirdly, financial markets became better equipped to diversify and defuse risks. While economic and financial globalization and innovation enable market players to finance from the markets, the emergence of large institutional investors and rapid develop-

ment of tools transferring credit risks helped diversify risks. Fourthly, abundant capital supply worldwide and low level of long-term interest rates. Petrodollar, high savings rate in Asia, low interest rates in Japan and Yen carry trade contributed to excess liquidity worldwide. Long-term interest rates and cost of capital were relatively low, funding economic growth.

The Chinese economy was characterized by the followings: Firstly, smooth and rapid growth. GDP for 2006 reached RMB 20.94 trillion yuan, up by 10.7%. Urban disposable income and net income for farmers were RMB 11 759 yuan and RMB 3 587 yuan per capita, which represented a real growth of 10.4% and 7.4% respectively. Export and import totalled USD 1.76 trillion, up by 23.8%. Trade surplus amounted to USD 177.5 billion, an increase of USD 75.5 billion y-o-y. Secondly, greater efficiency. Fiscal revenue totalled RMB 3.93 trillion yuan, up by RMB 769.4 billion yuan y-o-y. Value added by large industrial enterprises increased by 16.6% and profits by 31%. Thirdly, stable price level. CPI rose by 1.5% y-o-y, factory price of industrial products up by 3.0%, and purchasing price of raw materials, fuel and power up by 6.0%. GDP deflator remained at 3.2%. In addition, headway has been made in key areas and reforms while social undertakings were boosted. Steady macroeconomic development and improved overall economic efficiency laid a solid foundation for financial stability.

Box 1 China's Economic Development Contributes to Economic Growth and Financial Stability Worldwide

The Chinese economy has recorded rapid and sustained growth over the past three decades. Since 2002, the economy has been growing around 10%. World Bank estimates the average contribution of China's growth to world economy (at PPP) at 25%, to world trade growth 21%. China's economy has become ever stronger and more competitive, and Chinese people now live a better life. Also as the largest developing country in the world, China experiences stable, sustained and rapid economic development, which contributes to world economic growth and financial stability in the following ways:

First, increased productivity in China brings profits for importers, retailers and savings for consumers around the world. It also helps global financial stability by ea-

sing inflationary pressure.

Second, savings rate is higher than investment rate in China, and it allows for low-cost financing to other countries. The net savings lead to a sustained increase in trade surplus and foreign exchange reserves, some of which are invested in foreign bonds, in a way financing the growth of others at a low cost.

Third, rapid growth in import and FDI helps the economic growth of other countries and regions. World Bank estimates that over the past decade China's import increased by 477%, with 79% from developing countries, which increasingly favours China as an export destination. Meanwhile China's increasing FDI overseas benefits local economy and employment.

Impact of Economic and Financial Environment on Financial Stability

Steady international and domestic economic performance is a favourable condition for financial stability in China. Still financial risks exist in the world economy, and in the Chinese economy, which merits attention.

Global economic and financial risks should not be overlooked

Risk of global imbalances. The huge US trade deficit continued in 2006 while debt level soared. Oil exporting and Asian countries continued to run a trade surplus against the US, which implied the risk of disorderly adjustment following global imbalances. Fluctuation of major currencies, rise in interest rates, changes in international capital flows and investor confidence may all disrupt global financial markets and spill over to domestic markets.

Excessive fluctuations in oil and resources prices. Capital flows, speculative demand and supply shocks may set off violent fluctuations in oil and other commodity prices, which may undermine government efforts to control inflation and maintain financial stability. In the long run, international oil price hikes will spill over to production and consumption, exerting inflation pressure on the home market. Fluctuations on oil and other commodity markets will destabilize production thus affecting sustained and healthy economic development.

Excess liquidity and volatility in asset prices worldwide. Global liquidity excess in recent years has led to rising asset prices worldwide. Asset prices may become even more volatile as liquidity levels change. Policy measures to reduce liquidity may also affect asset prices. Therefore possible spillover of global excess liquidity to China need to be watched closely.

Global economic slowdown. As short-term in-

terest rates go up and demand for adjustable rate mortgage shrinks, housing price and investment along with consumption growth in the US are in a downward trend. Tightening policies adopted by other economies to ease inflation and to drain liquidity may slow down economic growth even more. A global slowdown will bring uncertainty to the export and economic growth of all countries, including China.

Risk of reversal of the global financial market cycle. There are signs in recent years pointing to investor optimism and low risk premium on financial markets globally, which have attracted huge inflow to financial markets seeking high returns. However, risks related to market cycle are on the rise, for instance in the new subprime loans in the US. As China's financial sector has never been so integrated into the global system, the risk of cyclical reversal globally will indeed impact China more than ever.

Box 2 Risks Arising from Subprime Loans in the US

In America subprime loans refer to loans that banks or lending institutions lend to borrowers who do not qualify for prime rate loans. The line between “prime” and “subprime” is drawn based on the credit score of a borrower. In other words, banks or lenders assess eligibility for prime rate loans according to the

borrower's credit rating¹. Non-qualifiers usually have less-than-sterling credit, or new immigrants who do not have credit records. As subprime borrowers usually have low credit rating, banks or lenders are less likely to recover such loans, hence demand much higher interest rates from borrowers.

¹ In the US, credit bureaus grade loan applicants in their personal credit rating systems, where scores range between 300 and 850. Higher credit score implies lower credit risk of a loan applicant, and vice versa. Banks or other lenders refer to this score as well as their lending strategies and criteria and the product-specific risks in deciding the credit level of each applicant. 660 is usually minimum; those who score higher may get prime rate loans whereas those below cannot.

Some lenders on this market are independent; others are affiliates to major lenders operating under different names. Some large financial corporations also provide loan support for subprime lenders. As an increasing source of funding for mid- and low-income homeowners, the market is growing rapidly. In 2006 subprime loans reached USD 640 billion in the US, or 5.3 times that in 2001, representing 13% of total home loan, up from 9% in 2001. Currently US home ownership is at a record high of 69%.

The flourishing subprime loans have followed a booming real estate market, but there are risks. According to statistics of Mortgage Bankers Association, the ratio of loans outstanding for over 30 days was 4.6% as of the third quarter of 2006, with subprime loans recording a 12.6% of default rate. As default and foreclosure escalate, lenders will suffer capital losses that may create shocks to the entire mortgage market. Falling stock prices of lenders—many have indeed got listed—will affect the financial market as a whole.

There are two reasons behind the risk concentration. First, risks arising from lower threshold for loan applicants and lenders' quest for high returns. The low interest rate policy pursued by the Federal Reserve be-

tween 2001 and 2004 helped the property market boom, amidst which subprime loans won over buyers with low credit scores. Some lenders even offered "zero down" "zero doc" loans: a borrower could purchase a home with no money out of pocket; only income statement was needed, not any proof of repayment capability. Property evaluation was more reliant on computer programmes instead of evaluator's opinion, which combined to undermine the market. Second, in a bullish market, under-funded borrowers could just sell or refinance their mortgages as the property appreciated. But the US property market began to cool in 2005, concurrent with rate increases, making property less liquid and valuable to pay for the mortgage.

Given there are a variety of players in the subprime market, the potential risk is widespread. First, lenders are being closed down. Second, mutual funds, hedge funds, large banks and insurance companies that hold subprime assets (including securitization) are faced with impairment. Third, as lenders are forced out of business, lenders of last resort like banks will tighten up credit, a vote of no confidence in the financial industry and economy as a whole, which may trigger global financial turbulence.

Structural problems in the economy need to be addressed

There are a number of problems in the Chinese economy that may stay for the medium and

long term: imbalance among the primary, secondary and tertiary industries, imbalance between the urban and rural areas and among regions, imbalance between investment and consumption, and imbalance in the balance of

payments. At present, the last two are the most pronounced structural imbalances.

In 2006 investment rate and consumption rate were 52.5% and 36.5% respectively. In addition to a less-than-optimal economic structure and impulse to invest by local authorities, the imbalance also resulted from SOEs' capacity expansion on most of their retained earnings. In other words, over half of the investment came from their own funds. The decline in the share of household disposable income in GDP accounted for lack of increase in the level of household consumption.

In 2006 the "twin surplus" continued, exacerbating the imbalance in the balance of payments. Cumulative trade surplus topped USD 177.5 billion, and FDI USD 69.47 billion, both of which contributed directly to the spike of foreign exchange reserves. The central bank supplied base money by absorbing foreign assets, adding to the liquidity in the banking system. The imbalance is the result of numerous factors including existing economic structure, global economic imbalances, changes in the international distribution of productivity and financial system. As the global industrial restructuring progresses slowly, it will take time for economic structural adjustment to take effect.

Inflation pressure has increased in general

As the upside risk of consumer prices in-

creased, overall inflationary pressure should be guarded against. Grain price hikes caused CPI to rise at the end of 2006. Looking forward, high prices of international oil and non-ferrous metal, rising agricultural prices, price reform of resource-based products, rising land prices and higher production costs arising from more stringent environmental and safety requirements as well as climbing labour cost may all push up CPI further. Given high possible investment and credit booms and excess liquidity, the risk of mounting inflationary pressure cannot be overlooked.

In response to the aforementioned problems, a comprehensive approach needs to be adopted to speed up economic structuring towards a development strategy centering on domestic demand as well as external demand and equilibrium in the balance of payments; to give full play to the role of fiscal policies, public finance in particular, to increase spending on education, medicare and social security and public services; to improve macro control and continue with the prudent monetary policy, which includes coordinating foreign and domestic current policies and liquidity management within the banking system to ensure proper growth of credit supply and stable prices; to further the reform of financial institutions and promote market development so as to create a sound environment for financial stability.

Box 3 Focuses of the Financial Stability Report by Other Countries

In its *Global Financial Stability Report* released in September 2006, IMF finds greater volatility in the international financial market and uncertainty of investor expectations about economic development and policy measures. The report believes that in the short run energy prices may rise again; the US property recession may undermine economic growth of the country and the world at large; the climate of financial markets may experience an unfavourable turn; changes in the investment strategy of Asian countries and oil producers with heavy foreign exchange reserve holdings may impact the adjustment of global imbalances; rapid growth in household credit may trigger asset bubbles and affect financial stability on the whole; but in the long term the world economy will continue to grow steadily and inflation will remain under control.

The Bank of England points out in its *Financial Stability Report* (July 2006) that since May 2006 risk preference has fallen worldwide, and as asset bubbles are being deflated, asset prices have begun to drop. The report thinks that the major risks for UK lie in rising risks in the international financial market, increasing debt ratios of non-financial sectors, greater structural changes in the financial system and inadequacy of market infrastructure such as the clearing system in the event of emergencies. Therefore risk measurement and management should be enhanced, and stress test

of the financial system improved, so as to maintain financial stability with stronger crisis management capabilities.

In its *Financial System Report* (July 2006), Japan believes that given improved asset quality, profits and capital adequacy in its banking sector, and greater confidence of the public and market participants in the financial system, Japan has by and large restored financial stability. The report holds that banks need to adapt to an ever changing financial environment by properly managing various risks, which is of vital importance to maintaining the stability and giving full play to the role of the financial system and achieving sustainable growth. As far as risks are concerned, the impact of investment movements in hedge funds and real estate funds needs to be fully understood. While pressing ahead with new business, banks should properly manage all the risks concerned, for instance, interest rate risks and liquidity risks that could be managed through stress tests.

Korea indicates in its *Financial Stability Report* (October 2006) that driven by export and equipment investment growth, the Korean economy has been growing well with financial stability in general and improved bank profits and capital adequacy in particular. Businesses are financially viable and solvent. However, uncertainty remains in property prices as aggregate household debts

(especially mortgage loans) continue to rise , chipping away overall debt repayment ability . Furthermore , there are still potential risks on the international financial market , for example , imbalance in the current account of major economies may impact Korea's financial stability .

The Monetary Authority of Singapore believes ,

in its *Financial Stability Review* (December 2006) , that the world economy is slowing down after four years of strong growth , which may bring changes to the business environment of the financial sector . But as Singapore's financial institutions , businesses and households remain financially sound , the country will be able to maintain financial stability .

(By Sun Tao , Yang Liu and Zhang Tiantian)

