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Excess Liquidity and Financial Market Risks

Speech by Mme. WU Xiaoling,
Deputy Governor of the People's Bank of China
at the Caijing Forum: China's New Financial Landscape
September 13, 2007, Beijing

To have a better understanding of the monetary policy operations of the central bank, one must first take a look at the phenomenon of excess liquidity. While we attempt to correctly understand the sources of excess liquidity, we must separate the liquidity management of the banking system by the central bank from the liquidity problems existing in the broad economy.

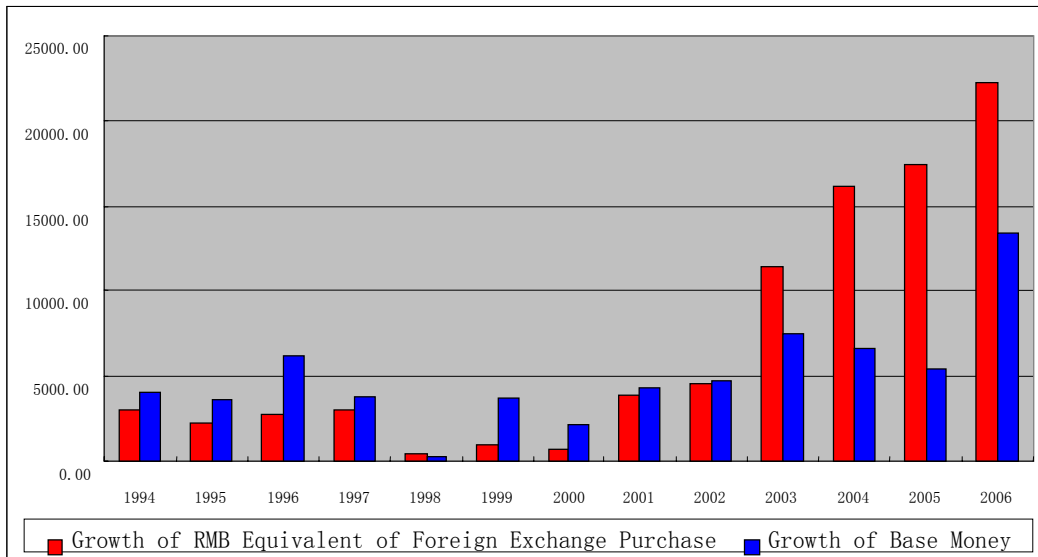
Liquidity in the banking system originates from the excess reserves held by the commercial banks in the central bank which reflects an expansion of the lending capacity of the commercial banks. Excess liquidity in the banking system often indicates an excessively high ratio of excess reserves and a much expanded lending capacity of the commercial banks.

Liquidity in the broad economy refers to the ability of the economy to cash in all assets (including financial assets), reflecting the relationship between broad money and financial assets and tangible assets. Excess liquidity in the broad economy often indicates excess supply of money which exerts upside pressures on the prices of financial and tangible assets.

Strengthening management over liquidity in the banking system constitutes an important component of the monetary policy conduct when the central bank passively releases base money into the economy.

Before 2002, the People's Bank of China (PBC) conducted its monetary policy mainly by appropriately releasing base money to increase liquidity as the purchase of foreign exchange by the central bank resulted in supply of base money more than needed by the economy. After 2002, the PBC mainly conducted its monetary policy by sterilizing the increase of base money passively released so as to control the growth of liquidity in the banking system. The reason is that money supply resulted from the central bank's purchase of foreign exchange has steadily increased over the recent years and has even exceeded the growth of base money by a large margin (see figure 1).

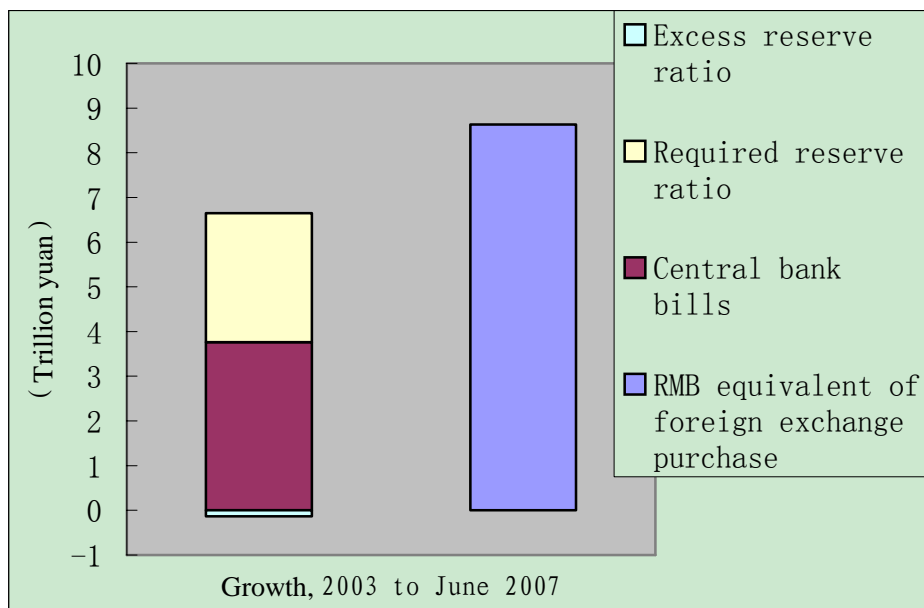
Figure 1: Comparison of the growth of RMB equivalent of foreign exchange purchase and the growth of base money



Source: People's Bank of China

It should be noted that through a mix of monetary policy instruments such as open market operations and the reserve requirement ratio, the central bank has to a large extent sterilized the excess liquidity in the banking system over the years. More specifically, monetary policy instruments like the central bank bills, reserve requirement ratio and excess reserve ratio have been applied to sterilize most of the money supply resulted from foreign exchange purchase, leaving the money supply appropriately at a level consistent with the needs of economic and social development (see figure 2).

Figure 2: The central bank sterilized excess liquidity in the banking system



Source: People's Bank of China

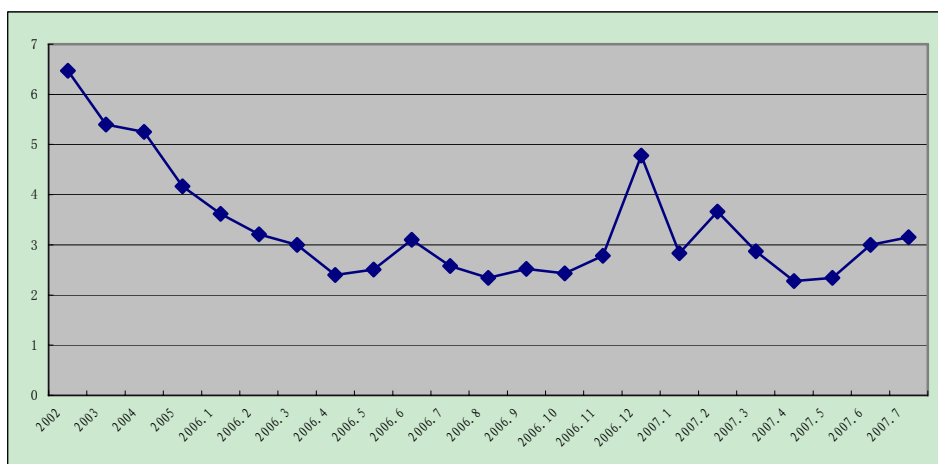
Special treasury bonds like the central bank bills are also monetary instruments that are used by the central bank in open market operations to release and absorb base money, and can produce the same impacts on liquidity situation. When the money supply target is identified, so is the intensity of open market operations of the central bank and the market should not panic over which specific monetary policy instrument is used to recall liquidity from the banking system.

Whether it be central bank bills or special treasury bonds, the central bank must function as the leading party in the open market operations so that the target of interest rate adjustment could be consistent with that of exchange rate management. And also because only the central bank has the capacity to perform this function, it has been able to ensure overall monetary stability in China. Imagine if there existed two leading institutions in the financial market involving financial macro control, it would be very hard to ensure the consistency between these two targets.

On the other hand, how should we determine which instrument to use in the conduct of monetary policy? Should it be open market operations or the reserve requirement ratio? In this regard, the central bank often has its decision made based on impacts of the intended monetary policy instrument on the market interest rates. When we do not like to see the market interest rate tends to rise excessively, we would use the reserve requirement ratio, as the remuneration on required reserves is only 1.89 percent and it is a mandatory requirement.

Thanks to market operations of the central bank, liquidity in the banking system has been brought under control, with the excess reserve ratio falling steadily since 2002 to about 3 percent in the first quarter of 2006. The excess reserve ratio further declined to about 2.5 percent in recent months. Of course, there are also exceptions when the excess reserve ratio can reach high levels, usually in late December and January, that is because during the holiday seasons the commercial banks need to keep abundant liquidity to meet cash demands of the customers. (see figure 3).

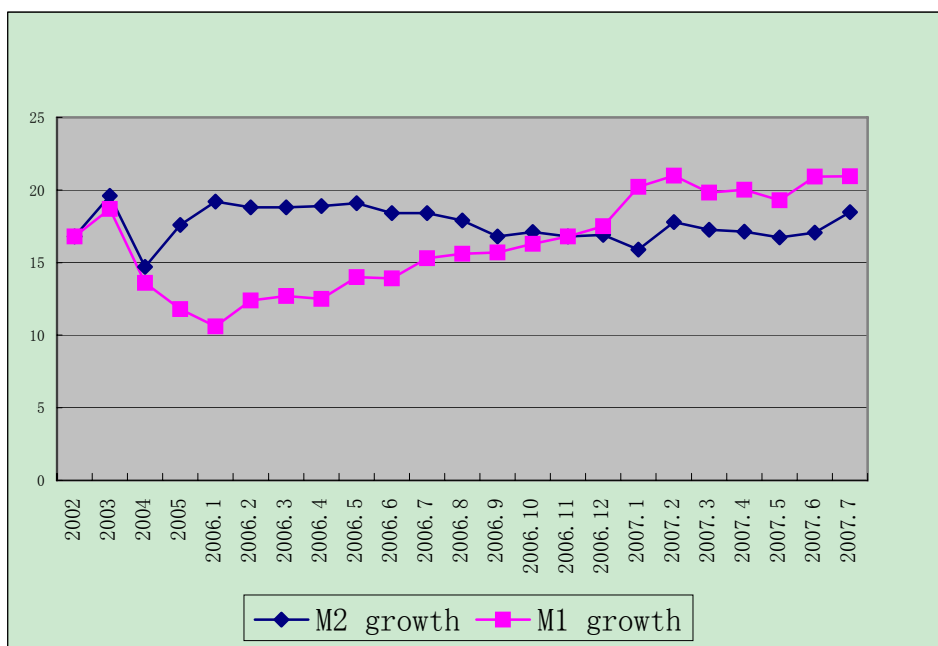
Figure 3: Excess reserve ratio, 2002 to July 2007



Source: People’s Bank of China

At the same time, broad money has also been brought under proper control despite the fact that the structure of money supply has undergone great changes (see figure 4).

Figure 4: M1 and M2 growth, 2002 to July 2007



Source: People’s Bank of China

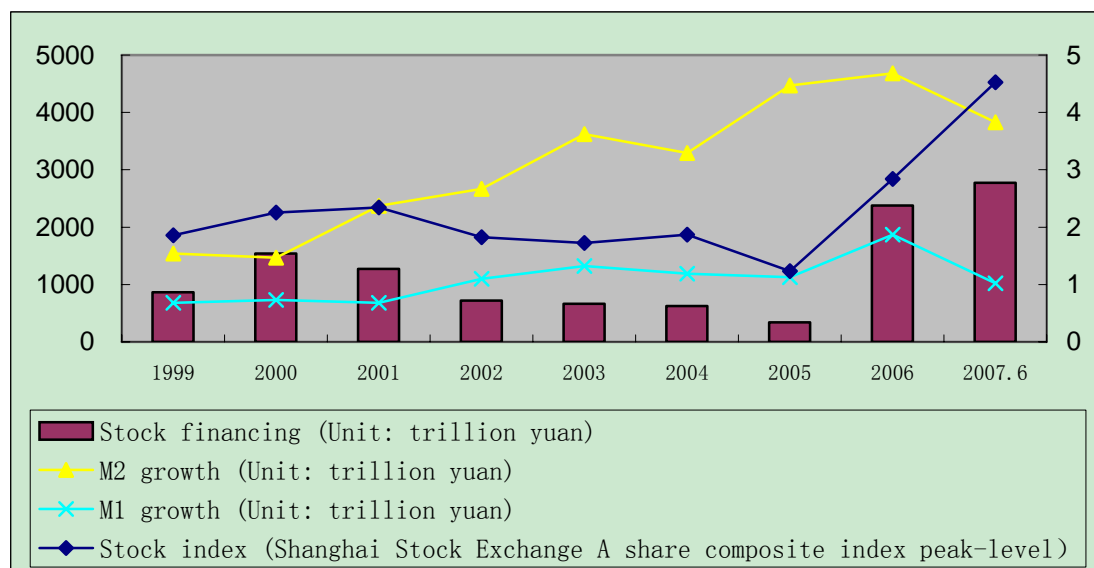
Over the recent years, the growth of M2 has displayed a trend of stable development. It has generally shown a somewhat downward adjustment and only picked up very recently. We are taking some measures trying to curb this upward trend. However, the growth of M1 has been accelerating at the same period, with the growth outpacing that of M1. The reason is that thanks to the successful reform of the non-tradable shares of the state-owned enterprises, capital market has experienced rapid development, attracting bank customers to move their time deposits to invest in

the stock market. And these funds have thus become deposits of the enterprises. Furthermore, to invest in the stock market, bank customers have also transferred large amounts of time deposits into current account, leading to rapid increase of demand deposits.

In general, the central bank has been effective in the management of liquidity in recent years. The sterilization operations will be continued until the central bank can actively release base money at its own initiative. But such a change depends on future developments of the “twin surpluses” of China’s balance of payments which in turn depends on the transformation of the Chinese economy.

In terms of the composition of financial assets in the society, though it can be affected by the money supply, the decisive factors are financial institutional structures and public confidence. Between 2001 and 2005, though M2 grew rapidly, funds raised in the stock market and index of the stock market both declined. But since 2006, although the growth of M2 decelerated, the index and financing amount of the stock market rose (see figure 5).

Figure 5: Comparison of the stock financing, stock index, M1 growth and M2 growth



Source: People’s Bank of China

This indicates that the stock market has its own unique operations, and the soundness of the market system as well as the public confidence play significant roles in fostering its development.

Nowadays, all the people are concerned about whether the international financial market or domestic financial market could sustain its healthy development. In my view, sound operation of the banking system plays the key role in forestalling risks in

the financial market. In the financial market, it is quite normal to see fluctuations of the financial assets prices. So long as the investors do not borrow too much from the banks to make the investment, the price fall of the stock market would only affect the distribution of the wealth and reduce the wealth effect, but not result in systemic risks. However, if the banks or market participants rely too much on the bank credit to invest in the financial products, a substantial fall of the price could affect the debt service capacity of the market participants or the liquidity of the banks, such a development would in turn trigger systemic risks and even threaten stability of the financial market.

Just like the turbulences caused by the subprime mortgages in the US, if the banks had not involved too much in this business, there would be no systemic risks. If on the contrary, too many banks rush to lend too much to their customers and engage excessively in the subprime mortgages business, there would be great potential risks.

As in China, financial institutions have only limited investment in the securities backed by subprime mortgages, so turbulence in the international market would not have substantial impact on the domestic economy. However the People's Bank of China is closely following the latest development of the risks associated with the subprime mortgages business and would factor in these risks when we design our next step to develop the derivatives market. The experiences and lessons of other countries are very important for us to avoid the same mistakes in the future.

On the other hand, when risks in the financial market begin to develop, the central bank will provide liquidity to the market so as to buttress public confidence and help the financial institutions in healthy condition to meet liquidity needs. However, market participants suffering financial losses as a result of their own investment mistakes must be left to cope with these losses by themselves, otherwise moral hazards would become a serious problem.

When the financial market, in particular the securities market, has a strong capacity to relocate resources, credit expansion must be well controlled so as to balance the relationship between financial asset structure and the money supply which constitutes the basic guarantee for a healthy development of the financial market.

At present, we see M1 is rising rapidly while the supply of M2 experiences low volatility. As M1 represents real purchasing power, we need to appropriately tighten the monetary aggregates to ensure market stability. However, with total deposits amounting to RMB38 trillion yuan (of which 17 trillion yuan are time deposits), the capital market is unlikely to face a shortage of funds. In this case, what would be the binding factors affecting development of the capital market in the future?

Externally, inflation induced by excessive credit expansion would be a negative factor for the market environment. Therefore, a sound or appropriately tightening

monetary policy stance would be helpful for healthy development of the capital market. For the market itself, if the market participants focus their investment returns more on short-term speculation rather on the longer-term profitability of the listed companies, the market would become more volatile.

The capital market should not panic over the monetary policy conduct by the central bank, rather it should try to identify potential market risks through monetary operations of the central bank. For the individual investors, they should rely on their independent and correct assessment of the economic development and profitability of the enterprises so as to make the value of the enterprises as their investment target and should not engage in too much speculations in the hope that someone else will have more money to buy their holding stocks. If such a sentiment materializes in the market, risks are only inches away.