

Effectiveness of Window Guidance and Financial Environment**— In light of Japan’s experience of financial liberalization and a bubble economy —**

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Window guidance is considered an important instrument of monetary policy by Chinese monetary authorities. Since the middle of 2009, window guidance has been strengthened in response to their fast growing economy and rising real estate prices, leading to the current slowdown in loan growth. Although evidence of the recent policy of window guidance has demonstrated its effectiveness, this may be because financial intermediary channels not subject to the control of window guidance are yet to be established in China. While window guidance in Japan similarly played a major role in monetary policy in the past, financial liberalization in the 1980s gradually undermined its effectiveness because liberalization led to the expansion of various financial intermediary channels unrestrained by window guidance. The effectiveness of the Japanese window guidance was further reduced by the low official discount rate, a monetary policy rate at that time, throughout the late 1980s. Since China is expected to see steady progress in its financial market infrastructure and financial liberalization, the historical transition of the role and effectiveness of the Japanese window guidance seems to offer a certain lesson to its neighboring country: progress in financial liberalization erodes the validity of window guidance over time and makes interest rate policy more important as a monetary policy instrument.

Introduction

The Chinese government has been intensifying its efforts to cool off the real estate market as it faces soaring real estate prices, a phenomenon that is especially striking in urban areas. A closer look at the real demand for property and the degree of leverage in the private sector in China may provide an interesting view of the current Chinese real estate market. Specifically, the situation in the Chinese property market today bears some resemblance to that of Japan in the early 1970s, when the property boom arising from “the plan for remodeling the Japanese archipelago” led to a surge in real estate prices in Japan.¹ During that period, the progress of urbanization stimulated strong housing demand in Japan under favorable conditions in which the low degree of leverage in both the corporate and

household sectors precluded the possibility of costly balance sheet adjustments. In this respect, the same conditions hold true for China today. Although China’s cooling measures are beginning to take effect, they are unlikely to put the economy through a large-scale, costly adjustment process.

In contrast, monetary policy operations and the financial environment in China may bear some similarities to those of Japan in the late 1980s. In those days, the Bank of Japan strengthened its window guidance on bank lending in an effort to tame surging bank loans and soaring land prices. However, the progress of financial liberalization and deregulation under the accommodative monetary environment circumvented the guidance measure by spurring capital market funding activity among Japanese firms and raising the amount of bank loans bypassing the

regulations. Consequently, the Japanese window guidance did not curb the growth of the money stock. The policy path being followed by China today seems to mirror that of Japan in the late 1980s: China is strengthening window guidance while keeping the policy rate at a low level, faced by excess bank lending, a rising money stock, soaring real estate prices and an economic rebound at the same time. Notwithstanding, the Chinese window guidance still appears to be effective as a monetary instrument in controlling the money stock and credit, as shown by the fact that the measure led to the recent slowdown in loan growth and had some effect in calming the real estate market,² even while the policy rate was kept at a low level.

The effectiveness of window guidance involves several issues including: (1) Can window guidance be used as an independently effective instrument without a concurrent policy rate change?; (2) Even so, can it have the effect of tightening monetary conditions without the acceleration in capital inflows that usually arises from such tightening measures?; (3) How will the various financial intermediary channels developed by financial liberalization and deregulation influence the effectiveness of window guidance? With these issues in mind, this report discusses the validity of the Chinese window guidance and how it may be impacted by financial liberalization in light of the Japanese experience during the bubble economy.

Window Guidance in China

Introduction of window guidance and its function

Even after the Chinese economic reform program began in 1978, the Chinese financial system retained the characteristics of a centrally planned economy. The People's Bank of China employed a rigorous credit plan to control the extent and orientation of lending of the four major state-owned banks—the Industrial and Commercial Bank of China, the Bank of China, the Agricultural Bank of China, and the China Construction Bank—in order to strictly control the size of the lending book at each bank. The credit plan went against the ethos of incorporating market mechanisms into the reform program, as well as

against the principle of allowing the four major banks, commercialized in 1995, to conduct lending business based on their own management policy.

Consequently, both the quarterly and annual targets for the amount of lending, which were directed at each of the four major state-owned banks, were abolished by the PBC. Instead, the PBC started to announce only a new annual reference target for the total amount lent by the Chinese banks as a whole. The new target functioned as a reference value on which the commercial banks relied in their own budgetary planning. The PBC also began to employ the new target as an important indicator to be monitored as part of its macro control policy. Subsequently, the PBC started to head toward the goal of achieving price stability and promoting economic growth by controlling the monetary base (the direct target) and the aggregate money supply (the intermediate target variable) through various means including interest rate policy, open money market operations, and reserve requirements.³

However, the PBC left room to intervene in bank lending activity using “window guidance”.⁴ The China Monetary Policy Report issued in 2006 states that “By communicating with the commercial banks and other financial institutions on a regular basis, the central bank is in a better position to have the market anticipate its monetary policy and thus to make its policy more effective. China’s experience in recent years indicates that improving transparency through window guidance is not only conducive to reducing costs of monetary policy operations, but also to helping the central bank realize its policy objectives and enhance the effectiveness of monetary policy.”⁵ This statement may reflect the following idea: Because China is in the process of incorporating incremental market mechanisms into its economy, indirect monetary policy instruments alone, such as interest rate policy, are still insufficient to control the activities of various economic entities, and hence the central bank needs to influence financial intermediaries directly.

Figure 1 shows the specifics of the window guidance of the PBC.

Figure 1 : Framework of Window Guidance by the People's Bank of China

<p>(Reference target for the growth in lending)</p> <p>The PBC determines the target for the total lending growth of all financial institutions at the beginning of each year.</p>
<p>(Dialogues with commercial banks)</p> <p>The PBC holds monthly meetings with commercial banks. In addition, the PBC holds ad-hoc small round table talks and sometimes issues written instructions.</p>
<p>(Financial institutions subject to window guidance)</p> <p>Financial institutions subject to window guidance include not only the four major state-owned banks, but also other joint-stock commercial banks and small local banks. As the PBC head office does to the major financial institutions, the local branches of the PBC also conduct window guidance to its financial institutions.</p>
<p>(Scope of window guidance)</p> <p>The scope of window guidance covers the allocation of bank lending, based on industry type or the size of borrower, in addition to the extent of loan growth. For example, the China Monetary Policy Report (Quarter Two, 2005) states “financial institutions were encouraged, through window guidance, to improve their credit structure and prevent heedless and low-level duplicated construction.” The Report also indicates that the commercial banks were encouraged to provide credit support for the business activities of SMEs, the expansion of consumption, and growth in employment.</p>
<p>(Penalty for disobeying window guidance)</p> <p>Punitive operations are sometimes applied to financial institutions through open market operations by the PBC if they stick to the lending attitude that goes against the policy intention of the PBC. For example, China Monetary Policy Report (Quarter Four, 2009) states “(the PBC) issued special central bank bills to commercial banks with relatively rapid credit extension to encourage them to pay attention to a stable and proper increase in credit.”</p>

Sources: The People's Bank of China, "China Monetary Policy Report" etc.

Window guidance of the PBC in recent years

The PBC has adapted the orientation and intensity of its window guidance in order to match the economic climate and the willingness of financial institutions to lend at each point in time. In this regard, the following three phases of policy development can be distinguished from 2007 onwards:

[1] Fall 2007 – Fall 2008: Incorporation of credit limits

During this period, the threat of overheating in the Chinese economy intensified and the growth of bank lending gathered pace in spite of the policy rate hike and the liquidity absorption mechanism implemented by the monetary authority. Accordingly, the PBC introduced credit limits in the fall of 2007 in order to strengthen its efforts to curb lending activity among commercial banks.⁶ The newly introduced credit limits were similar to the credit plan which had existed until 1998 in the sense that both of these measures set rigorous constraints on the growth of bank lending. The growth of bank lending started to slow down once credit limits were implemented.

[2] Fall 2008 – early 2009: Elimination of credit limits and adoption of guidance to activate bank

loans

In late 2008, the global financial crisis triggered by the U.S. subprime mortgage problem intensified and began to have an adverse effect on the Chinese economy. In response to the worsening situation, the PBC eliminated the rigid constraints on credit increase among commercial banks and encouraged financial institutions to raise the volume of bank loans to a reasonable extent.⁷ Consequently, commercial banks all became more willing to lend at the same time and bank loans grew sharply to such an extent that the growth of bank lending in the first half of 2009 alone exceeded that in the whole of 2008.

[3] Late 2009 – current: Re-strengthening window guidance

The surge in bank lending, accompanied by the threat of overheating real estate investments, led to a policy reversal in the PBC in favor of strengthening its window guidance again to curb the growth of bank loans. Efforts to intensify window guidance increased further in 2010 in a move that seemed to demonstrate the determination of the policy makers in the central government to work together with the goal of curtailing lending growth within its annual policy target.⁸

Evaluation of recent developments in the Chinese window guidance

Recent developments in the management of window guidance and the corresponding change in the money stock in China seem to indicate that window guidance has functioned properly as expected in achieving the policy goals of the monetary authority, as shown in Figure 2. The growth of bank lending and the money stock gradually slowed down during the period in which window guidance was re-strengthened after late 2009, as well as during the period between the fourth quarter of 2007 and early 2008 when credit programming was implemented. Notably, variation in the total amount of bank loans and the money stock was kept under control, although PBC adjusted the benchmark lending rate and the deposit only to a limited extent in response to the large fluctuations in nominal GDP growth rate (Figure 3). This fact seems to show the effectiveness of window guidance in China as a monetary policy instrument.

The following two points may explain why window guidance has been effective in China. First, financial intermediary channels that are not subject to window guidance controls are still immature in China, and the lending of banks subject to window guidance dominates financial intermediation. For example, as shown in Figure 4, bank lending accounted for 86% of all the funding channels in 2009 in the private non-financial sector, which indicates the dominance of the indirect finance system in China. Even for funding channels in the direct finance system such as the issuance of stocks or bonds, China's State Council has taken a rigorous supervisory approach in a consistent and orderly manner.

Second, it is suggested that together with window guidance, the use of prudential policy by the Chinese policy authorities including the State Council and the relevant departments under the Council has played a role in controlling bank lending and the money stock. In China, the China Banking Regulatory Commission, the banking supervision entity responsible for supervising banks, oversees the regulatory loan-deposit ratio, the regulatory capital ratio, the loan loss rate and similar indices. For example, the policy

Figure 2: Growth of loans and money stock and the transition of window guidance in China

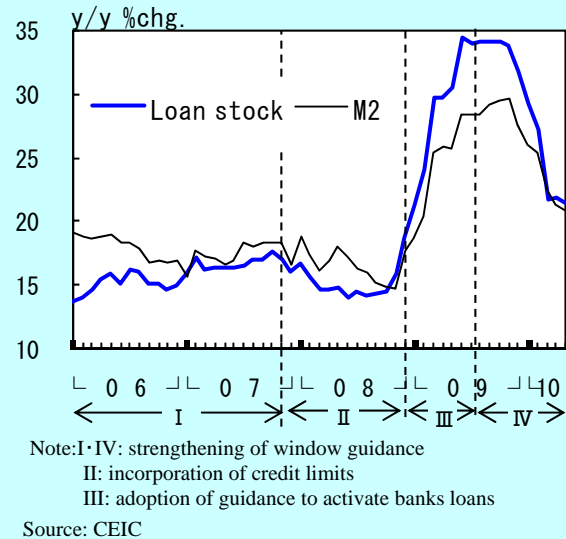


Figure 3: Nominal GDP growth and interest rates in China

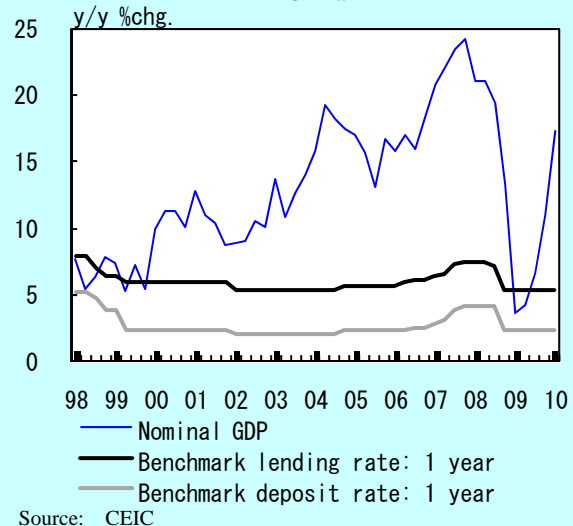


Figure 4: Proportion of lending source by domestic non-financial corporations in China

	2006	2007	2008	2009
Bank Loan	87.9	81.6	83.8	85.9
Equity	6.0	13.6	5.9	4.1
Bond etc.	6.1	4.8	10.2	10.1

Source: The People's Bank of China "China Monetary Policy Report"

authority recently raised the minimum down payment for home purchases and asked for loan loss provisions to be increased in response to the current surge in real estate prices. It is often pointed out that these measures are consistent with the policy of the PBC window guidance and thus reinforce its effectiveness.

Thus, window guidance in China can be considered

an effective monetary policy instrument to date. However, a question that should be asked is whether it will remain effective on the horizon. The experience of window guidance in Japan may provide some hints on the answer to this question, as described below.

Lessons from Japan's Window Guidance

History of Japan's Window Guidance

The Bank of Japan (BOJ) incorporated window guidance into its policy framework in the mid-1950s⁹. It was the time when the Japanese economy was beginning to enter a period of rapid economic growth and the interest rate policy alone, as typified by the operation of the official discount rate, proved to be unsuccessful in curbing the surge in the growth of commercial bank lending, which resulted from the strong demand for funds by the corporate sector. Consequently, during the period of tightening monetary conditions in 1957, the BOJ requested large banks (major city banks and long-term credit banks) to observe the amount of allowance for their loan growth, which was each assigned by the BOJ in view of their individual sizes, lending plans and funding positions. Later on, the BOJ gradually extended such guidance measure by including local banks, mutual banks, trust banks and large Shinkin banks in its target. The role of the Japanese window guidance further shifted from a temporary and emergent measure only employed during the period of tightening monetary conditions, to a permanent policy instrument, which was to be utilized even in the accommodative monetary environment. However, as discussed later, the progress of financial liberalization and deregulation gradually undermined the effectiveness of and the necessity for the Japanese window guidance throughout the bubble period of the late 1980s, ending up with the abolition of the guidance measure in 1991.

The effectiveness of Window Guidance: independent tool or complementary tool

When the window guidance was in frequent use in Japan, the guidance measure was regarded by the BOJ as “a complementary tool to support general monetary policy instruments, such as change of the official

discount rate”, rather than “an independent monetary policy instrument¹⁰.” This point of view demonstrated the following ideas of the BOJ: (1) window guidance is supposed to only provide indirect support for other policy instruments, including the manipulation of official discount rate, as the latter policy instruments are considered primary workforce for monetary policy; (2) on the flip side of the coin, window guidance alone cannot exert a sufficient policy impact without the concurrent use of other monetary policy instruments, because the guidance measure is confined to a secondary role in the monetary policy.

In contrast to this BOJ's view of “complementary tool theory” which considered the role of window guidance to be supplemental in the monetary policy framework, the academics at that time led the argument for so-called “independent tool theory”, which explained that window guidance could have an independent policy effect of its own without the support of other policy instruments¹¹. The distinction between “the complementary tool theory” and “the independent tool theory” is crucial in understanding how the management of monetary policy should be conducted. If the “complementary tool theory” holds, then it follows that the use of window guidance for tightening monetary conditions must entail the various interest rate hikes. If the “independent tool theory” is valid, then strengthening the window guidance is expected to tighten monetary conditions even while interest rates are kept constant by the BOJ. For that matter, the “independent tool theory” predicts that window guidance enables a central bank to cool off its domestic economy without spurring the inflow of foreign capital arising from policy-rate hikes.

Although judging which of the theories is correct is beyond the scope of this paper, it can be safely said that the effectiveness of window guidance as an independent policy instrument is likely to depend on the structure of financial system. In line with this discussion, it is equally reasonable to consider that the validity of the Japanese window guidance became diminished in accordance with changes in the

financial structure over time.

For example, it would appear that the window guidance was effective to a certain extent in the mid-1950s when the guidance measure was newly incorporated into the policy framework. During that period, the Japanese financial structure was characterized by the following points: (1) the heavy reliance of corporate sector on bank loans for financing; (2) the absolute predominance of major city banks over other (regulated) financial institutions in the area of lending businesses; (3) the high dependency of those city banks on borrowings from the BOJ. The presence of this financial structure made the use of window guidance on the lending of the city banks more fast-acting and reliable in controlling money stock on a macro-basis and affecting the economic activity of private sectors to a certain extent, in the sense that the guidance measure had more immediate effects than the other policy instruments and such effects came with certainty.

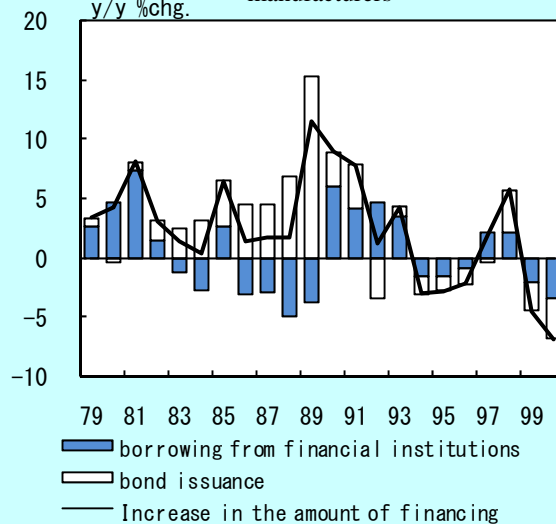
As earlier mentioned, the BOJ expanded the scope of financial institutions subject to the window guidance beyond the city banks, in an effort to maintain the effectiveness of the guidance measure. However, since the 1980s, under the progress of financial liberalization, the financial intermediary channel for the corporate sector became diversified, as exemplified by the issuance of corporate bonds and the increase of the so-called “impact loans”. The diversification in the financial intermediary channel led to the erosion of the effectiveness of the window guidance as an independent policy instrument. From the perspective of the “complementary tool theory”, it can be also noted that the diminishing effectiveness of the Japanese window guidance throughout this period was partly due to the delay in the policy actions toward interest rate hikes because such delay made it difficult for the guidance measure to exert a supplementary effect in spite of the re-intensifying of the window guidance during the bubble period in the 1980s. The next section discusses more on these points.

Window Guidance in the bubble period in Japan: the effect of financial liberalization

Although the occurrence of the bubble economy in

the late 1980s reflects the combined effects of various factors, aggressive bank lending behavior and accommodative monetary measures adopted over the long term are two of the driving forces which contributed to the generation and expansion of the bubble economy¹². The aggressive lending behavior did not abruptly show up during the accommodative period in the late 1980s. Rather, such behavior already came to be observed in the early 1980s under the circumstances of financial liberalization and deregulation. Typical events of such financial liberalization and deregulation include the revision of the Foreign Exchange Law in 1980, the elimination of regulations on yen conversion in 1984 and so on, all of which led to the growth of capital transaction between Japan and overseas. Equally, various measures to liberalize the financial business and to deregulate securities markets started in the 1980s. Furthermore the stepwise introduction of deregulation of deposit interest rates was initiated from 1985. A series of these moves toward financial liberalization and deregulation, as mentioned here, significantly affected the economic behavior of firms and banks. For example, under the progress of deregulation in the corporate bond market, large manufacturing businesses, which used to rely heavily on bank lending to raise funds, began to pay off their bank debts by financing through the issuance of corporate bonds, especially, convertible bonds or warrants (Figure 5).

Figure 5: Financing activity by large Japanese manufacturers



Source: Ministry of Finance of China, "Financial Statements Statistics of Corporations by Industry, Annually"

Japanese banks were only gradually admitted into securities businesses. This delay in the expansion of securities businesses by banks gave rise to a sense of danger concerning “the risk of large firms becoming less reliant on banks”, thus driving many banks to increase collateralized loans to the small and medium-sized businesses which had little access to capital markets, retail loans, and real estate-related loans to the property developers, non-banking finance companies, and construction companies (Figure 6).

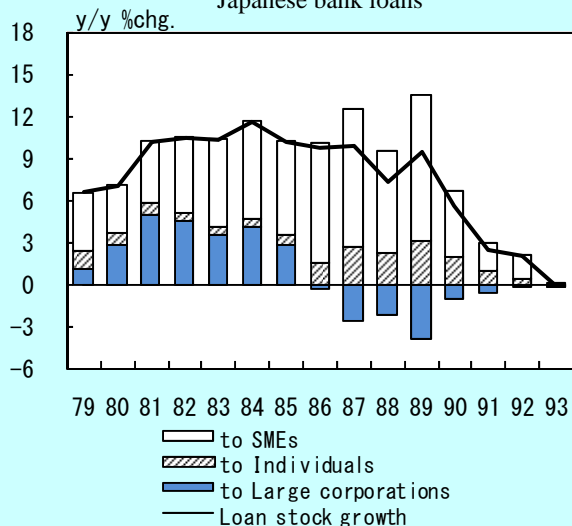
Meanwhile, the BOJ continued to seek a policy shift toward the tightening of monetary conditions, as it faced a significant surge in the asset prices, such as stock and real estates, together with a rapid growth of money stock reflecting the expansion of funding activity in the corporate sector (Figure 7 & 8). Notwithstanding, the official discount rate remained unchanged at 2.5%, the then lowest level, for almost 2 years between February 1987 and May 1989. Several factors account for the lingering accommodative monetary policy measure over years: (1) the necessity to respond to the "high-yen recession" caused by rapid appreciation of the yen after the Plaza Agreement in 1985; (2) the existence of rationale of macroeconomic policy that the current account surplus should be reduced by expanding domestic demand under international policy coordination, in line with the Plaza Agreement.

The BOJ made efforts to request banks to obey "the

continuation of holding prudent lending attitude", and further strengthened the window guidance measure, as it observed the economic recovery gradually becoming apparent from the spring of 1987. However, such policy efforts had only limited effects as the official discount rate was yet to be changed while the financial liberalization and deregulation went underway. Consequently, the growth of the money stock continued to increase, reflecting the influences of expansion of financing through capital markets and impact loans, even though the growth of domestic loans was curbed thereafter (Figure 6 & 7).

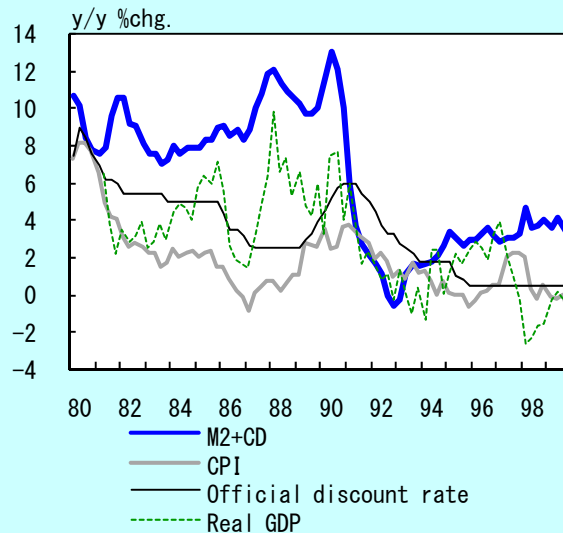
Under the stepwise progress of deregulations on the eligibility of corporate bond issuance, as earlier mentioned, the surge in stock prices, partly spurred by

Figure 6: Distribution of borrowers of Japanese bank loans



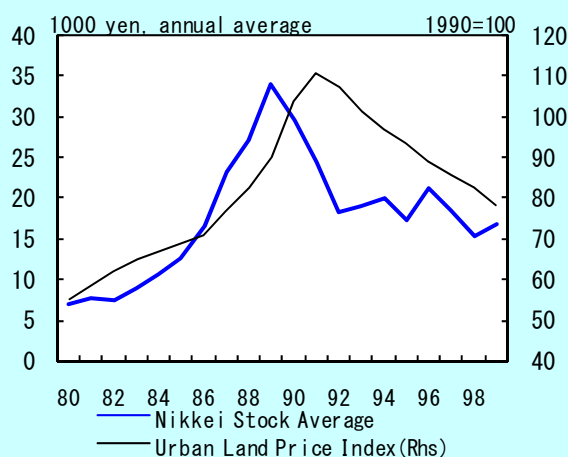
Source: Bank of Japan, "Loans and Discounts Outstanding by Sector"

Figure 7: Economic and financial conditions in Japan



Sources: Ministry of Internal Affairs and Communications of Japan, Cabinet Office (Government of Japan), Bank of Japan

Figure 8: Asset prices in Japan



Sources: Japan Real Estate Institute, Nikkei

the financial deregulation, reduced the cost of equity finance such as the issuance of convertible bonds and warrants. Subsequently, the amount of corporate financing through capital markets skyrocketed (Figure 9). These developments undermined the effectiveness of the window guidance because the guidance measure only targeted bank lending.

For that matter, the window guidance was only targeted for loans in yen which were booked at domestic head office and branches, thus excluding the loans booked overseas. As a result, banks significantly increased the amount of impact loans, in an effort to bypass the limits imposed by the window guidance. The setup for a loophole arising from impact loans was created well before by the establishment of the Japan Offshore Market (JOM) in 1986, ushered by the revision of the Foreign Exchange Law in 1980 which liberalized the impact loan by residents (Figure 10).

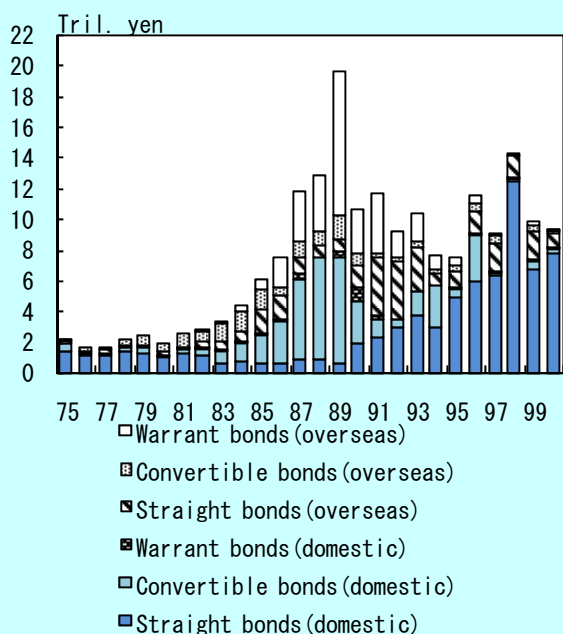
The JOM is an offshore market that is separate from the domestic market. Financing activity through the JOM is permitted only for offshore investments and there is a constraint on the allocation of funds obtained through the JOM into domestic lending. To avoid this restriction, Japanese banks lent loans financed through the JOM to their foreign branches.

Their foreign branches in turn lent loans to domestic firms as impact loans. This bypassing process increased the amount of impact loans. Also, it should be noted that the growth of impact loans, triggered by the deregulation such as the creation of the JOM, was further accelerated by the improvement in the funding capacity of firms, which resulted from the increase in the collateral value that the long-term accommodative environment generated with the surge in asset prices.

Termination of Window Guidance

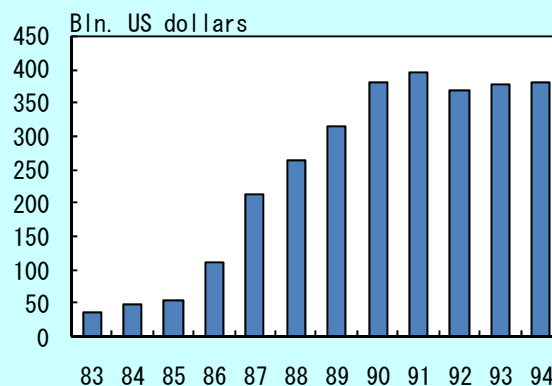
As previously mentioned, the development of financial liberalization decreased the effectiveness of the Japanese window guidance, as an independent policy tool. Even from the perspective of the “complementary tool theory”, it would appear that the delay in policy rate hikes during the period of the bubble economy dampened the effectiveness of the guidance measure. In the late 1980s, the BOJ promoted the developments of market infrastructures concerning short-term financial markets, thereby making contributions to enhance the functionality of the interbank market. Accordingly, changes in the short-term rates of the interbank market became more tied to those of the entire financial markets through the arbitrage between the markets so that the foundation of the transmission channels for interest rate policy was established. In other words, it follows that the establishment of interest rate channel, the main route for spillover effects of monetary policy,

Figure 9: Bond issuance by Japanese listed companies



Source: Tokyo Stock Exchange

Figure 10: Outstanding amount of impact loans



Note: The figure above is the sum of foreign currency impact loans to residents (foreign currency loans provided by domestic branches of Japanese and foreign banks), foreign currency loans to residents provided by overseas branches, and impact loans made in euroyen to residents (loans in yen provided by overseas branches of Japanese banks).

Source: Gaikokukawasejyouhousha, "Gaitamenkan"

reduced the need for the window guidance to reinforce the effects of other monetary policy instruments. In addition to the decrease in the importance of the window guidance, the adverse effects of the guidance measure were often pointed out, such as the possibility of undermining the market competition among banks by causing inflexible lending shares, or generating the inefficiency of resource allocation through the credit rationing. In relation to credit rationing, it is often pointed out as a problematic issue that the lending by the Japanese city banks was biased toward their large industrial groups¹³. All of these developments and issues led to the BOJ's decision on the abolition of the window guidance in 1991.

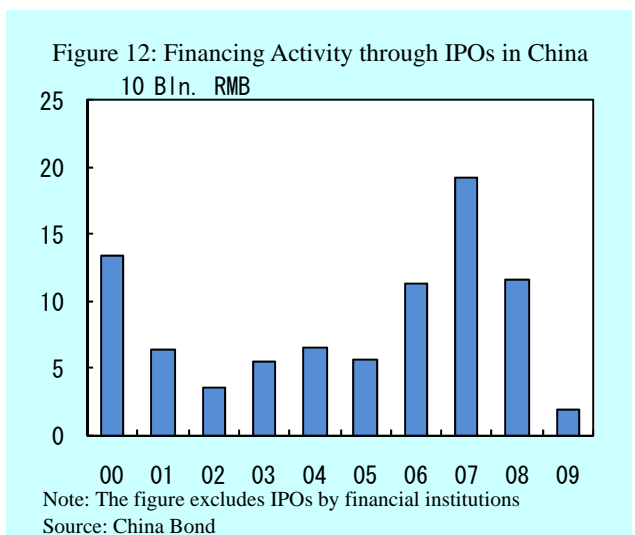
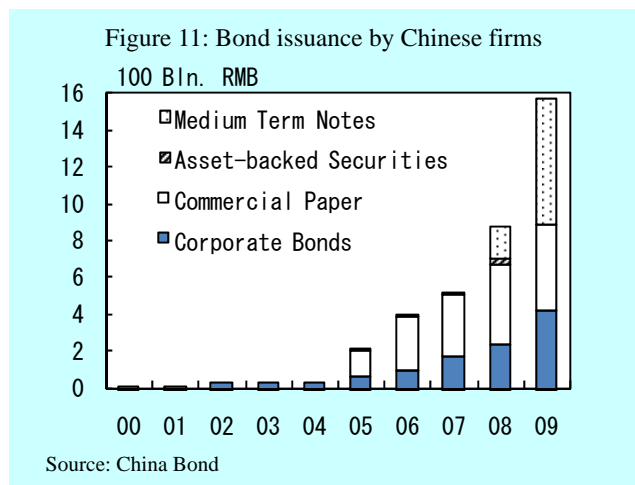
Impact of Financial Liberalization in China on the Effectiveness of Window Guidance

The use of window guidance in combination with other tools is considered to have been effective in controlling the amount of credit and money stock in China, partly because China is still halfway through the development of its market infrastructure and financial liberalization program. However, on the horizon the historical transition of the role and effectiveness of the Japanese window guidance seems to suggest some lessons for China in its use of window guidance, even though such guidance has been effective to date. One lesson is that financial intermediary channels that bypass the scope of window guidance are likely to develop over time as China makes progress in the areas of financial market infrastructure and financial liberalization, just as such channels eroded the validity of the window guidance in Japan.

In practice, the Chinese government has already started to push the expansion of its domestic security markets. This initiative will gradually increase the share of financing activity through the securities markets, which fall outside the scope of the current window guidance. The Chinese domestic bond and stock markets are likely to undergo further development on the horizon. While the issuance of corporate bonds in China is still subject to relatively strict government controls, since 2008, the authorities

have allowed firms to issue medium term notes and commercial papers in the interbank bond markets as long as firms make a prior notification. Reflecting these moves, the issuance of corporate bonds has continued to rise as seen in Figure 11.

It is sometimes observed that the new financial intermediary channels other than those of bank lending affect the economy to a certain degree, as is evident from the fact that in addition to bank loans as major financing channels, urban development investment vehicles, a kind of special purpose vehicle for infrastructure and real estate development sponsored by the Chinese local governments, financed the expansion of real estate investments through an increase in bond issuance¹⁴. Funding activity through the issuance of stock is expected to show steady growth as well. In fact, as shown in Figure 12, the volume of IPOs increased in 2006 and 2007 when stock prices soared in tandem with the economic expansion in China.



In addition to the expansion of direct financing through domestic capital markets, the flow of capital from abroad may increase over time in China. The Chinese government has enforced relatively rigid restrictions on international capital transactions. However, recent developments in the integration of the Chinese economy into the world economy, together with the gradual deregulation on capital transactions, have caused an increase in the scale of and variation in private capital inflows into China. In particular, it is observed that there has been a sharp rise in the inflow of so-called “hot money,” speculative foreign capital entering China in various forms through loopholes in the regulations. As shown in Figure 13, the net inflow of private foreign capital turned positive again in 2009 and has been on the rise since late 2009, after a sharp contraction in late 2008 due to the heightening of the global financial crisis.

The capital inflow into China as described here is likely to grow in the coming decade. The Chinese government is trying to encourage the move towards the globalization of Chinese firms, leading to an increase in the number of foreign local subsidiaries. The internationalization of the RMB are proclaimed in order to make it more recognized and exchangeable

around the world. Accordingly, it is likely that Chinese firms will start financing activity overseas in RMB.

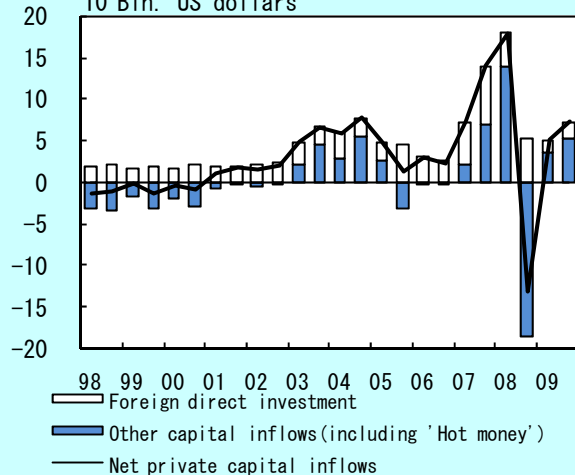
Japan’s experience of a sharp increase in the volume of “impact loans” during the period of the bubble economy provides an important lesson: the overheating of the domestic economy and the asset markets without any attempt to raise the policy interest rate is likely to lead to a further increase in capital inflows from abroad, which in turn will accelerate the overheating of the economy. If the expansion of capital inflows into China gains momentum, a similar situation tends to occur in the course of time.

In addition to the impact of changes in the financial system, the adverse effects of window guidance need to be noted. The occurrence of credit rationing with a failure in the function of interest rate adjustments is not necessarily desirable in terms of the efficiency of capital allocation. In the presence of lending volume limits due to window guidance, banks might maintain lending to large corporations while curtailing lending to small and medium-sized enterprises (SMEs) or to firms with which they have not previously dealt, even if these firms are likely to show high growth. In fact, it has been pointed out in China that small private businesses all along have difficulty in obtaining bank loans, and that banks prefer lending to large state-owned firms¹⁵. Having recognized this problem, the authorities have focused their efforts on encouraging banks to expand SME lending. It appears that there is a need to guide the direction of reforms toward the realization of more efficient allocation of capital through the market mechanism of interest rates, along with progress in financial market infrastructure and the transparency of corporate accounting.

Conclusion

It can be said that the development of financial market infrastructure and financial liberalization is a necessary and inevitable part of ensuring more efficient allocation of capital through the interest rate mechanism and of disseminating the effect of central bank interest rate policy. Such progress in the areas

Figure 13: Private capital inflows to China
10 Bln. US dollars



Notes: “Other capital inflows” are calculated as (change in foreign reserves) - (current account balance) - (foreign direct investment). In calculating changes in foreign reserves, we adjusted foreign currency swap transactions between the central bank and commercial banks, reserve deposits by commercial banks made in foreign currencies, capital injections to the Sovereign Wealth Fund (CIC) from foreign reserves, and capital injections into state-owned commercial banks.
Source: CEIC

of market infrastructure and financial liberalization is expected to undermine the validity of window guidance. Equally, the establishment of a transmission route for interest rate policy is likely to reduce the need for window guidance. In this respect, the experience of the diminishing role of window guidance in Japan seems to suggest an important lesson: progress in financial liberalization erodes the validity of window guidance over time and makes interest rate policy more important as a monetary policy instrument. Hopefully, this lesson will be of help to future policy operations in China.

¹ A detailed discussion can be found in the following paper: Muto, Matsunaga, Ueyama, and Fukumoto, "On the Recent Rise in China's Real Estate Prices," Bank of Japan Review, 2010-E-3, April 2010.

² For more information, see the People's Bank of China, "China Monetary Policy Report, Quarter One, 2010."

³ For more information on the Chinese macro economy, see Marvin Goodfriend, and Eswar Prasad, "A Framework for Independent Monetary Policy in China", IMF Working Paper WP/06/111, IMF, May 2006."

⁴ In this paper, "window guidance" in China means the monetary policy tool employed by the PBC. However, the China Banking Regulatory Commission (CBRC) is considered to guide the details and pace of lending by banks in terms of credit risk controls. For example, the CBRC instructs banks to minimize property-related loans.

⁵ For more information, see the People's Bank of China, "China Monetary Policy Report, Quarter Four, 2006."

⁶ The PBC has officially restrained loans through volume limits since the beginning of 2008. However, the PBC is considered to have started implementing controls in the fourth quarter of 2007. For more information, see Huang Jinlao, "Indispensable Credit Quota Control," China Finance, China Financial Publishing House, March 2010.

⁷ For more information, see the People's Bank of China, "China Monetary Policy Report, Quarter Four, 2008."

⁸ The PBC (in "China Monetary Policy Report, Quarter One, 2010") and the CBRC (in the statement made by Liu Mingkang, CBRC Chairman, on January 20, 2010) have revealed their stance on controlling the growth and structure of bank loans.

⁹ Discussions about the history of window guidance in Japan can be found in the following papers: Kure Bunji, "nihon ginko no madoguchi shidou(in Japanese)", Kikan gendai keizai, Nikkei, Vol.17, March 1975. Hiroe, "Madoguchi shidou(in Japanese)", in the Section 7 of "Nihon no kinyu shijou to seisaku(in Japanese)", Akira Furukawa, Showadou, 1983.

¹⁰ For more information, see the Bank of Japan, "Nihon Ginko -sono kinou to sosiki- (in Japanese)", April 1967.

¹¹ In addition to Hiroe(1983) above mentioned, more discussion can be found in the following paper: Iwao Kuroda, "madoguchi shidou wo meguru bunseki no saikentou(in Japanese)", Kikan gendai keizai, Nikkei, Vol.37,

December 1979.

¹² A detailed discussion can be found in the following paper: Okina, Shirakawa and Shiratsuka, "The Asset Price Bubble and Monetary Policy: Japan's Experience in the Late 1980s and the Lessons", Monetary and Finance Studies, Bank of Japan, Vol.19, February 2001.

¹³ A detailed discussion can be found in the following paper: Hoshi, T., D. Scharfstein, and K.J. Singleton, "Japanese Corporate Investment and Bank of Japan Guidance of Commercial Bank Lending," in Japanese Monetary Policy, K.J. Singleton, ed., The University of Chicago Press, 1993.

¹⁴ Local bond issuance increased rapidly from 2008 to 2009 (rising in value from 68.4 to 223.2 billion renminbi). It seems that most of these local bonds were issued by urban development investment vehicles.

¹⁵ Li Zibin, Chairman of the China Association of Small and Medium Enterprises, stated as follows: "Small and medium private enterprises have been the target of a credit crunch by commercial banks. According to statistics, 4.3 million small private businesses in China produce 60% of GDP and pay half of all tax. However, the share of loans to small private businesses by domestic commercial banks is only 22.5%. Moreover, the share declined to 15% after tight monetary policy was implemented"("21st Century Business Herald", Dec. 12, 2008). One of the factors in the financing difficulties faced by small private businesses seems to be the governance problem among of banks. In this regards, the reforms to improve bank governance by listing the state-owned commercial banks and encouraging foreign investors have been important for efficient resource distribution.

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