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Monetary policy made in China

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- As the Chinese economy is slowing down, the People's Bank of China (PBoC) is providing further stimulus.
- Over the years, the PBoC has acquired substantial authority on its own. But the bank is still far from being a central bank like its western counterparts. It lacks transparency, its monetary policy decisions are influenced by the central government and its policy architecture remains pre-modern.
- Although monetary policy has worked well in stabilizing the economy in the past, it is doubtful that this will remain so under today's domestic and international conditions.

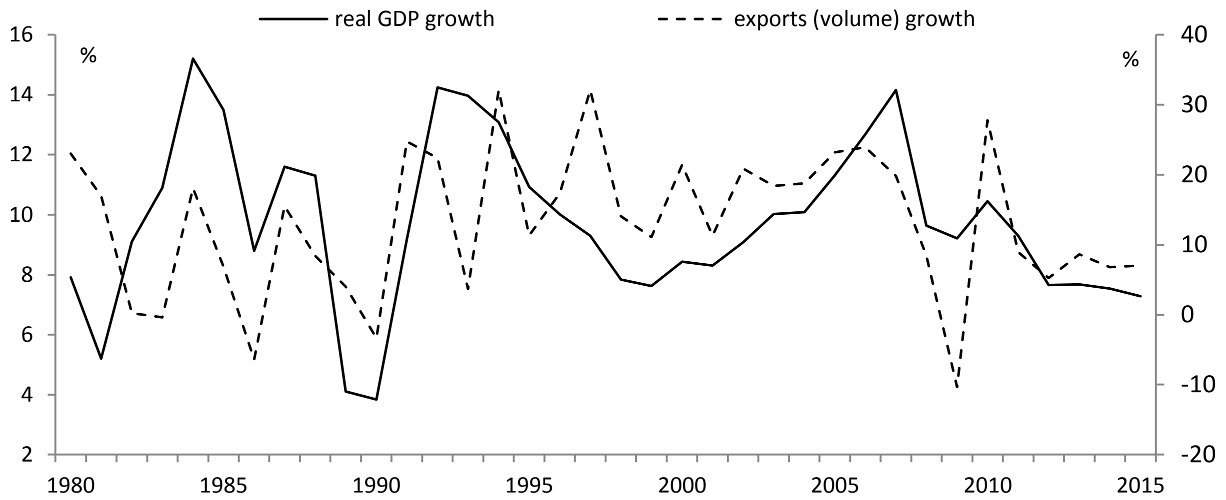
The economy, the government and its central bank

China went through a spectacular period of high GDP growth prior to 2008, but economic conditions have worsened substantially more recently, due mainly to a faster-than-expected slowdown of export growth and sluggish real estate investment (Fig. 1 and 2). The world looks to China, as the country has become one of the main sources of global growth. Recent economic weakness comes at a wrong moment for both China and the rest of the world. Against this background, the Chinese authorities try to change the course.

A leading role in the effort to revive the economy is given to the People's Bank of China (PBoC), the institution responsible for monetary policy. Recent monetary policy interventions through the reduction of the benchmark interest rates, of the reserve requirements and the announcement of relaxation of the maximum loan-to-deposit ratio of 75 percent show the determination of the bank to counter sluggish growth. So far, however, the policy has failed to revive growth and may have contributed to stock price volatility.

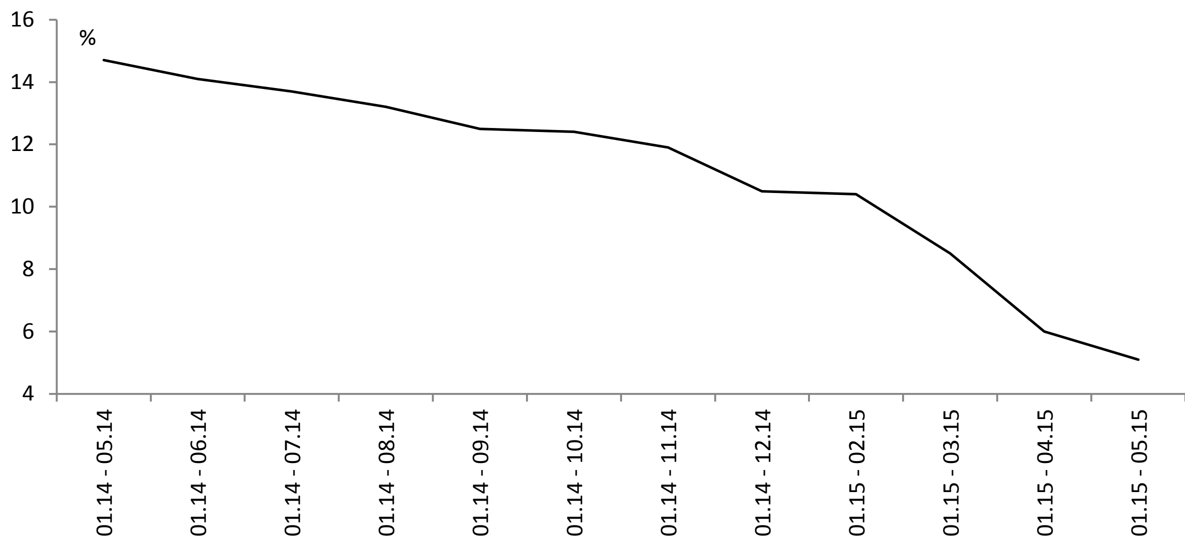
Despite the persisting close relation to the government (the State Council), the PBoC has achieved some independence, giving it some room for taking policy decisions on its own. To this end, the bank has a broad mix of administrative and more market-oriented

Figure 1. Growth rates of real GDP and of the volume of exports (right scale).Position:



Source: Haver; World Economic Outlook, April 2015 (estimates after 2012).

Figure 2. Annualized growth rates of real estate investment between January 2014 and May 2015



Source: National Bureau of Statistics of China.

instruments, which seem to be well-tailored to the hierarchical organization of the economy. However, the combination of domestic structural economic weaknesses and a weak global recovery limits the ability of the PBoC to boost growth through monetary policy.

The core of the monetary policy framework

According to Chinese law, "the People's Bank of China is to establish a monetary policy committee, whose responsibilities, composition and working procedures shall be prescribed by the State Council and shall be filed to the

Standing Committee of the National People's Congress. The Monetary Policy Committee shall play an important role in macroeconomic management and in the making and adjustment of monetary policy."[1]

The main task of the Monetary Policy Committee (MPC) is to consult and advice the PBoC on the formulation and adjustment of monetary policy. It is also supposed to apply monetary policy instruments as well as coordinate monetary and other macroeconomic policies. To cope with these tasks, the Committee should implement "comprehensive research on macroeconomic situations and the macro targets set by the government".

The MPC is composed of fifteen members, including central bank officials, ministers from other governmental bodies, and external experts (Tab. 1). There seems to be no strict rule concerning the number, composition and terms of the committee's members. During the recent adjustment of the MPC in June 2015, seven committee members were appointed, with the number of members increasing from thirteen to fifteen. The central figure in the committee is played by the governor, nominated by the Premier of the People's Republic of China and appointed/removed by the Standing Committee of the National People's Congress. The governor supervises the work of the central bank and is assisted in his duties by the deputy governors.

The formal objective of the monetary policy is "to maintain the stability of the value of the currency and thereby promote economic growth".[2] In public speeches and writings, PBoC

Table 1. Composition of the Monetary Policy Committee of the People's Bank of China.

MPC member and administrative role	Name
Governor	Zhou Xiaochuan
Deputy Governor, Administrator of the State Administration of Foreign Exchange	Yi Gang
Deputy Governor	Pan Gongsheng
Deputy Secretary-General of the State Council	Xiao Jie
Assistant of PBC Governor	Zhang Xiaohui
Deputy Head of the National Development and Reform Commission	Lian Weiliang
Vice Finance Minister	Shi Yaobin
Chairman of China Banking Regulatory Commission	Shang Fulin
Chairman of China Securities Regulatory Commission	Xiao Gang
Chairman of China Insurance Regulatory Commission	Xiang Junbo
Commissioner of National Bureau of Statistics	Wang Baoan
Head of China Association of Banks	Tian Guoli
Expert from the academia	Fan Gang
Expert from the academia	Huang Yiping
Expert from the academia	Bai Chongen

Source: www.pbc.gov.cn

[1] Art. 12 of the Law of the People's Republic of China.

[2] Information on the monetary policy framework in China is mostly retrieved from the official website of the PBC, http://www.pbc.gov.cn/publish/english/957/index.html.

governors have repeatedly argued that the bank's policy objective is comprehensive, aimed at low inflation, high employment and growth, and balance in the balance of payments. But in practice, inflation is clearly the primary goal of the PBoC, facilitating the achievement of the other objectives. As an intermediate objective, the PBoC targets broad money (M2) growth.[3] Once the central government establishes inflation and growth targets for the following year at the annual Central Economic Work Conference, the PBoC follows with a decision over the broad money growth target. Based on this, a consistent target for credit growth is established and serves as guidance for financial institutions' activities. To achieve these targets, the central bank adjusts the base money supply through a set of quantitative, administrative, and price-based measures, as discussed below.

The PBoC is also monitoring financial stability, but in this task it is supported by three regulatory agencies, the China Securities Regulatory Commission (established in 1992), the China Prudential Regulatory Commission (established in 1998), and the China Banking Regulatory Commission (established in 2003). With this, an over-burdening of monetary policy by having it at the same time pursue financial stability is to be avoided.

To achieve its objective(s), the PBoC uses a mixed set of monetary policy instruments, consisting of direct, quantitative controls and more indirect, market-oriented instruments. The mix reflects, on the one hand, the legacy of a hierarchical policy order and, on the other hand, practical constraints set by the transition from less developed market structures.

After the official abandonment of the practice of credit plans in 1998 (consisting of setting loan quotas for individual financial institutions), the PBoC intensified the use of other, more modern instruments, such as reserve requirements, central bank benchmark interest rates, and open market operations (Tab. 2).

The crucial and now the most actively used "standard" instruments are at present the reserve requirement ratio and the benchmark lending and deposit rates. In addition, however, the bank intensively implements an atypical instrument of "window guidance", the latter reflecting China's hierarchical policy set-up, given by the central bank's sway over subordinated commercial banks.

Besides this explicit set of instruments, the central bank may use "other policy instruments specified by the State Council". This is how the bank, or more precisely the government, keeps the option to flexibly use credit controls. This happens any time bank lending grows too fast, as in late 2003 when banks were forced to call back loans, in late 2007 when new lending was virtually frozen, and in early 2010 when quarterly and monthly lending quotas on commercial banks were adopted. The purpose of this was to more promptly calm inflationary pressures induced by exchange rate intervention.

The reserve requirement ratio sets the proportion of deposits banks must hold in reserve, currently at 17.5 percent for small and medium depository institutions, 19.5 percent for large depository institutions and 16 percent for rural credit cooperatives and small financial

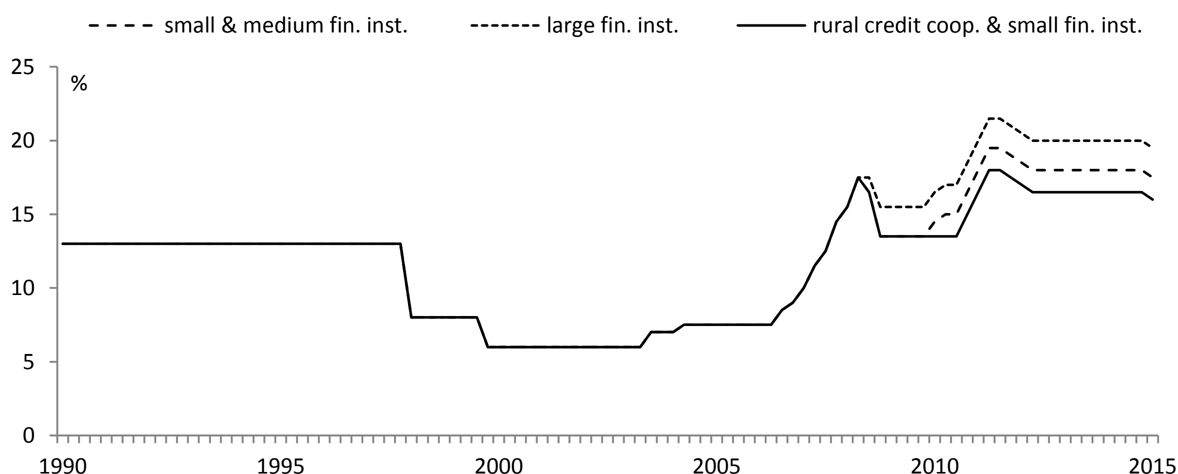
[3] This target, together with the stabilization of currency value and the maintenance of balanced international payments account, was formulated in the Party resolution in 1993.

Table 2. Main monetary policy instruments of the People's Bank of China.

Instrument	Main characteristics
Reserve requirement ratio	Top-down, direct monetary policy instrument. Requires from the banks to hold a proportion of deposits in reserve. The ratios currently vary between three types of banks: small & medium depository institutions (17.5%), large depository institutions (19.5%) and rural credit cooperatives & small financial institutions (16%).
Interest rates	Market-oriented monetary policy instruments. The PBoC sets its benchmark one-year lending and deposit rates, which are the rates at which banks charge their borrowers or pay their depositors. Other policy rates, i.e. required (and excess) reserve rate, rediscount rate (at which financial institutions rediscount commercial bills to get liquidity), and lending rate (at which the central bank provides refinance credit on a fixed-term basis to financial institutions), are all controlled by the central bank, but of lower importance.
Open market operations (OMOs)	Market-oriented monetary policy instrument. Introduced in the early 1990s, but initially scarcely used. Re-launched officially in May 1998, after a series of liberalization episodes that were previously hindering the effectiveness of OMOs. This instrument can consist of repo and reverse repo operations, outright transactions, the issuance of central bank bills, and the Short-term Liquidity Operation (SLO).
Window guidance	An administrative monetary policy instrument. Consists in regular and unscheduled meetings with representatives of selected financial institutions, organized under special or urgent circumstances. The aim of window guidance is to exercise administrative pressure on financial institutions to follow the official instructions.

Source: Own elaboration based on Bell & Feng ['The rise of the People's Bank of China: the politics of institutional change', Cambridge: Harvard University Press, 2013] and Wang & Hu [The China Monetary Policy Handbook, UBS Investment Research, Asian Economic Perspectives, Second Edition, 2011].

Figure 3. Reserve requirement ratios.



Source: Haver.

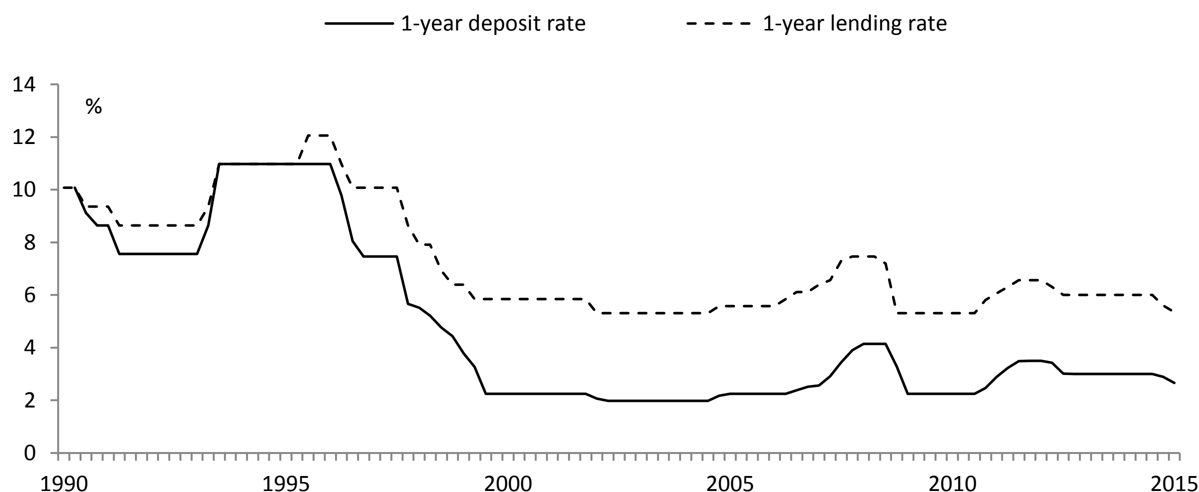
institutions (Fig. 3). Reserve requirements are way above comparable rates in any other large economy. Given a predominant role played by the banking sector in the Chinese financial system, the high effectiveness of this policy instrument in influencing money supply resulted in its more frequent use at least since 2004. In this period, the PBoC tapered issuing central bank bills to sterilize a fast increase in FX assets – a maneuver appearing increasingly costly in front of continuing inflows of foreign reserves – and started to use the reserve requirement ratio instead.

An important advantage of using this ratio as a policy tool is that it can be used to effectively freeze funds until the bank decides on the ratio again. Also, the PBoC pays a much lower interest rate on required reserves than is the market rate on the central bank bills.

In the late 1990s, the PBoC started to adopt the policy of "window guidance", also labeled "moral suasion" or "jawboning". The policy consists of executive meetings (regular or unscheduled, depending on the occurrence of special or unexpected circumstances) with representatives of selected financial institutions. The usual participants are the representatives of the Big Four state-owned banks as well as other financial institutions, usually banks. The aim of the meetings is to exercise administrative pressure on financial institutions to act in line with official prescriptions. This instrument is perceived as an important tool improving the effectiveness of the policy transmission and has been crucial in preventing events of excessive credit expansion in the early 2000s. In this environment, given that the overheating episodes were sector-specific (property, mining and heavy industry) rather than economy-wide, administrative controls were aimed to precisely target the problematic sectors, rather than distort the overall economic activity.

The benchmark interest rates were treated as secondary instruments until the late 1990s. The PBoC tended to prefer quantitative tools, although a few adjustments of the benchmark

Figure 4. Benchmark interest rates.



Source: Haver.

rates to achieve macroeconomic goals were taking place, especially between 1993 and 1996 (Fig. 4). But these instruments gained slightly more importance recently, in particular thanks to a series of interest rate liberalization steps initiated by the bank.

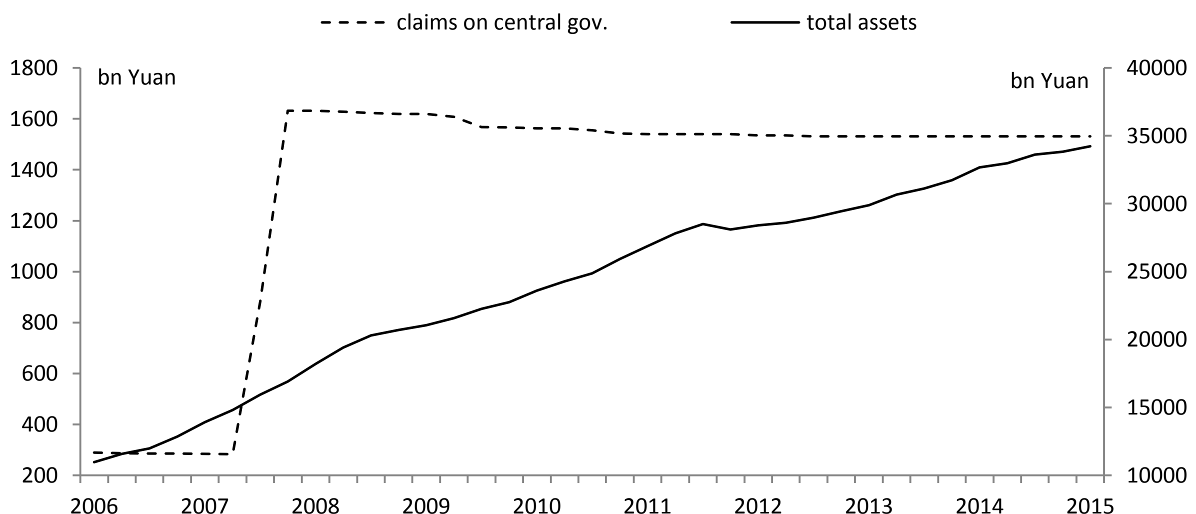
Today, most of the money market and bond interest rates are determined by the market, but the PBoC still controls two important sets of benchmark interest rates, i.e. deposit and lending rates. The continuously growing importance of these rates as monetary policy instruments is confirmed by the fact that the benchmark rates were cut four times in seven months between November 2014 and the end of June 2015[4] in an attempt to improve credit growth and thus shore up flagging activity.

Like in the case of interest rates, a rather limited use was made of OMOs in the first period of the latest reform wave, probably due to limited knowledge and experience in implementing this more indirect policy instrument. Only more recently, with the progressive development of foreign exchange and treasury bond markets, the OMOs have become an increasingly important policy instrument in China. Correspondingly, the PBoC's holding of government treasury bonds rose from 283 billion yuan in the second quarter of 2007 to 1.6 trillion yuan in the fourth quarter of 2007, although it remained relatively stable over the years as a share of total bank's assets (Fig. 5).

An atypical central bank

The evolution of monetary policy design and implementation over the last three decades should be seen in a broader effort of the Chinese state to establish new institutions capable of managing and regulating the emerging market economy. During the reform era beginning in the early 1990s, a substantial consolidation of the bank's monetary and financial authority took place. In March 1995,

Figure 5. PBoC's balance sheet: total assets (right scale) and claims on central government.



Source: Haver.

[4] The last cut in both the benchmark interest rates (by 25 bp) and the reserves requirement ratio applied to banks with sizeable lending to farmers and small businesses (by 50 bp) was made on June 27, after a remarkable selloff in Chinese stocks.

the National People's Congress established the legal basis for the PBoC. This marked a crucial step towards modernization of the Chinese central bank, as the institution obtained a formal status and the mandate to "formulate and implement" (Art. 2) monetary policy and to monitor financial supervision. But the PBoC has not yet left behind its past that was characterized by high price volatility due to the establishment of market-based pricing of goods and services. Ongoing changes, particularly in the housing and property sectors, bring new monetary policy challenges as they are accompanied by asset price inflation.

Moreover, the PBoC is far from independent from political influence. The bank is prohibited from the financing of the government budget and enjoys discretion over its own financial budget. But the bank formally acts under the leadership of the State Council, Chinese government, which approves "key issues" of monetary policy (i.e. the annual supply of banknotes, the setting of interest rates, and exchange rate policy).

The PBoC also lacks transparency. Although minutes of the MPC meetings are recorded and enclosed with the proposed annual monetary decision of the PBoC to the State Council for approval, they are kept secret from the larger public. In its 2013 *Annual Report* (the last version available in English), the bank states that "it has attached great importance to communication with the market and guidance of expectations." Among the main means of communication, *China Monetary Policy Report*, *China Regional Financial Performance Report*, as well as "multiple forms of media" were used. It holds true, however, that mainly evidence delivered by unofficial sources through the local media reveals relatively objective and fresh facts on policy discussions held at the PBoC.

Anecdotal evidence from 2014 tells, for instance, that the central bank lent the state-owned China Development Bank one trillion yuan (USD 163 billion). The move was reported in the media and coined as a Chinese-style quantitative easing, given that the central bank effectively printed cash in an effort to stimulate the economy. But the PBoC has not even confirmed the operation. Another half-secret episode of expansionary monetary policy occurred some months later, when between September and October 2014 the central bank injected another 769.5 billion yuan via loans to commercial banks in a kind of medium-term lending facility. This time, the action was followed by an official note from the bank on November 6, admitting that the liquidity was provided, but without disclosing any detail regarding the terms, the height of the lending, or the participating commercial banks.

The lack of transparency has its price when it comes to international comparisons: the PBoC scores among the least transparent central banks worldwide.[5] But the secretive behavior is not at odds with the central bank's role as a bank to the government, reluctant to release too much information about the public finances. Given that the PBoC is not independent from the government, transparency - which is a key ingredient of accountability and responsiveness to the public - could appear to be unnecessary.

But the lack of transparency could prevent the markets from reacting to policy decisions, undermining the effectiveness of the monetary

[5] In terms of communication, the PBC has been ranked third-worst of 14 big central banks – as reported by a recent Barclays survey. According to a broader index of transparency constructed by Dincer and Eichengreen ['Central bank transparency and independence: updates and new measures', International Journal of Central Banking, 10(1), 189-253, 2014], the PBC scores 4 over 15 in 2010, similarly as Bahrain, Bangladesh, Maldives and Venezuela.

policy. This explains why the markets did not react as much as expected after the latest interventions, with the interbank lending rate responding little to the interest rate adjustment. In addition, the lack of transparency could induce policy inflexibility. This is because credibility of policy moves assures more leeway to deviate from a normal policy stance under extraordinary conditions, as it may be better understood that such a deviation is of a temporary nature.

Great expectations to avoid great deceleration

Several challenges stay ahead of the PBoC. The Chinese economy is cooling down and expected to grow at the slowest pace for years. Growth is likely to be below the government's target of around 7 percent for this year. The slowdown is mostly driven by weakening exports and real estate activity. The latter is struggling with a significant excess supply and weak demand. Although retail sales grew by 10 percent on the year in April, they showed the worst monthly performance of the last nine years. Additionally, Chinese consumer price inflation was revised down to 1.2 percent, more than half the level of the government's official target of "around 3 percent" for this year. Also, nonperforming loans increased, making commercial banks more cautious in lending to the private sector. All this raises hopes for further monetary stimulus.

But the effectiveness of monetary policy may be reduced by several factors. It is very likely that weakness in the industrial production is more structural and due to severe overcapacity. In addition, owing to high indebtedness of companies, China might fall in a balance-sheet recession. In such circumstances, despite the very low interest rates, companies are reluctant to take up new credit and further monetary expansion would be ineffective. Also, despite the lure of the Chinese stock market performance, capital is flowing extensively out of China, reflecting in part growing concerns over financial stability, dampened prospects over Chinese growth and anticipation of further monetary policy accommodation. It is true that Beijing has the necessary tools to manage (excessive) cross-border capital flows, but if misused, this undermines the trust of investors.

The past experience of the Asian financial crisis and domestic deflation between 1998 and 2002 has revealed the ability of the PBoC to find a balance between the government's proactive fiscal policy and its own more cautious monetary stance. Later experiences of the period 2003-2007 delivered additional evidence that the bank is able to tackle asset price bubbles and to fight inflationary pressures through extensive sterilization measures. But the times are different now. The economy is slowing due to weak exports and a supply overhang in some domestic sectors. All this could mean that despite the extraordinary capacities of discretion and clout in the monetary policy making, the PBoC might no longer be able to prevent the "great deceleration".

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