FOR PROFESSIONAL INVESTORS – 5 January 2024

Chi on China

IMPLICATIONS OF CHINA'S IMPAIRED MONETARY TRANSMISSION MECHANISM

Perfection is not attainable, but if we chase perfection, we can catch excellence.

Vince Lombardi

SUMMARY

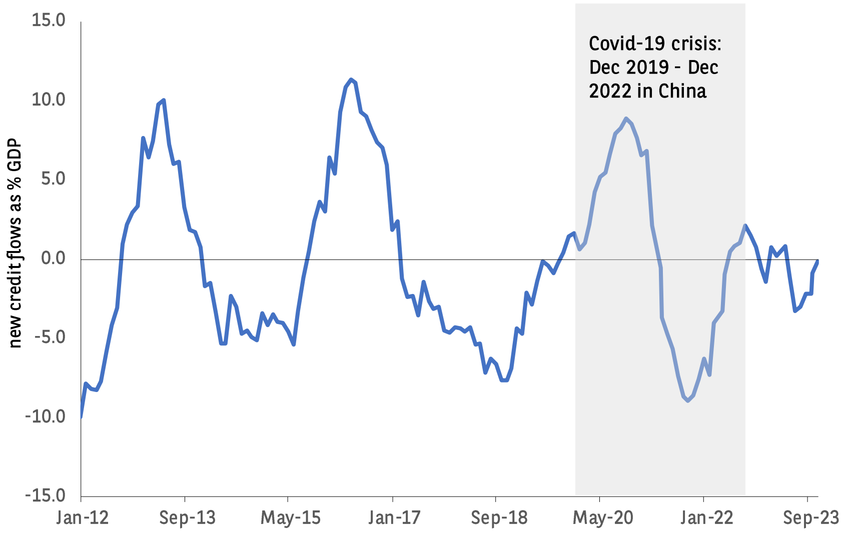
- China's monetary transmission mechanism has become ineffective in reviving growth momentum since the Covid-19 health crisis. This likely reflects both policy and structural problems due to incomplete reform of the monetary policy framework.
- Despite years of interest rate liberalisation, implicit interest rate controls still exist. The government's 'visible hand' of administrative controls has rendered market forces dysfunctional, thus making monetary transmission ineffective.
- Cyclically, this means Beijing must ease policy more and longer than in the previous cycles to deliver the same growth impact. In the longer-term, it will have to reduce its 'implicit guarantee' further and truly liberalise interest rates to allow the monetary pricing tools to work properly.

Recent research shows that China's monetary policy has evolved from a quantity-based framework that uses the bank reserve requirement ratio (RRR), credit quotas and allocation directives, to a mixed system that also includes price-based tools, notably interest rate and signalling from the interest rate corridor, to influence economic and financial behaviour. This change has greatly increased the role of market expectations in transmitting monetary policy to the domestic economy.

However, a recent market study[1] found that China's monetary transmission mechanism has become impaired since the pandemic. The absence of a sustained recovery in the credit impulse (i.e., the ratio of new credit flows to the system as a share of GDP), which is an economic leading indicator, despite rounds of monetary easing, underscores the severity of this problem (Exhibit 1).

Exhibit 1:

Monetary easing has not boosted China's credit impulse



sources: CEIC, UBS, BNP Paribas Asset Management 26 Dec 2023

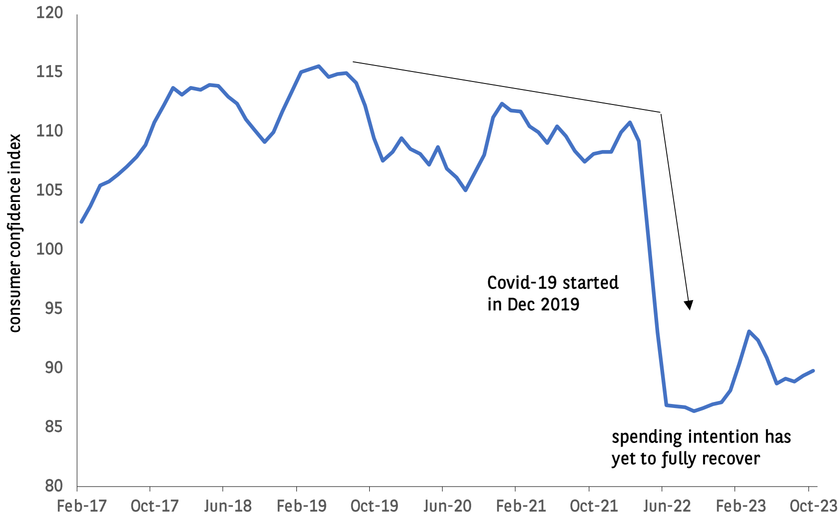
POLICY PROBLEMS

Three years of Zero Covid Policy, the tightening of regulations (notably on the tech sector) between 2020 and 2022, and chronic weakness in the property sector since the pandemic have destroyed public confidence and blunted the policy easing effect on reviving China's growth momentum and 'animal spirit'. Hence, private consumption and investment spending have failed to respond to the easing measures (Exhibits 2 and 3).

[1] "*Why China's Monetary Easing Has Become Less Effective Post-Covid*", Lisheng Wang, Hui Shan, Maggie Wei *et tal*, Asia Economic Analyst, Goldman Sachs, 18 December 2023.

Exhibit 2:

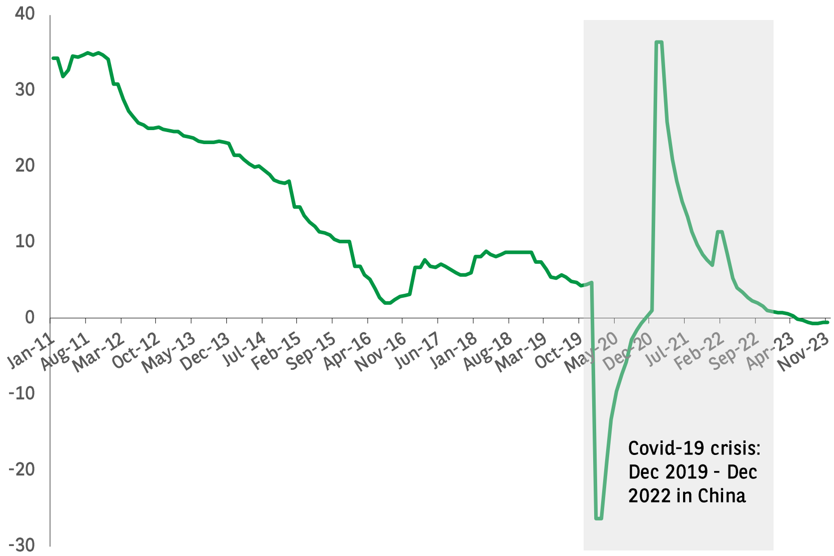
Chinese consumer willingness to spend* plunged due to Zero-Covid Policy



sources: CEIC, BNP PAribas Asset Management 26 Dec 2023

Exhibit 3:

Private sector investment growth (%YoY)

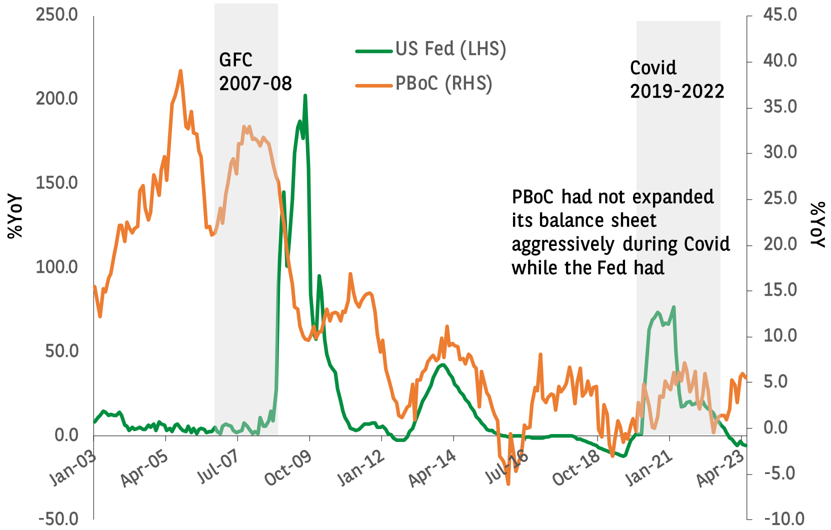


sources: CEIC, BNP PAribas Asset Management 26 Dec 2023

Beijing's 'incremental easing' approach over the past two years did not help turn the situation around. It simply was not enough, especially when the monetary transmission mechanism is broken. Throughout the pandemic, the PBoC chose not to expand its balance sheet aggressively to pump-prime the economy, despite all its talks of policy easing, while its developed market central bank counterparts engaged in quantitative easing through massive balance sheet expansion (Exhibit 4).

Exhibit 4:

Central bank balance sheet growth



sources: CEIC, BNP Paribas Asset Management 26 Dec 2023

Unlike governments in developed markets, China's government also refrained from providing any fiscal support to the Chinese consumer during the pandemic. The difference in this fiscal policy approach explains China's lack of consumption recovery post-Covid compared to the robust consumption growth seen in the West.

CYCLICAL IMPLICATIONS

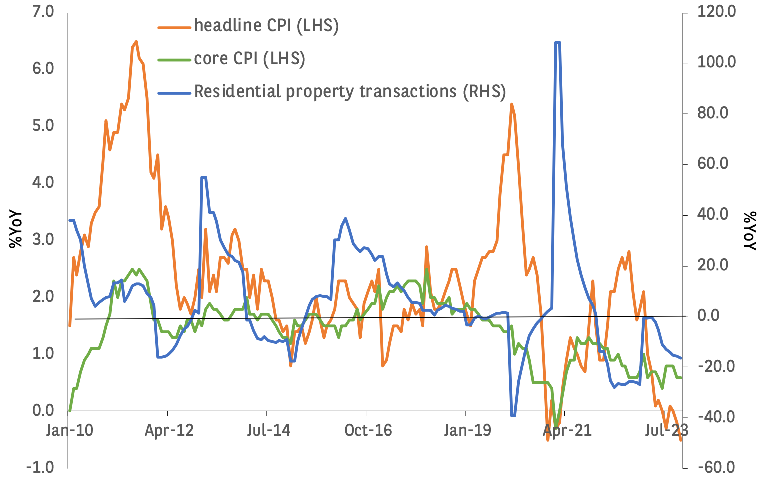
Granted, Beijing wants to quit the old debt-fuelled supply-expansion growth mode. So, it is willing to tolerate slower growth by focusing on structural reforms, debt reduction and de-risking the financial system. However, this deflationary policy mode runs the risk of mis-calculating the economy's resilience to negative shocks and deprives it of recovery momentum! The loss of monetary transmission efficacy argues that the PBoC would have to pursue more aggressive easing and sustain it for longer than in previous cycles to achieve the same growth impact.

Realising that China's property market woes are spreading the risk of deflation (Exhibit 5), Beijing has ramped up policy easing to stabilise the property sector, notably by accelerating urban village renovation and social housing construction and increasing financing for viable non-state-owned developers. The PBoC has also announced a plan to inject more than RMB1 trillion to fund property and infrastructure investment in major cities and has drawn up a 'whitelist' of 50 developers for credit support.

The risk, however, is the timing of implementation. At the time of writing, many of these measures are yet to be carried out.

Exhibit 5

China's property transactions contracting, CPI flirting with deflation



sources: CEIC, BNP Paribas Asset Management 26 Dec 2023

THE TRANSMISSION MECHANISM…

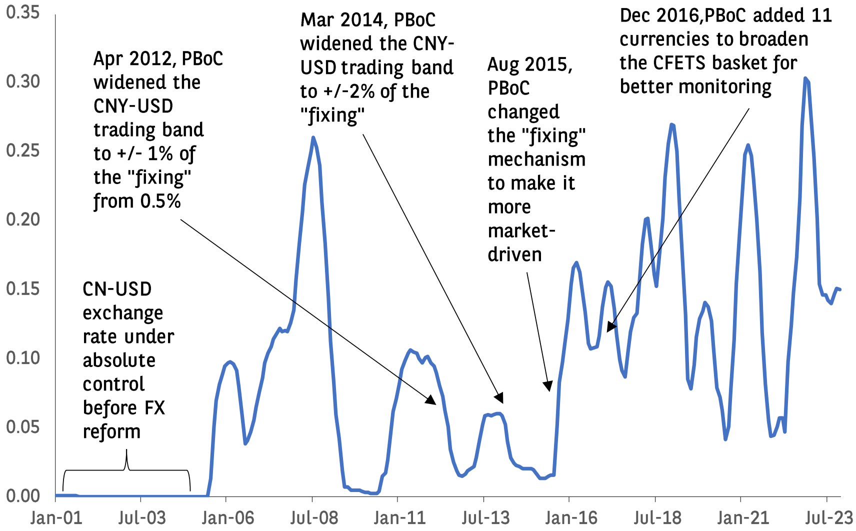
While aggressive monetary easing could fix the cyclical economic weakness, the loss of monetary transmission efficiency is a structural policy problem that risks ineffective economic management in the long-term. Meanwhile, capital account liberalisation is complicating this policy problem because it is forcing Beijing to choose between exchange-rate and interest-rate control under the 'Impossible Trinity'[2]. To tackle these challenges, China has been experimenting with an 'interest rate corridor' framework since 2013.

China has indeed come a long way in modernising its monetary framework. It has opted for retaining monetary autonomy (i.e., controlling the interest rate) and freeing up the exchange rate (albeit within Beijing's management limits). This policy choice has resulted in the sharp rise in the volatility of the CNY-USD cross-rate over the years (Exhibit 6).

[2] The Impossible Trinity, or the Trilemma, argues that under an open capital account, an economy cannot control both the exchange rate and the interest rate at the same time; the Interest Rate Parity theorem underscores such logic. In other words, under the Impossible Trinity, the government can control either the interest rate (and let the exchange rate float) or the exchange rate (and let market forces determine the interest rate), but not both.

Exhibit 6:

Rising CNY-USD volatility* along with FX reform



* 12-month rolling standard deviation   sources: CEIC, UBS, BNP Paribas Asset Management   26 Dec 2023

The PBoC has also added price-based tools and new lending facilities to its quantity-based tool kit since 2013 to improve monetary control and identify policy rates for operating the interest rate corridor. These new tools include:

- Short-term liquidity operations (SLO): This supplements open market operations (OMO) and is used on a discretionary basis to manage liquidity fluctuation in the system.
- Standing lending facility (SLF): This is like the European Central Bank's marginal lending facility. It has a one- to three-month maturity and requires collateral for providing liquidity support to financial institutions.
- Medium-term lending facility (MLF): This is like the SLF but with longer tenor, typically between one and three years. The MLF rate directly affects the Loan Prime Rate (LPR)[3] that banks charge their most creditworthy clients. It also affects the Chinese government and, hence, corporate bond yields.
- Pledged supplementary lending (PSL): This supplements the PBoC's re-lending scheme to provide funding for the policy banks to undertake public housing and infrastructure projects.[4]

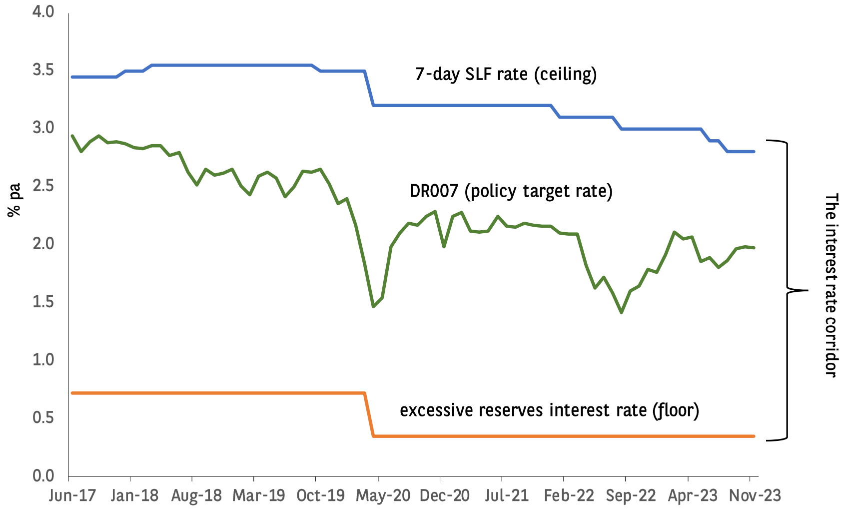
Since 2017, the PBoC has used the 7-day SLF interest rate as the ceiling of the interest rate corridor, the interest rate that it pays on the banks' excess reserves as the interest rate floor, and the pledged 7-day interbank market rate (or DR007) as the policy target rate in the corridor (Exhibit 7).

[3] The PBoC first created the LPR in October 2013 as a lending rate that the commercial banks can offer their most creditworthy clients. It was the average rate calculated from the quotations submitted by 10 commercial banks and was supposed to be a market driven interest rate because it reflected credit market conditions (while the official benchmark rate is set at the PBoC's discretion hence is not market driven). But the LPR did not work as intended, as banks ignored it, and no one followed it. So, the PBoC reformed the LPR in August 2019 by taking the average of the quotations submitted by 18 commercial banks and adding to it a premium (usually within 100 bps) over the MLF rate. By linking the LPR to the MLF, the authorities hoped to make bank lending rates market driven as the MLF rate is supposed to reflect credit market demand and supply conditions.

[4] PSL differs from conventional re-lending that the PBoC uses frequently as a liquidity management tool in that PSL requires collateral, such as Treasury bonds and bills (while re-lending does not) and has a loan maturity of more than a year (while re-lending loans typically mature in less than a year).

Exhibit 7:

China's interest rate corridor



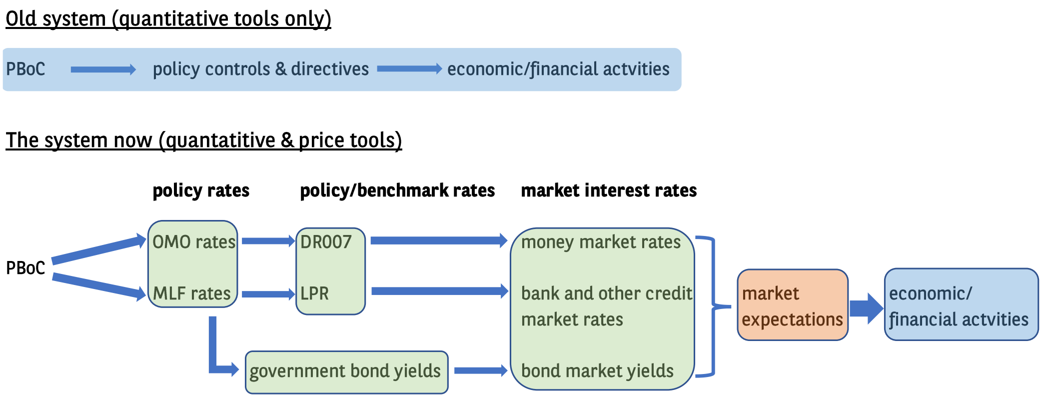
sources: CEIC, BNP Paribas Asset Management 26 Dec 2023

The PBoC conducts OMO (through repo to withdraw liquidity and reverse repo to inject liquidity) to move the policy target rate within the corridor, hence sending signals to the market about its policy stance. A move of the target rate towards the ceiling signals monetary tightening while a move towards the floor signals policy loosening. Meanwhile, open market operations affect the repo and reverse repo rates, which the PBoC monitors closely to gauge money market demand and supply forces.

China's monetary policy transmission under this regime is more complicated than the old model of direct quantitative controls because market expectations and credit prices, including interest rates, bond yields and other credit market rates, are part of the transmission process (Exhibit 8).

Exhibit 8:

China's monetary tranmission mechanism



source: BNP Paribas Asset Management 26 Dec 2023

Theoretically, the adoption of an interest rate corridor requires market-driven interest rates. Such a system could go a long way to strengthen China's monetary policy management by improving the credit-pricing mechanism through the elimination of the incentive distortions that misprice credit in the old administrative control system. Indeed, former PBoC governor Yi Gang advocated as early as in 2008 to liberalise China's interest rates and reform the exchange rate regime to enable these price-based policy tools to play their roles in monetary policy transmission.

…AND THE STRUCTURAL HEADACHES

The trouble is that the old habit of control dies hard.

Firstly, beyond than the monetary authorities, there are other government ministries and authorities that have a say on formulating credit policies. These include the National Development and Reform Commission (NDRC), Ministry of Finance (MoF), Ministry of Industry and Information Technology (MIIT), Ministry of Housing and Urban-Rural Development (MOHURD) and local governments. From time to time, these bodies' political objectives not only create conflicts with the PBoC's monetary policy objectives but also impose administrative control over market forces in affecting credit price movement and allocation.

Secondly, China's interest rate corridor is not truly market driven. The PBoC runs the corridor system with multiple policy tools. In addition to the SLF (the current rate ceiling), it also exercises discretion on using the SLO, MLF, PSL and RRR to affect liquidity and interest rates of these lending facilities. There is no consistency in terms of when to use which facility. All these factors have eroded the policy-signalling function of the interest rate corridor.

Crucially, despite an ostensible completion of interest rate liberalisation[5], there are still hidden interest rate controls, with the benchmark interest rates and administrative directives still distorting capital allocation. One only needs to ask: with all lending and deposit interest rate restrictions abolished years ago, why does Beijing keep the benchmark rates, which should be non-binding constraints on loans and deposits?

On the lending side, the reason is that SOEs, local government companies and large companies still borrow at the benchmark rates, and they remain the only entities that have access to these preferential rates, which are significantly below market rates. This shows that:

1) Financial repression still exists,
2) These government and government-related entities, with their soft budget constraints, are still driving most domestic investment. Despite all the talks about the diminished role of the state sector, many private-sector investments are dependent on the demand from these SOE, local government, and large company investments.

Thus, retaining the benchmark lending rates mutes the effects of interest rate liberalisation by keeping cheap credit flows to the inefficient sectors and, thus, reflects hidden interest rate controls. The introduction and reform of the LPR in 2013 and 2019, respectively, made little change to the situation because the MLF rate, over which the LPR is priced, is not fully market driven as many have assumed.

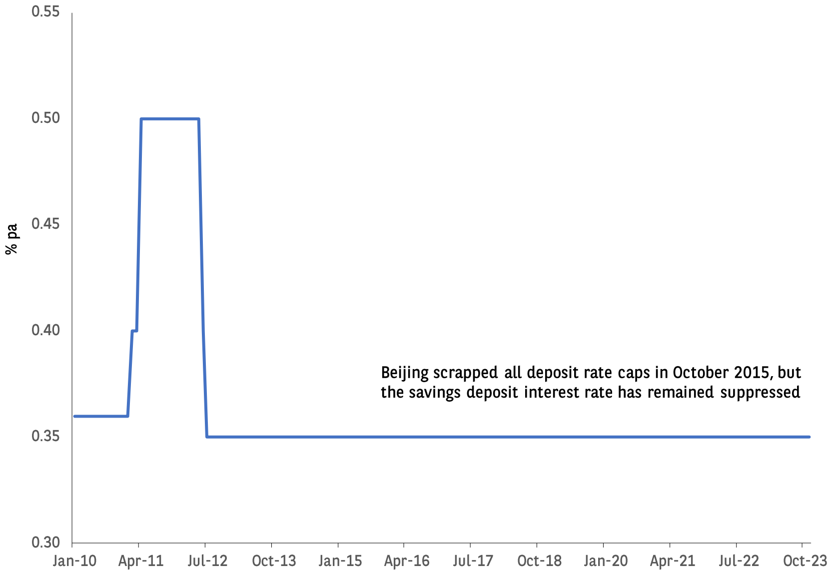
On the deposit side, scrapping the deposit rate cap should lead to market pricing of interest rates for savers by inducing competition among financial institutions. This should, in turn, break the big state banks' monopoly of amassing cheap funds as the small banks can bid for funding by offering higher interest rates.

However, incentive distortions, such as implicit guarantees and the cozy relationships between SOEs and big banks that restrict fund flows, are still prevalent. They have prevented effective competition from happening and

[5] Beijing scrapped all the lending rate ceilings and floors by 2013 and all the deposit rate caps in late 2015.

so eroded the effectiveness of market forces on pricing capital. This explains why the household savings deposit rate has not changed/risen despite the abolition of the deposit interest rate cap in 2015 (Exhibit 9).

Exhibit 9:
China's household savings deposit interest rate



sources: CEIC, BNP Paribas Asset Management 26 Dec 2023

POLICY INERTIA

There is also a problem of policy inertia. The lending facilities in the PBoC's policy tool kit are not fully market determined. The central bank exercises discretion from time to time on deciding the allocation of funds from, and even setting the interest rates of, the SLO, SLF, MLF and PSL facilities to designated banks and economic sectors. Even the RRR is unevenly adjusted by Beijing's visible hand.

Finally, China's OMO are immature as the market segment of the financial system is still not fully developed. Its OMO are concentrated on the repo market using securities maturing in less than 91 days and central bank bills maturing in under a year. This prevents the PBoC from conducting longer-term OMO, such as asset purchases in the market, as a crisis management tool. The PBoC has yet to incorporate government and high-quality corporate bonds in its OMO process.

THE FUTURE MONETARY FRAMEWORK

Under the old monetary framework, interest cut (hike) and liquidity injection (withdrawal) were two separate policy moves (not necessarily implemented simultaneously) in China. There has been some improvement in this disconnect of China's monetary policy management since the adoption of the interest rate corridor. However, to make its monetary framework effective, China needs to allow market forces to work properly in the interest rate corridor. In other words, the PBoC needs to 'normalise' its policy towards the developed market model where an interest rate cut (hike) and liquidity injection (withdrawal) is one combined move implemented through market forces.

When the market driven monetary transmission mechanism is established, the PBoC should scrap the lending and deposit benchmark rates. Future interest rate adjustments would take the form of changes in the PBoC's target policy rate. This, in turn, would require an improvement in the OMO process to minimise the volatility of short-term money market rates, which act as the conduit for transmitting the policy rate effect to market interest rates. This would mean further capital market reform and financial liberalisation.

The road to improving the monetary transmission efficiency is long and bumpy. During the transition, there will likely be confusion about the PBoC’s policy stance because there are no policy rates for anchoring expectations. Market players must monitor all the interest rates in the PBoC’s policy tool kit (i.e., those that correspond to the SLO, SLF, MLF, PSL) and the RRR to gauge the PBoC’s monetary stance.

In recent years, regulatory policies have often hurt economic growth and investor sentiment despite the central government’s broad pro-growth macroeconomic policy stance. Meanwhile, the old habit of control and meddling by government ministries is not going to go away quickly. Thus, enhancing policy coordination between the monetary and fiscal policies (and between the central and local authorities), hardening the budget constraints of the state companies, and increasing financing support for the SMEs and private sector could help reduce the distortion on China’s monetary transmission mechanism in the short- to medium- term.

Chi Lo
BNP Paribas Asset Management

DISCLAIMER