



Chi on China

FOR PROFESSIONAL INVESTORS – 9 February 2018

MEGA TRENDS OF CHINA (5): EVOLUTION OF A NEW MONETARY FRAMEWORK

The future doesn't belong to the fainthearted; it belongs to the brave.

Ronald Reagan

SUMMARY

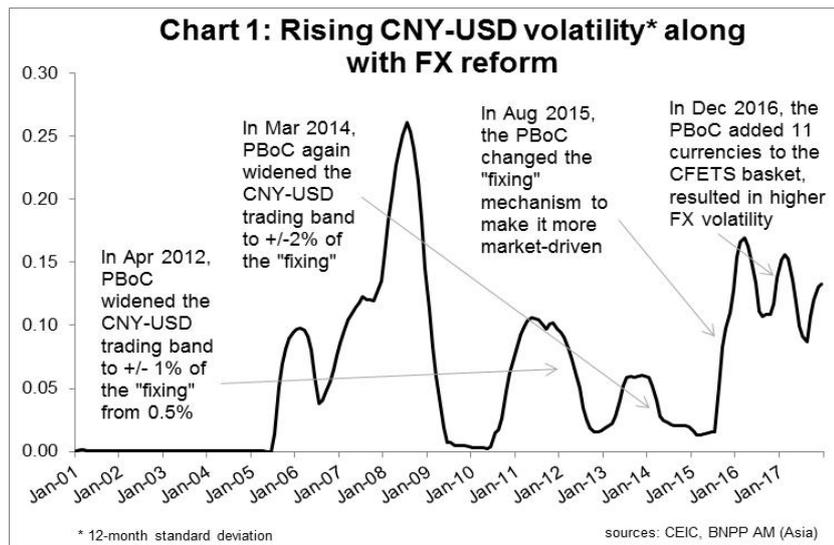
- In the process of opening up the capital account, China has been experimenting with an “interest rate corridor” framework since 2013 to prepare for the advent of the Impossible Trinity when it will have to choose between exchange-rate and interest-rate autonomy under free capital flows.
- The recent change in the policy role of the bank reserve requirement ratio is the latest evidence of the authorities shifting from its antiquated quantity-based monetary policy practice to the price-based interest rate corridor policy framework.
- Beijing’s biggest challenge is to find the right market interest rates for operating the “corridor” when domestic interest rates are, in contrast to conventional wisdom, still not fully liberalised. This begs the question of which interest rate(s) the markets should monitor to gauge the PBoC’s policy stance.

Since opening the capital account in 2000, albeit slowly and asymmetrically, China has started reforming the renminbi’s “fixing” mechanism and enlarging the daily CNY-USD trading band, thus making renminbi trading increasingly flexible (Chart 1), within its tolerable limits that is. This shows that Beijing has a policy preference for monetary-policy autonomy over exchange-rate control as China moves towards the Impossible Trinity.



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Capital account liberalisation also means that market expectations will play an increasingly important role in transmitting monetary policy to the domestic system, implying that the current government-controlled benchmark-rate system would become obsolete. Thus, the People's Bank of China (PBoC) has to search for a new policy framework to accommodate market-based monetary management and it has been experimenting with an interest rate corridor system since 2013.

CHINA'S INTEREST RATE CORRIDOR

Theoretically, an interest-rate corridor is a monetary management system that involves three policy rates: an interest-rate ceiling, a floor and a policy target rate. The latter is set by the central bank and lies between the rate ceiling and the floor. The policy target rate is usually the short-term interbank market interest rate. The ceiling rate usually comes from the lending facility offered by the central bank in its role as the "lender of last resort". The interest rate paid on reserves (or excess reserves in China's case) that banks held at the central bank serves as a floor to the corridor.

Once an interest-rate corridor is constructed, the central bank uses open market operations (OMO) to adjust the aggregate liquidity in the financial system in response to changes in demand and supply conditions to ensure the policy rate remains within the corridor. The purpose of the OMO is to manage market expectations that are consistent with attaining its policy goals.

Since 2013, the PBoC has introduced new lending facilities in an attempt to improve monetary control and identify policy rates for operating the interest rate corridor. The tools include:

- Short-term liquidity operations (SLO): This is a supplement to OMO, and is used on a discretionary basis to manage temporary liquidity fluctuation in the system.
- Standing lending facility (SLF): This is similar to the ECB's marginal lending facility. It usually has 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.
- Pledged supplementary lending (PSL): This is a form of lending that supplements the PBoC's re-lending scheme to provide funding for the policy banks to undertake public housing and infrastructure projects. PSL differs from traditional re-lending, which the PBoC uses frequently as liquidity management tool, in that it

requires collateral, such as Treasury bonds and bills (while re-lending does not) and has loan maturity of more than a year (while re-lending loans typically mature in less than a year).

Since 2017, the PBoC has used the SLF interest rates (one day, one week and one month) as the ceiling of the corridor and the interest rate that it pays on the banks' excess reserves as the rate floor. The pledged 7-day interbank market rate (code DR007) has been the policy target rate (Chart 2).



Between 2013 and 2016, the 7-day repo rate and 3-month SHOBOR were experimented as policy target-rates. But these rates also apply to the transactions between banks and non-bank financial institutions (NBFIs) while the SLF is purely for bank-to-bank transactions. So when the PBoC switched to using the SLF as the rate ceiling in 2017, it also decided to use an interest rate that is only applicable to bank-to-bank transactions, i.e. the DR007, as the policy target rate.

The PBoC conducts OMO (through repo to withdraw liquidity and reverse repo to inject liquidity¹) 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.

It is clear from the recent movement of the policy target rate (Chart 2) that the PBoC has a tight policy bias that is consistent with the government's regulatory tightening to force debt-reduction in the economy. But the PBoC also wants to prevent liquidity crunches from hurting growth. So when the policy target rate gets near or hits the interest-rate ceiling, it injects liquidity to push it down (Chart 2).

SHIFTING AWAY FROM QUANTITY-BASED MONETARY MANAGEMENT

The recent discriminatory cuts in the bank reserve requirement ratio (RRR) are the latest evidence that the PBoC is shifting away from its old quantity-based monetary management framework to the price-based interest rate corridor. It announced on 30 September a double-tier RRR cut, to be effective in January 2018 that:

¹ The repo and reverse repo definitions in China for OMO may be different from those in the other (especially developed) markets.

- 1) Banks that have at least 1.5% of their new, or outstanding, loans in 2017 in “inclusive finance” (defined as loans less than RMB5 million made to SMEs, self-employed individuals and start-ups, rural businesses and students) will be eligible for a 50bps cut in their RRR.
- 2) Banks with “inclusive finance” loans of more than 10% of their new, or total, loans will be eligible to an additional 100bps (i.e. a total 150bps) cut in their RRR.

Then in the last trading day of 2017, it announced a temporary (30-day) two-percentage-point cut in the RRR for domestic commercial banks to meet high liquidity demand ahead of the Chinese New Year.

All the previous RRR adjustments were permanent in nature and uniform across the board (though large and small banks have always had different RRRs). These recent uneven cuts were unconventional and showed that the authorities had changed the role of the RRR from being a monetary policy tool to a temporary liquidity management tool working within the interest rate corridor.

CHANGES NEEDED

In the past, the RRR was a crucial monetary policy tool in the system where investments by the state-owned-enterprises (SOE) were not sensitive to changes in the price of credit. Thus, changes in the RRR which led to outright changes in the amount of liquidity were more effective in affecting SOE investments.

Furthermore, between 1994 and 2013 China's balance of payments (BoP) surplus caused a persistent appreciation of the renminbi that ran against the authorities' policy of exchange rate stability. Thus, the RRR adjustments (basically hikes) were used as a sterilisation tool for the PBoC to mop up the excess liquidity resulted from the FX intervention to curb renminbi appreciation.

But things have changed to erode the policy role of the RRR. Firstly, the emergence of the private sector has made investments more sensitive to credit pricing by reducing the weight of SOE investment in the economy. Secondly, China's BoP surplus has turned into periodic deficits since late 2013, breaking the renminbi's persistent appreciation trend. Hence, the RRR's function as a monetary sterilisation tool has become redundant. These changes suggest that adjustments in the RRR are no longer a policy signal for the PBoC's monetary stance.

Adoption of an interest rate corridor system will require market-driven interest rates and will go a long way to reforming China's monetary policy management by improving the effectiveness of policy communication and monetary transmission mechanism. The far-reaching effect of such a system is to improve China's credit-pricing mechanism, as the incentive distortions that have mispriced credit under the current monetary framework will have to be eliminated. This also means Beijing will have to eventually retreat from the financial sector and its implicit guarantee policy.

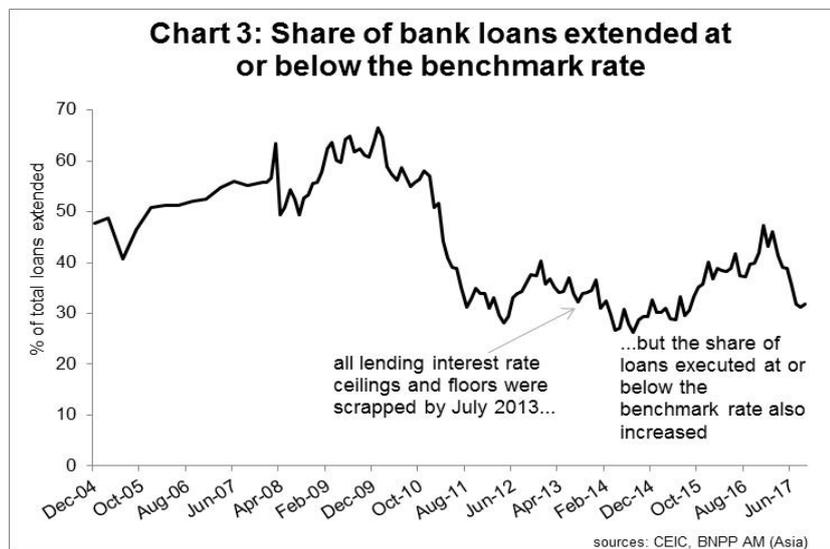
THE CHALLENGES

However, making these changes are tall orders. Firstly, financial liberalisation in China has made the relationship between the monetary aggregates and economic activity unstable. Hence, the PBoC has not been able to choose the appropriate interest rates for constructing the interest rate corridor. This has resulted in a Chinese corridor system with multiple policy tools – in addition to the SLF (the current rate ceiling), the PBoC also uses the SLO, MLF, PSL and the RRR to affect liquidity at its discretion. There is no consistency for when to use which facility. This erodes the policy-signalling function of the corridor!

Secondly, despite an ostensible completion of interest rate liberalisation², 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, why does Beijing still keep the benchmark rates, which should be non-binding constraints on lending 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 due to financial repression. Some official data shows that local governments and their related companies account for 90% of all domestic investment; others show that SOEs account for over a third of domestic investment. There is no data breakdown to clarify this overlap.

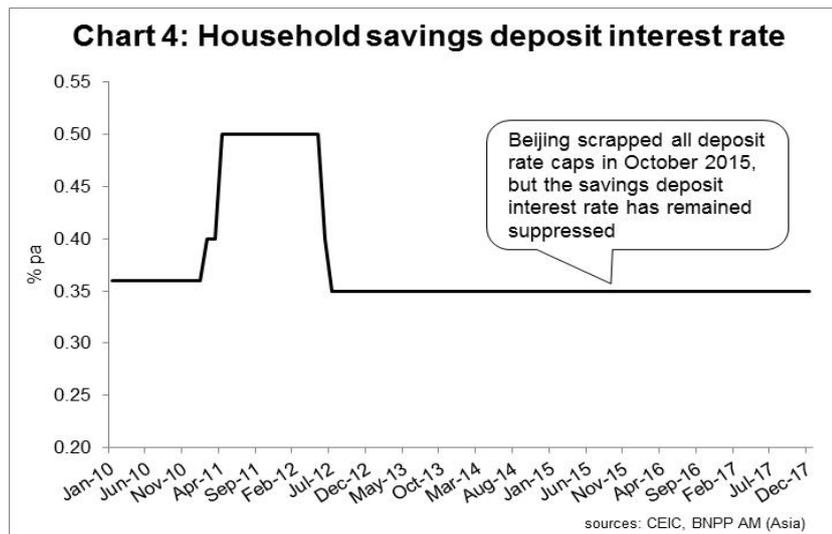
The point is that these entities, with their soft budget constraints, are still driving most domestic investment as many private investments are dependent on the demand derived from the SOE, local government and large company investments. Retaining the benchmark lending rates mutes the effects of interest rate liberalisation by keeping cheap credit flows to the inefficient sectors and is, thus, representative of hidden interest rate controls. In fact, the share of bank lending executed at or below the benchmark rate has increased in recent years, showing that the benchmark rate is still binding (Chart 3).



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

However, incentive distortions, such as implicit guarantees and cosy relationships between SOEs and big banks that restrict fund flows, are still prevalent. They have prevented effective competition from happening and, thus, eroded the effectiveness of market forces on the pricing of capital, despite the abolition of the deposit interest rate cap. This explains why the household savings deposit rate has not risen despite the scrapping of the deposit rate cap in 2015 (Chart 4).

² Beijing scrapped all the lending rate ceilings and floors by 2013 and all the deposit rate caps in late 2015.



There is also a problem of policy inertia. The lending facilities in the PBoC's policy tool kit are not fully market-determined. The availability of the SLO, SLF, MLF and PSL facilities are still determined by administrative directives in terms of which banks will get the loans and to which sectors the banks can lend. Even the RRR now can be unevenly adjusted by Beijing's visible hand.

Last but not least, China's OMO is immature as the market segment of the financial system is still not fully developed. Its OMO is 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

Nevertheless, the PBoC is preparing to shift towards a new market-driven policy framework as China moves towards the Impossible Trinity³. Beijing has already chosen to let go of exchange rate controls and retain monetary autonomy. When the market-driven monetary transmission mechanism is fully established, the PBoC will scrap the lending and deposit benchmark rates. Future interest rate adjustments will take the form of changes in the PBoC's target policy rate. This will require it to improve the OMO 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 means further capital market reform is needed.

Under the current monetary framework, interest cut (hike) and liquidity injection (withdrawal) are two separate policy moves (not necessarily implemented simultaneously) in China. The new monetary paradigm should "normalise" China's monetary policy framework towards the developed market model where interest rate cut (hike) and liquidity injection (withdrawal) will be one combined move implemented through market forces.

³ A discussion on the PBoC's other policy challenges can be found in *"China's Impossible Trinity: The Structural Challenges to the 'Chinese Dream'"*, chapter 10, Chi Lo, Palgrave Macmillan 2015.

During this stage of transition, confusion about the PBoC's policy stance leading to market volatility is expected because there are no policy rates for anchoring expectations. The market players will have to monitor all the interest rates in the PBoC's policy tool kit (i.e. those correspond to the SLO, SLF, MLF, PSL and the RRR) to gauge the PBoC's monetary stance.

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