Opinion **Central bank intervention**

The People's Bank of China has a transparency problem

A central bank communication strategy is vital if it is to achieve its aims

ESWAR PRASAD

The PBoC's opacity leaves financial market participants guessing about its monetary policy strategy © Andrea Verdelli/Bloomberg

Eswar Prasad AUGUST 26 2024

The writer is a professor at Cornell University and senior fellow at the Brookings Institution

If monetary mystique is an art, the People's Bank of China takes that to the extreme. Among the major central banks in both advanced and emerging markets, it is the only one that does not make changes to interest rates and other aspects of monetary policy linked to a predictable cycle of policy committee meetings. Instead, policy changes are made on an ad hoc basis and communicated through press release.

As the central bank of the second-largest economy and one that aspires to promote market mechanisms, this lack of transparency has many negative ramifications, both domestic and international. The PBoC's opacity leaves financial market participants guessing about its monetary policy strategy.

Rather than managing expectations about interest rates, a key element of central bank policy, the PBoC usually ends up on the defensive, reacting to market developments. This renders the transmission of monetary policy into economic activity and inflation, a byzantine process in the best of circumstances, even harder to manage. Another consequence is the unnecessary build-up of pressures on the exchange rate when currency traders are trying to surmise the PBoC's intentions in one direction or another.

This lack of communications has previously backfired badly. In August 2015, a well-intentioned surprise move to free up the exchange rate, communicated through a cryptic statement, created market panic. The widening of the renminbi's trading band against the dollar was accompanied by a nearly 2 per cent devaluation, incorrectly seen as a sign of more devaluation to come. The PBoC eventually held a press conference to clarify its intentions. But the damage was done, with capital fleeing China and the currency depreciating sharply.

The PBoC is attempting to modernise monetary policy by using interest rates to control credit creation in the economy rather than directly ordering banks to expand or limit credit. This laudable objective is hampered by the absence of a transparent framework for adjusting interest rates. This also makes it harder to promote the renminbi's role as an international currency. It leaves foreign investors dubious about the PBoC's claims of allowing for a market-determined exchange rate and not managing it using capital controls. The lack of transparency makes it harder for the PBoC to resist market pressures.

The PBoC admittedly does not have a free hand. It lacks statutory independence and its governor does not have the status of a cabinet minister. Monetary policy decisions are taken by the State Council, a political body, although the central bank certainly influences those decisions. This puts it in a sticky situation in which it cannot project itself as an independent decision-making body.

However, other emerging market central banks such as the Reserve Bank of India have not let their lack of statutory independence get in the way of a communication strategy that explains the rationale behind decisions. The RBI's open communications have given it credibility and, in turn, allowed it to gain some de facto independence. The RBI now has operational independence in managing interest rates and the Indian rupee's exchange rate, within the broad framework set by the government. The Indian government has understood that this independence is valuable, keeping interest rates, and therefore borrowing costs, down and reducing exchange rate volatility.

The PBoC wants to modernise China's monetary policy, liberalise financial markets and promote the renminbi. To accomplish all this, it needs a better policy framework, even if the actual decision-making process stays out of its hands. More open communications are a prerequisite, though, for any framework to deliver good results. Without that, it is futile for the Chinese government to expect the PBoC to deliver effectively on its mandates of promoting monetary and financial stability.