Monetary Policy in China

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China's increasing openness to trade and financial flows and the economy's gradual transition to a market-oriented one has increased the importance of developing an effective monetary policy framework. Monetary policy plays a crucial role in macroeconomic and financial stability, helps promote the efficient allocation of resources and serves as a buffer against internal and external shocks. China's monetary policy framework has evolved over time but remains constrained by a managed exchange rate regime, institutional weaknesses, and an underdeveloped financial system that reduces the potency of the monetary transmission mechanism.

Current state of monetary and exchange rate policies

The main nominal anchor for China's monetary policy has been the nominal exchange rate, which was pegged to the dollar from the mid-1990s until July 2005. In that month, the renminbi was revalued against the U.S. dollar by about 2 percent and, according to the People's Bank of China (PBC), the currency was thereafter managed against an undisclosed basket of currencies. In practice, the renminbi has remained tightly managed against the dollar, with the PBC subsequently indicating that on any given trading day the bilateral exchange rate would be allowed to float within a band of 0.3 percent relative to the closing price of the previous day. The renminbi was repegged to the dollar during the global financial crisis and then once again allowed to appreciate against the dollar starting in June 2010. In April 2012, the floating band was widened to 1.0 percent per day.

The exchange rate regime has restricted the PBC's ability to use the conventional monetary policy instrument of the policy interest rate. Until the end of 2011, there

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were strong pressures on the renminbi to appreciate. The PBC has had to intervene heavily in foreign exchange markets to prevent further nominal appreciation of the renminbi. This has led to a dramatic accumulation of foreign exchange reserves, from a level of $156 billion in 2000 to $3.2 trillion as of the second quarter of 2012 (Prasad and Ye, 2012). While China does have capital controls in place, these controls have become increasingly porous over time, compromising the independence of monetary policy (Prasad and Wei, 2007).

A further constraint is that, until recently, banks' deposit and lending rates were directly controlled by the government. Since 2003, interest rates have been progressively liberalized and the situation now is that the baseline lending rate constitutes a floor for lending rates and the baseline deposit rate constitutes a ceiling for deposit rates. Thus, in principle, banks can set interest rates more freely than in the past although the minimum spread between lending and deposit rates is mandated by the government and cannot be reduced by competition. In practice, actual lending and deposit rates do still cluster around the baseline rates, suggesting that distorted incentives and noncompetitive behavior have dampened the effects of interest rate liberalization. For instance, as noted by Prasad (2009), state-owned banks (which still dominate the banking system) have a strong incentive to lend to state-owned enterprises as such loans are effectively backed by the government.

Figure 1 shows that the baseline deposit and lending rates have moved in lockstep, and with limited variation, over the last decade. Real interest rates, shown in Figure 2, are of course more volatile. It is interesting to note that the real deposit rate has been low or negative for much of the last decade, with the rate being especially low (large negative) in 2004 and 2007. In those years, the real lending rate was also quite low. Many authors have argued that the low deposit rates, which cannot be increased when banks compete for deposits due to the deposit rate ceiling, effectively impose a tax on households and is a sign of financial repression (see, e.g., Prasad, 2009; Lardy, 2012). The absence of other avenues, such as corporate bond markets, for less-risky saving

opportunities has kept Chinese households in the thrall of banks despite low returns on savings.

In market economies, policy interest rates typically affect the interbank lending market and, through that channel, eventually affect real economic activity. In China, the large banks have a broad base of retail deposits that tend to be weakly interest-elastic, making these banks less sensitive to changes in baseline rates. By contrast, the smaller banks such as joint stock commercial banks tend to rely more on the interbank markets for their short-term funding and liquidity needs. These smaller banks are therefore more sensitive to interest rate fluctuations but the five large state-owned banks, which still account for about two-thirds of assets and liabilities in China's banking system, are far less sensitive.

Given the weaknesses in the interest rate channel of monetary transmission, the PBC has tended to rely on quantity measures. These take the form of guidance on credit expansion as well as guidance on specific industries that banks are encouraged to offer more (or less) credit to, depending on broader macroeconomic circumstances as well as concerns about slowdowns (or overheating) in specific industries.

The PBC has another policy instrument that it has used extensively in recent years—reserve requirements as a percentage of deposits. By changing reserve requirements, the PBC can effectively drain or inject liquidity into the banking system. Banks can also place additional deposits at the PBC, constituting excess reserves. Excess reserves may be considered a liquidity buffer and may also reflect weak credit demand conditions.

During the last decade, reserve requirements were used as a monetary management tool and to sterilize the effects of foreign exchange market intervention. Consequently, the required reserve ratio rose sharply over the last decade (Figure 3). The cuts in this ratio during the worst of the global financial crisis and more recently in response to

the economic slowdown of 2012 indicate that this ratio is used as a policy tool to both tighten and ease monetary policy. The excess reserves ratio has gently trended downward over time but is somewhat volatile, indicating that banks use this as a liquidity management tool. The rates of remuneration on required and excess reserves were 1.62 percent and 0.72 percent, respectively, as of September 2012. The PBC has also used changes in these rates to signal its monetary policy intentions.

During the previous decade, the PBC reached the limit on sterilized intervention through the purchase of government bonds as the supply of those bonds was rather limited given the low level of explicit central government debt (less than 20 percent of GDP). This led the PBC to issue its own short-maturity bills and to use those as a sterilization tool, by varying both the quantity and rate of remuneration on those bills. The total amount of outstanding PBC bills peaked in 2008 at around $700 billion (the yield on those bonds at the time was about 4 percent). More recently, the outstanding stock of PBC bills has diminished substantially.

The picture that emerges from this discussion is of a heavily constrained monetary policy framework where the nominal exchange rate remains the key nominal anchor and a variety of mostly quantitative tools are used to implement monetary policy. This combination of policies has delivered relatively moderate inflation over the last decade. But it does have a price in terms of economic welfare and efficiency. An independent interest rate policy is a key tool for improving domestic macroeconomic management and promoting stable growth and low inflation. As the Chinese economy becomes more complex and market-oriented, it will become harder to manage through command and control methods as in the past. And, as it becomes more exposed to global influences through its rising trade and financial linkages to the world economy, it will also become more exposed to external shocks.

Monetary policy is typically the first line of defense against macroeconomic shocks, both internal and external. Hence, having an independent monetary policy is

important for overall macroeconomic stability. Monetary policy independence is, however, a mirage if the central bank is mandated to attain an exchange rate objective. A more flexible exchange rate is a prerequisite for an independent monetary policy.

Independent interest rate policy, in turn, is a key input into financial sector reforms. Chinese banks have still not developed risk-assessment expertise or been given the right incentives to lend on commercial principles. Using interest rate policy, rather than government directives, to guide credit expansion is essential to encourage banks to become more robust financial institutions. Trying to foster the commercial orientation of the banking sector in the absence of monetary policy tools to guide credit and money growth is one of the factors holding back banking reforms.

Goodfriend and Prasad (2007) argue that China should eventually adopt an explicit inflation objective — a long-run range for the inflation rate and an explicit acknowledgement that low inflation is the priority for monetary policy — as a new anchor for monetary policy. An inflation objective, coupled with exchange rate flexibility, would work best to stabilize domestic demand in response to internal and external macroeconomic shocks. Indeed, focusing on inflation stability is the best way for monetary policy to achieve broader objectives such as financial stability and high employment growth. Over time, the inflation objective would provide a basis for currency flexibility. Thus, exchange rate reform will be seen as a key component of an overall reform strategy that is in China's short- and long-term interests.

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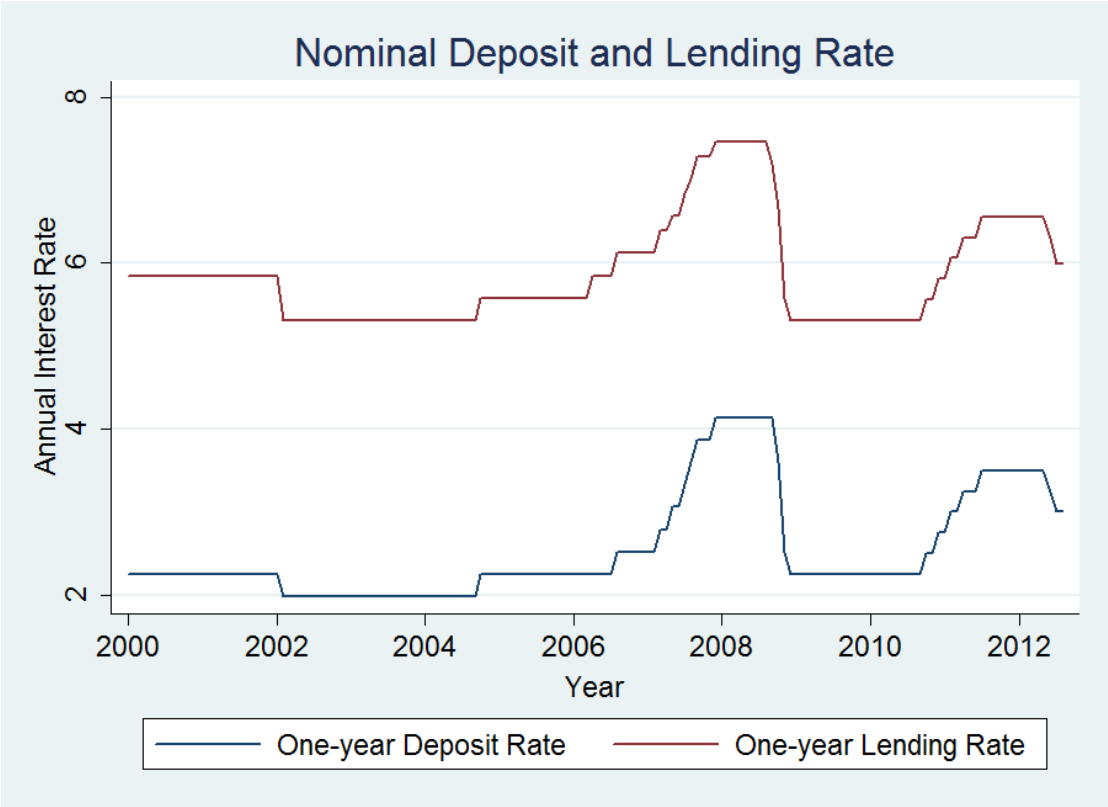
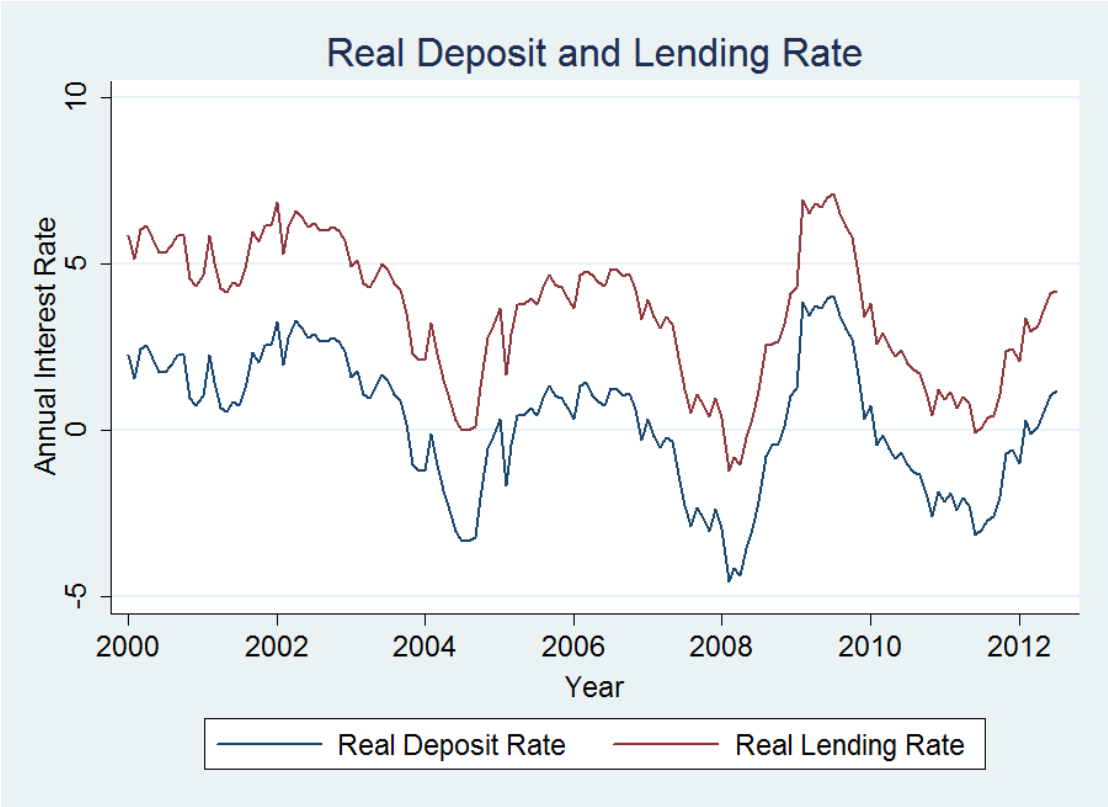
Figure 1. Benchmark Nominal Deposit and Lending Rates
(in percent)



Source: People's Bank of China.

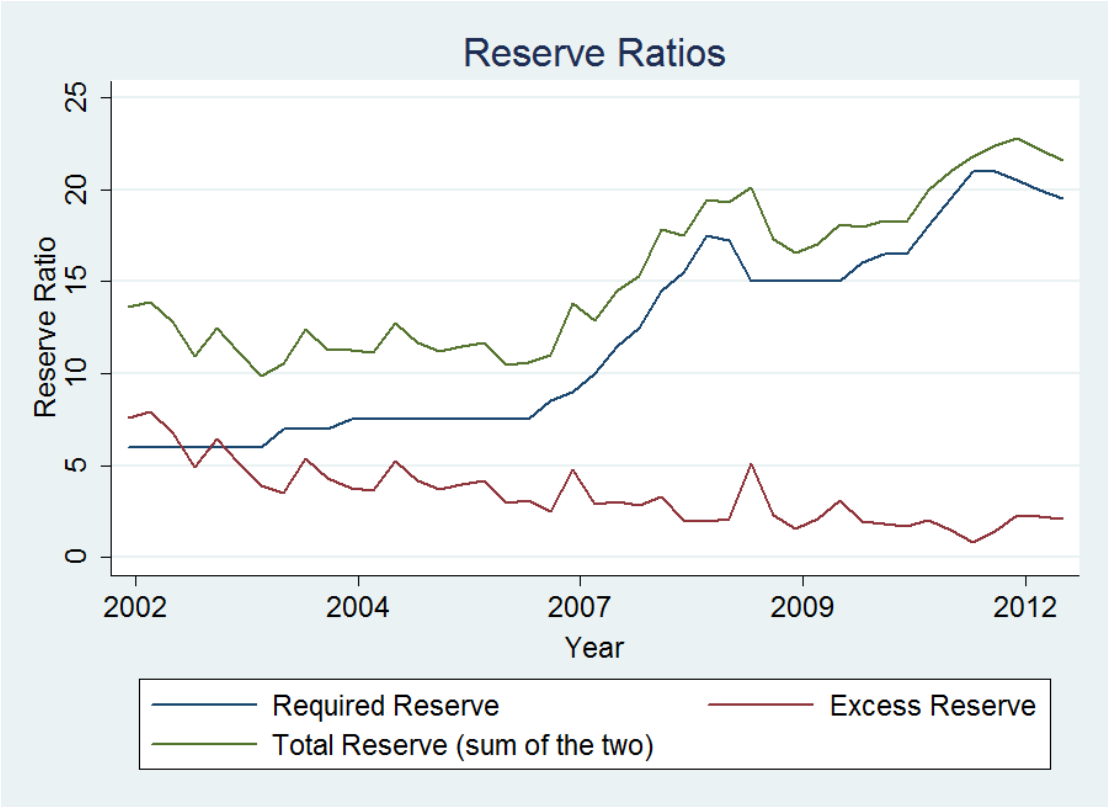
Figure 2 Real Deposit and Lending Rates
(in percent)



Source: People's Bank of China and National Bureau of Statistics.

Notes: The real interest rate is calculated by subtracting inflation from the nominal interest rate. The inflation rate is calculated as the percentage change of the CPI between the current month and twelve months prior.

Figure 3 Reserve Ratios
(in percent)



Source: People's Bank of China.

Notes: Reserves are expressed as a ratio to deposit liabilities of the banking system.