THEME

China | Monetary Policy: New Framework, New Stance

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Summary

- The People's Bank of China (PBoC) is establishing a "corridor system" as its new monetary policy framework. Under this system, the new policy target is the pledged 7-day interbank market rate while the rates of Standing Lending Facility (SLF) and excessive deposit reserves constitute the upper and lower bounds of the "corridor" respectively. The central bank will align the policy rate target with their desired levels via open market operation (OMO).

- Such a "corridor" system is also characterized by the plurality of policy tools. In practice, the central bank can conduct its monetary policy via (i) adjusting the size of OMO, (ii) moving the SLF and MLF rates, or (iii) deliberately selecting the tenor of the SLF and MLF offered to banks.

- Even with the new framework and policy tools in place, we don't expect the traditional tools of benchmark lending/deposit rates and Required Reserve Ratio (RRR) to be abandoned soon. They are likely to become the heavy weapons in the PBoC's arsenal, which are to be tapped when the authorities find it necessary to give a strong policy signal to the market.

- The stance of monetary policy this year is likely to be prudent in real sense. As the economy is subject to enormous uncertainties externally and domestically, the central bank has to walk a fine line between containing financial risks on the one hand, and averting a sharp growth deceleration on the other.

The "corridor system" of monetary policy takes shape

After wrapping up its decades-long process of interest rate liberalization in late 2015, the People's Bank of China (PBoC) sought to upgrade its monetary policy framework and establish a "corridor system" of interest rates. The reform of the monetary policy framework is justifiable given that the traditional policy tools, including both benchmark lending/deposits rates and required reserved ratio (RRR), are incompatible with the new environment of liberalized interest rates.

Under such a "corridor system", the movement of new policy rate target will be confined to a specific range, the "corridor". It is especially suitable for a financial system which is dominated by commercial banks while has a bond market not well-developed. (See our previous thematic report of China's monetary policy framework)

After careful testing and calibrating over the past couple of years, the PBoC's design of the new "corridor system" now emerges clearly. As the central bank revealed in its quarterly Monetary Policy Conduct Reports of Q3 and Q4 2016, the upper bound of the "corridor" are the interest rates of Standing Lending Facility (SLF) with the tenors of overnight, 7-day and 1-month, which are charged by the PBoC on short-term liquidity borrowing of qualified commercial banks. Through the SLF, the central bank can inject liquidity to the money market. In addition to the SLF, the central bank has other liquidity injection tools with longer tenors of 3-month, 6-month and 1-year, namely the Medium-term Lending Facility (MLF). At the lower bound of the "corridor" is the interest rate which the central bank pays on banks' excessive deposit reserves (currently at 0.72%). As such, banks can withdraw liquidity from the money market at the lower bound of the "corridor" when the money market interest rate falls below this level.

The new policy rate target is the pledged 7-day interbank market rate. It differs from the previously speculated candidates of 7-day repo or 3-month Shibor. It is because the pledged 7-day interbank market rate only applies to bank-to-bank transactions while the other two also apply to the transactions between banks and non-banking financial institutions in the money market. Given both the SLF and MLF are only eligible for banks; it is desirable to target a policy rate purely for bank-to-bank transactions.

As designed, the movement of the policy rate target should be effectively confined to the "corridor" because otherwise banks will directly go to the central bank for their liquidity borrowing (at the upper bound) or lending (at the lower bound). In the meantime, the central bank will frequently conduct open market operation (OMO) to align the policy rate target with policymakers' desired level. Currently the main policy tools of OMO include 7-day, 14-day and 28-day repo (and reverse repo), which function to withdraw (or inject) liquidity from (into) the money market. In 2016, the PBoC announced that the frequency of OMO was increased to be on a daily-basis from two days per week previously.

Table 1

Key interest rates of the "corridor system"

Pledged 7-day repo rate in the interbank market (DR007): new policy target	The 7-day repo rate for bank-to-bank transactions in the money market.
Rate on excessive reserve: likely to be the lower bound of the "corridor"	The PBoC also pays an interest rate of 0.72% on banks' excessive reserves in their central bank accounts.
SLF (Standing Lending Facility): the upper bound of the "corridor"	The tenors include overnight, 7-day and 1-month. SLF is mainly for the central bank's lending to policy banks and nationwide commercial banks. Policy and commercial banks need to use collateral to get SLF.
MLF (Medium-term Lending Facility)	The tenors include 3-month, 6-month and 12-month. MLF is for the central bank's lending to commercial banks and policy banks. Collateral is required for MLF applications.
Central Bank Repo and Reverse Repo: policy tools of Open Market Operation (OMO)	The tenors include 7, 14 and 28 days. Repo is the operations that the central bank withdraws liquidity from the market; while reverse-repo is the opposite operation of repo

Source: BBVA Research

A system with multiple policy tools

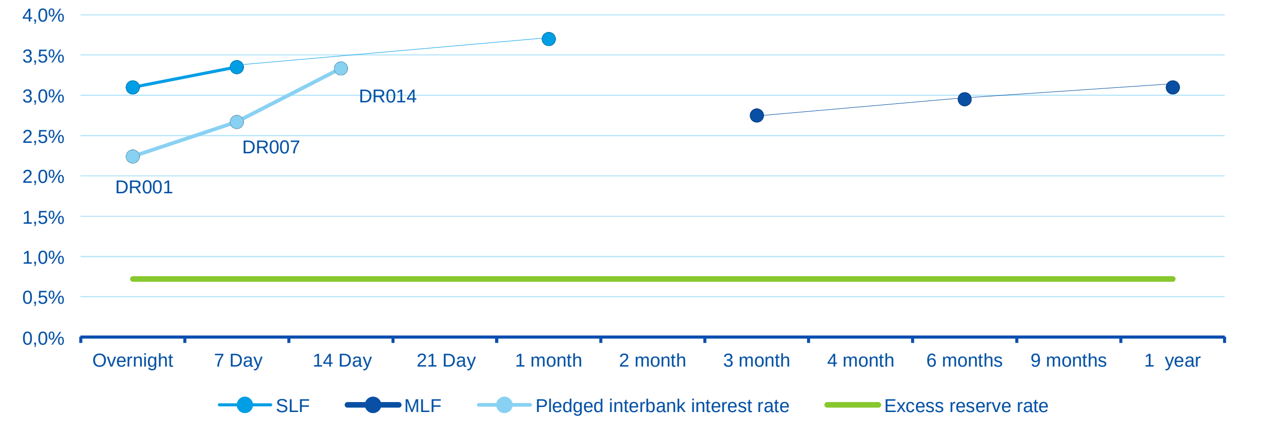
Such a "corridor" system is characterized by its plurality of policy tools. In particular, a number of SLF and MLF rates at the upper bound of the "corridor" almost form a yield curve while the policy rate target has only one tenor. (Chart 1) The "corridor" system is still in its fledgling stage. And China's financial markets are far from mature. All these could hamper the transmission of monetary policy from the policy rate target to other important interest rates in the money market. More policy tools can give the central banks more levees to directly influence other important interest rates.

In the policy conduct under the "corridor" system, the PBoC can choose to adjust the amount of liquidity injection via OMO or move the SLF and MLF rates. For example, the central bank, in early February, hiked the overnight, 7-day and 1-month SLF rates by 35, 10 and 10 basis points, respectively. Moreover, the central bank can deliberately select the tenor of the SLF and MLF to indicate their policy stance. In this respect, the PBoC have frequently used 6-month and 1-year MLF to inject liquidity into the money market since August 2016, attempting to raise the financing cost of small banks and thereby discourage them from building up leverage.

The "corridor system" also enables the central bank to flexibly pursue other monetary policy objectives than economic growth and price stability. According to other emerging markets' experience, the "corridor system" can help to manage capital flow volatility, in particular during the episode of capital inflows. For example, the central bank can asymmetrically widen the "corridor" to the downside in face of rising pressure of capital inflows. As such, the policy target can quickly decline to discourage further capital inflows. On the other hand, the "corridor system" has some disadvantages in market communication, due in part to its multiplicity of tools and policy objectives. As such, the launch of the "corridor system" requires the authorities to improve their capacity and skills in market communication.

Chart 1

The SLF and MLF rates have formed a yield curve to cap the policy target (as of February 21st)



Source: CEIC and BBVA Research

Traditional monetary policy tools won't be abandoned soon

Theoretically, two important traditional policy tools---the benchmark interest rate and deposit required reserves ratio (RRR) will become redundant after the "corridor system" is established. However, we don't believe that the authorities will shelve them forever. Indeed, there are currently considerable amounts of financial products which are linked to benchmark lending and deposits rates, in particular mortgages loans and loans for large corporates. In the meanwhile, the RRR of large banks are still as high as 16.5% of their deposit balance. The adjustment of the RRR can still unleash or lock up huge amount of liquidity.

All in all, these traditional tools, in particular the RRR, will become the heavy weapons in the PBoC's arsenal. As explained in the previous section, the "corridor system" could send vague policy signals to the market, in particular in times of market stress. At such junctures, the authorities can resort to the traditional tools so as to give a clear and strong policy signal to the market.

Monetary policy will remain "prudent" in 2017

Over the past few years the PBoC had formed a habit of defining their monetary policy stance as "prudent" while keeping deploying all forms of easing measures to stem the growth slowdown. However, such a case is likely to be changed this year as a confluence of factors prevent the central bank from loosening further. In particular, some high-rank officials of the central bank have recently identified some obstacles to policy easing, including: (i) asset bubbles, especially in the housing market; (ii) continuing depreciation expectation of the RMB; (iii) rising inflation expectations, especially, the soaring PPI; and (iv) the unbalanced economic structure. Moreover, according the recent statements of the authorities, they seem ready to relay the baton of growth-boosting to fiscal policy while maintaining a neutral monetary policy with a little tightening bias.

However, we also deem that the room for further tightening is very limited for this year's monetary policy. Although growth momentum has visibly picked up in China, its sustainability remains a question. Moreover, the authorities are reported to craft out ambitious plans to curb shadow banking activities so as to contain rising financial risks. Given the tremendous size of the shadow banking sector, new regulations could exert significantly tightening effects on the banking sector and the entire economy. Under such a circumstance, the authorities might be forced to reverse its monetary policy stance again and inject a large amount of liquidity into the banking sector (likely via RRR cuts) to avert a systemic debacle and a growth hard-landing.

On balance, the stance of monetary policy this year is likely to be prudent in real sense. As the economy is still subject to enormous uncertainties externally and domestically, the authorities, on the front of monetary policy, have to walk a fine line between containing financial risks on the one hand, and averting a sharp growth deceleration on the other.

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