CFDS
At Henan University

# MP Report

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A guide to monetary policy in the PRC

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## Moderate expansion to compensate stricter regulation

*In our MP Reports, we aim to provide a concise and timely analysis of Chinese monetary policy that makes it accessible for an international audience. The reports are published at least at a quarterly basis, more often if surprising policy changes warrant further information.*

### The current economic background

In their first term in office the PBC's new governor Yi Gang and new party secretary Guo Shuqing, who have been appointed at the 13th National People's Congress this March, are facing interesting times to say the least.

With the "new normal" it is still hard to assess the location of the Chinese economy in the business cycle. Growth is substantially lower than it has been in the pre-crisis period (and immediately after), and at this point it is hard to judge, how much of this can be attributed to the business cycle and how much to the inevitable slowdown of growth with China approaching the natural end of its miraculous catching up process. In consequence, monetary policy faces almost unprecedented uncertainty.

The Chinese government has identified the risk associated with the cumulation of debt and the extremely high leverage, especially in state-owned enterprises, as one of the main tasks for the coming years. The PBC will play a major role in accompanying the banks in the process of taking over risks from the private sector without creating an overly fragile financial sector in the process.

At the same time, China is facing the prospect of a trade war with the world's largest economy, the US. It seems that the US perceives the "Made in China 2025" strategy and the "Belt and Road Initiative" as challenging to their (technological) leadership. Therefore, the US have taken a more aggressive stance against Chinese ambitions. Officially justified with national security reasons and as retaliation against Chinese protectionism, the US has launched a series of tariffs mostly targeting the Chinese economy. The PBC will oversee promoting the internationalization of the RMB during those turbulent times.

### Monetary policy in early 2018

Over the past quarter the PBC focused on financial market regulation to reduce leverage in the economy. Most recently, this has been accompanied by a moderate


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monetary expansion to ease the consequences of regulation on money supply. Table 1 summarizes the key policy actions of the PBC in the first months of 2018.

### *Lowering the required reserve ratio*

In a decision from April 19th the PBC announced that the required deposit reserve ratio will be reduced by one percentage point to 14% to 16% (depending on the type of institution), effective from 25 April 2018. This reduction will free around 1.3 trillion RMB.

*Table 1: Policy actions from January to April 2018*

| | |
|---|---|
| Jan 5th | Improved policies for cross-border RMB Business to facilitate trade and investment |
| Jan 5th | Regulation of bond market participant / corporate governance in the financial sector |
| Jan 26th | Notification on the implementation of the upcoming debt-to-equity swap |
| Feb 27th | Introduction of loss absorbing capacity bonds |
| Mar 21st | Regulation on e-payment systems provided by foreign companies |
| Apr 19th | Reduction in the required reserve ratio to compensate expiring MLF |

*Note: The PBC has issues additional policies mostly dealing with quality of life changes, simplifying procedures required for personal and business accounts. Since they play a minor role for the monetary policy stance and financial stability at best, they are not covered in the report.*

This mostly serves to accommodate the expiration of RMB 900 billion of midterm lending facility (MLF) loans around the same time, resulting in a very moderate net expansion of 400 billion. With the reduction in uncertainty that is achieved by allowing banks to act with their own funds rather than having to rely on PBC loans, this should widen the maneuvering range of the banks. The reduction of required deposit reserve ratio increases the profit margins of commercial banks, as it reduces the marginal operating cost.

With this moderate expansion, the PBC still mostly sticks to its official neutral monetary strategy, especially since new financial regulation to decrease leverage might have a contractionary impact on money supply. In particular, the Chinese central government, is aiming to eradicate the large shadow banking sector by 2020. That is, liabilities that are currently off-balance-sheet, must be gradually shifted to the balance sheets by that deadline. The lower reserve ratio offers Chinese commercial banks the flexibility that is necessary to adjust their asset structure accordingly.

The high regard for the stability of the banking sector in the conduct of monetary policy reflects the increased coordination between monetary authority and banking regulators. With the appointment of the Head of the China Banking Regulatory Commission, Guo Shuqing, this will probably remain a corner piece of Chinese macroprudential practice in the future.

It is noteworthy, however, that this clearly signals that the PBC is no longer following the lead of the Federal reserve as it did until last year, when the PBC still mirrored the Fed's interest rate increase. Given the prospect of a trade war and a weak US dollar that makes capital flight unattractive, this does not come as a surprise.

### *RMB internationalization*

In January and March, the PBC issues two new pieces of regulation to foster the internationalization of the RMB (and the Chinese financial market in general), thereby backing the governments Belt and Road Initiative.

Since January, all cross-border trade allowed by the law to be settled with foreign exchange can also be settled with RMB by enterprises. The provision of cross-border payment services and RMB investments by overseas investors have been greatly simplified. While possibly less relevant for monetary conditions in China but providing an interesting signal of the recent Chinese growth policy, the policy also encourages overseas investors to participate in (RMB based) carbon emission trading in China.

On March 31st, the PBC partially opened the Chinese market for electronic payment services. Through branches on the territory of the PBC foreign institutions can now provide electronic payment services within China. It is interesting to note that this is the first policy issued by the new leadership of the PBC, signaling (a) the commitment to the (gradual) opening of the Chinese financial market and (b) recognition of the importance of electronic payment for the Chinese monetary system.

### *Reducing corporate leverage and bank risk taking*

The PBC is continuing its efforts to reduce the economic leverage ratio and strengthen financial regulation to reduce financial risk that were its focus in 2017.

On January 5th, PBC, China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC) and China Insurance Regulatory Commission (CIRC) jointly issued a statement on bond trading. While mostly enforcing existing regulation, and emphasizing internal control mechanisms, the policy makers urge bond market participants to reduce their leverage ratios and strengthen their risk management.

On January 26th, the PBC, again jointly with several other agencies and the ministry of finance, announced guidelines for banks to tap private funding that will ultimately be used to support debt-to-equity swaps for over-leveraged enterprises. Under the new guidelines, investors are encouraged to set up private equity funds to raise and invest money to deal with the corporate debt problem.

The latter policy tackles the widely acknowledged over indebtedness of the private (non-financial) sector. By embedding it into the wider framework of bank regulation (such as the former mentioned policy), the PBC aims to assure that moving risks from the non-financial to the financial sector does not create undue fragility in the banking sector.

Most recently, to increase the loss absorbing capacity of banks in accordance with the Basel accord, since February 27th banks can issue loss absorbing capacity bonds that include a debt-to-equity swap clause, that allows those bonds to be swapped for equity (conditional on PBC approval).

## Current Monetary Policy Stance

Despite recent changes, Chinese monetary policy remains at its mostly neutral stance. The mild expansion mostly compensates tightening from the regulatory side. Both deposit and loan benchmark rate remain unchanged on their levels from October 2015 at 0.35 and 4.35 percentage points respectively.[1]

However, in particular real estate loans usually require substantially higher loan rates, indicating some success in curbing the exuberance in the housing market. The PBC responded much less elastic than before to the US Federal Funds target rate with its own reverse repo rate, only increasing the rate from 2.50 by 5 basis points to 2.55 following the 25 basis point hike of the Fed,

[11] Since the binding range around the target rate has been abolished, this is however less important than it has been in the past.

thereby indicating some decoupling from the US policy.

The Central Committee of the Communist Party of China, China's core policy making body, confirmed this neutral path with moderate expansion at its last meeting held on April 23rd. In the spirit of the meeting, China will maintain its expansionary fiscal policy and neutral monetary policy this year. However, the CCCP shifts the focus from the "control of money supply" to accommodating adjustments of the economic structure and expanding domestic demand, thereby indicating the moderate expansionist policy we are currently observing.

## Financial and monetary statistics[2]

### *Growth of monetary aggregates slowed down*

The development of monetary aggregates in the first quarter of 2018 was mostly stable. According to the PBC, outstanding M2 stood at RMB 173.99 trillion at the end of March, which is an increase of 8.2 percent since March 2017; M1 is 52.35 trillion, increasing 6 percent year on year. M0 currently measures 7.27 trillion, showing an increase of 6 percent year on year. On a net basis, during the first quarter, the PBC injected RMB 204.7 billion of cash into the system, slightly less than the 234.2 billion in the preceding quarter. The fluctuation in the year over year growth rates of M0 (see Figure 1) is exclusively driven by seasonal effects due to the different date of Chinese New Year, which fell on January 2017 but February 2018.

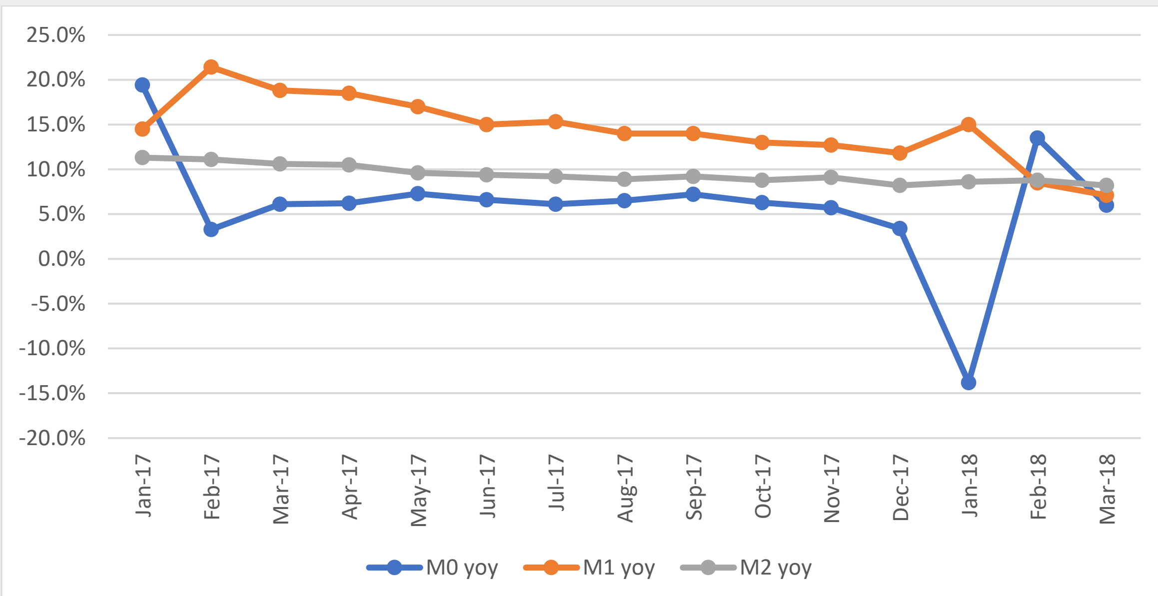


*Figure 1: Year over year growth of money supply*

### *RMB and foreign currency deposits in financial institutions maintained stable growth*

End of March, outstanding RMB and FX deposits totaled RMB 174.44 trillion, an increase of 8.4% year on year. For the first time in the past year, the growth of RMB deposits was (marginally) larger

[2] The statistics reported here are based on information from the PBC reports and the PBC website.

than the growth in deposits denominated in foreign currency.

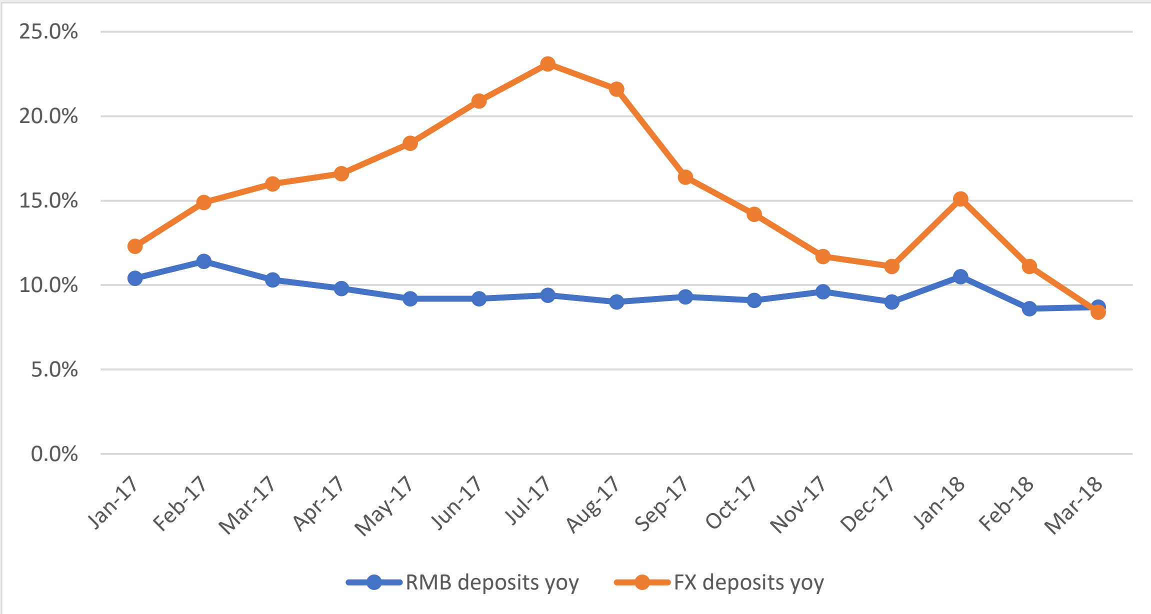


*Figure 2: Year over year deposit growth*

### *Lending by financial institutions grows rapidly*

Outstanding loans in domestic and foreign currencies of all financial institutions totaled RMB 130.45 trillion at the end of March, increasing by 11.9 percent year on year. Outstanding RMB loans grew 12.8% year on year to RMB 124.98 trillion. RMB loans and FX loans increased to RMB 4.86 trillion and USD 32.4 billion respectively.

### *Interbank market very active*

In March, the total volume of deals in the interbank market was 272.4 trillion, representing a 32.3 percent year on year, indicating quickly increasing financial integration in China.

In March, the weighted average interest rate of interbank lending was 2.74%, a 0.01% increase from February; the weighted average interest rate of pledged repos was 2.9, an increase of 0.06%, mostly reflecting the change in the PBC's reverse repo rate.

### *China's foreign exchange reserves stay stable while RMB appreciates*

China's foreign exchange reserves stood at USD 3.14 trillion at the end of March, and the USD/CNY central parity was set at 6.2881. This is an increase of 3.9% since the end last year. The biggest range of appreciation happened at the end of January, with the exchange rate being mostly stable since.

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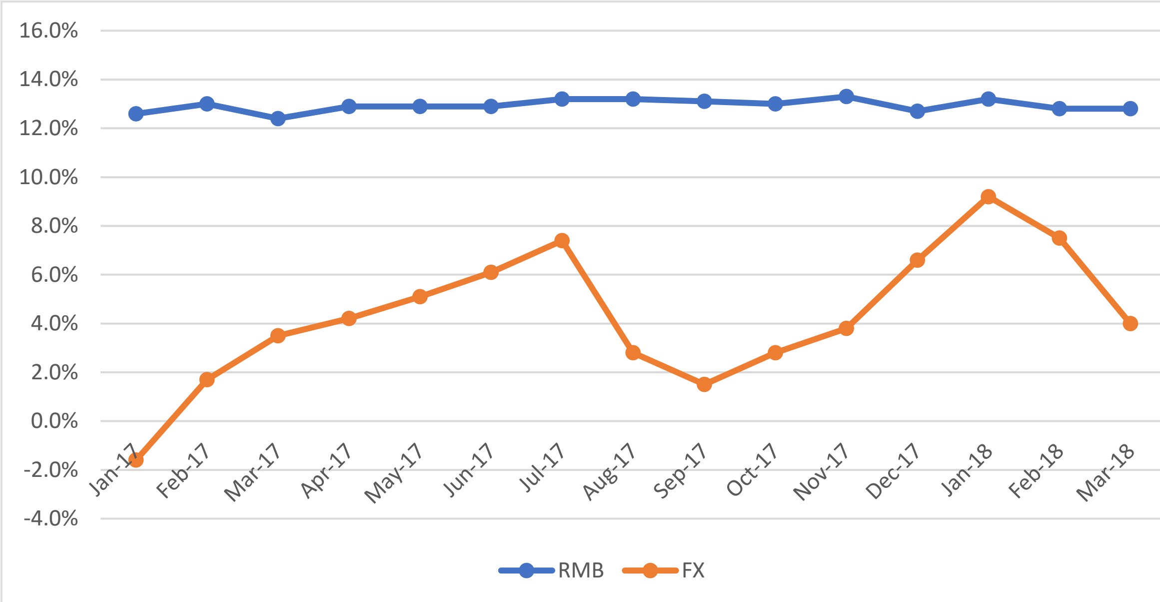


*Figure 3: Year over year loan growth*