CFDS AT HENAN UNIVERSITY

MP Report 2

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A guide to monetary policy in the PRC

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Monetary policy mostly neutral with small expansionary impulses

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 the second quarter of 2018, the PBoC faced many international and domestic challenges.

Since early 2018, the PBoC has initialized a series of policies to curb risk in national financial markets such as cracking down on shadow bank financing and tightening the supervision of asset management. At the same time, the PBoC cut the required reserve ratio (RRR) to mitigate the impact of increasing regulation and help commercial banks move off-balance-sheet loans back to their balance-sheet. Yet, industrial companies are clearly feeling the consequences of the deleveraging policy of the past few quarters. It has become increasingly difficult to raise new funds and repay existing debt, leading to a record number of bond defaults this year.

In consequence, the PBoC is gradually shifting its focus from macroprudential policies to stabilization. Over the past month, the use of the term "deleverage" in official documents issued by the PBoC has been gradually declining.

In the second quarter, the PBoC's key challenges were increasing economic uncertainty in China and escalating trade tensions with the United States continued. On July 6th, the tariffs imposed by the Trump administration on Chinese exports to the US covering goods in a total value of 34 billion RMB became effective. The Chinese government retaliated immediately with equally sized tariffs on U.S. exports. Due to the pressure on Chinese exports, the PBoC refrained from leaning against the depreciation of the RMB caused by the trade conflict to a lesser extent than observed in the past when the RMB came under pressure. Yet, to avoid capital flight the PBoC still took action using its foreign reserve to mitigate the impact of the current economic climate. In total, it allowed the RMB to depreciate by roughly 8 percent since March 2018. Foreign reserve data for August (where the RMB faced the most pressure) is not yet available. Since the beginning of the trade conflicts reserves show a moderate

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decline, indicating that – at very least – the PBoC is not actively pursuing a strategy of devaluation.

Monetary policy in the second quarter 2018

Over the past quarter the PBoC continued its efforts to stabilize the financial system and tried to mitigate the impact of the trade conflict with the U.S on the Chinese economy. On June 28th, the People's Bank of China released its 2018 Q2 statement on the monetary policy committee (MPC) meeting. Table 1 summarizes the key policy actions of the PBoC in the recent months of 2018.

Table 1: Policy actions from April to August 2018

Apr 27th	New guidelines on tightening regulation on non-financial enterprises' investment in financial institutions
Apr 27th	New guidelines on standardizing the asset management businesses of financial institutions
May 5th	Launch of phase 2 of the RMB cross-border interbank payment system
Jun 1st	New regulation on money market fund business
Jun 1st	Expanded range of qualified collaterals for the PBoC's Medium-Term Lending Facility
Jun 24th	Special requirement reserve ratio (RRR) reduced to support debt-equity swap and small enterprises
Aug 3rd	Raising the risk reserve requirement on FX forward sales to 20 percent

Increasing aggregate liquidity

On June 24th, the PBoC reduced required reserve ratio for the third time within a year. From July 5th, 2018, the latest step will lower the RRR for commercial banks by another 0.5 percentage points. This will release around 700 billion RMB, bringing the total liquidity released through RRR cuts during the first half year of 2018 to more than 2 trillion RMB.

The RRR reduction mostly serves to support the access of small enterprises to the credit market and to facilitate debt equity swap programs. However, it is also coordinated with the State Council to accommodate the refinancing of state owned enterprises who issued a range of securities that are about to reach maturity.

On June 1st, PBoC decided to consider small and medium sized enterprises, green, and agricultural bonds that are rated AA and corporate debenture bonds that are rated AA+ or AA as qualified collateral for the medium-term lending facility (MLF), thereby easing the access of banks to this additional tool for liquidity provision.

The previous expansionary action of the PBoC in the past quarters mostly compensated contractionary impulses created by its macroprudential policy (such as its efforts to promote deleveraging and reduce shadow banking). While those efforts are still ongoing, there is no immediate contractionary counterpart (at least not of similar magnitude) for the current reduction in the RRR and the eased access to liquidity. Together with the reduced emphasis on deleveraging, this might imply that the PBoC is considering to slowly move to a more expansionary policy stance (matching the current business climate that is deteriorated by the trade conflict). Further reductions in the RRR are well possible within this year.

Table 2: Recent changes of the required reserve ratio

Date	Large-scale Financial Institutions			Small-medium-scale Financial Institutions		
	Before	After	Adjustment	Before	After	Adjustment
2015.02.05	20.00%	19.50%	-0.50%	18.00%	17.50%	-0.50%
2015.04.20	19.50%	18.50%	-1.00%	17.50%	16.50%	-1.00%
2015.06.28	RRR cut by 0.50% for selected types of financial institutions					
2015.09.06	18.50%	18.00%	-0.50%	16.50%	16.00%	-0.50%
2015.10.24	18.00%	17.50%	-0.50%	16.00%	15.50%	-0.50%
2016.03.01	17.50%	17.00%	-0.50%	15.50%	15.00%	-0.50%
2018.01.25	RRR cut by 1.50% for selected types of financial institutions					
2018.04.25	17.00%	16.00%	-1.00%	15.00%	14.00%	-1.00%
2018.06.24	16.00%	15.50%	-0.50%	14.00%	13.50%	-0.50%

Financial Regulation

In particular at the beginning of the quarter, the PBoC was still strongly pushing its macroprudential policies. On April 27th, two new guidelines to reduce risk in the financial sector and curb shadow banking have been published.

First, under the approval of the State Council, the PBC released *the guidelines on standardizing asset management businesses of financial institutions.* In the guidelines, the PBoC forbids implicit repayment guarantees of asset management products, increase transparency by enforcing standardized management practices and limiting maximum leverage ratios. Finally, and in line with further current and previous policies to discourage shadow banking and limit financial operations to financial institutions, non-financial institutions are no longer allowed to issue or sell asset management products unless stipulated by the state.

Second, the PBoC jointly with the China Banking and Insurance Regulatory Commission (CBIRC), and the China Securities Regulatory Commission (CSRC) issued *guidelines on tightening regulation on non-financial Enterprises' Investment in financial institutions.* The main objective of those guidelines is to prevent shadow banks from expanding and thereby promote deleveraging in the Chinese economy.

August 3rd, the PBoC decided to raise the risk reserve requirement on FX forward sales to 20 percent. While, FX forward sales can serve as an instrument to hedge exchange rate risk, they can also serve as highly risky investments. Additionally, the PBoC is concerned about the potential implications of speculation in forward sales on the spot market.

RMB internationalization

On May 5th, the PBC fully launched phase 2 of the RMB cross-border interbank payment system (CPIS). CIPS provides fund clearing and settlement services to domestic and foreign participants in cross-border RMB transactions.

Current Monetary Policy Stance

Despite recent changes, Chinese monetary policy continues to remain its mostly neutral stance but with a slightly more expansionary flavor. Both deposit and loan benchmark rate remain unchanged on their levels from October 2015 at 0.35 and 4.35 percentage points respectively. However, market interest rates keep increase, as the deleveraging continues, and credit default occurs.

Summary Financial Indicators

Growth of monetary aggregates slowed down

The development of monetary aggregates in the second quarter of 2018 was mostly stable. According to the PBoC, the growth of outstanding broad money (M2) has slightly decreased to 8% year-over-year to RMB 177.02 trillion (compared to 8.3% in the last quarter); the narrow money aggregate (M1) grew by 6.6% year-over-year to RMB 54.39 trillion, which indicates a slight acceleration in M1 growth. Both M1 and M2 have grown substantially faster than the monetary base M0 which increased by 3.9 % (year-over-year) to roughly RMB 6.96 trillion. Given the current stage of the development of the Chinese financial markets, this increase of the money multiplier is not unusual and can be interpreted as sign of the ongoing financial deepening.

RMB and foreign currency deposits in financial institutions growth rate decelerate

By the end of June, outstanding RMB and FX deposits totaled RMB 178.34 trillion, an increase of 8.1% year on year. This growth is entirely driven by the growth of RMB deposits. FX deposits have (slightly) decreased for the first time in the past year. This represents a massive decline in the growth rate of foreign assets since last year. One year ago at this time, the year-over-year growth rate of foreign deposits was still at 25%, exceeding the growth of RMB deposits by far. This decline might reflect the reduced need for foreign currency in times when trade is likely to decrease due to the trade conflict instigated by the Trump administration.

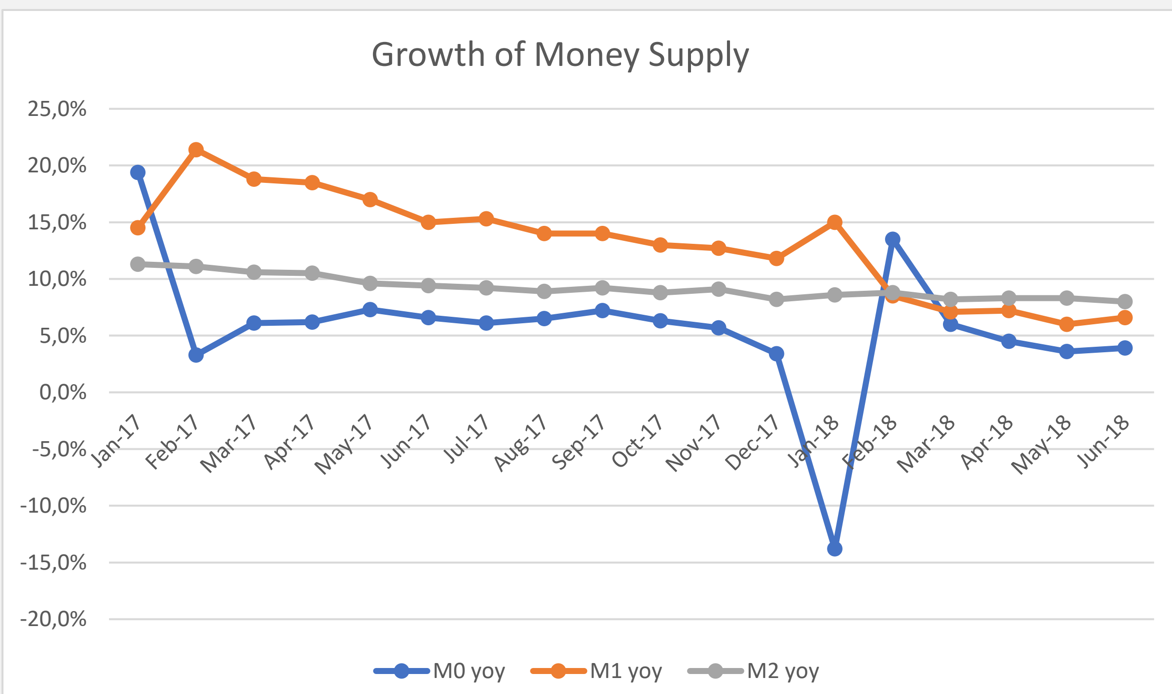

Figure 1: Growth of Money Supply

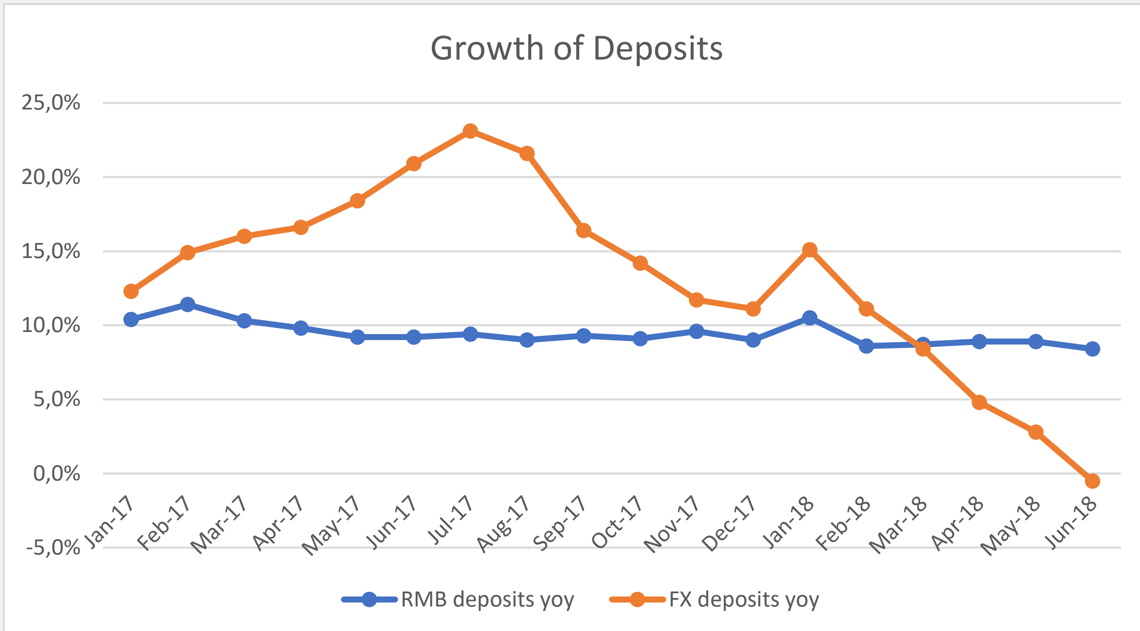

Figure 2: Growth of Deposits

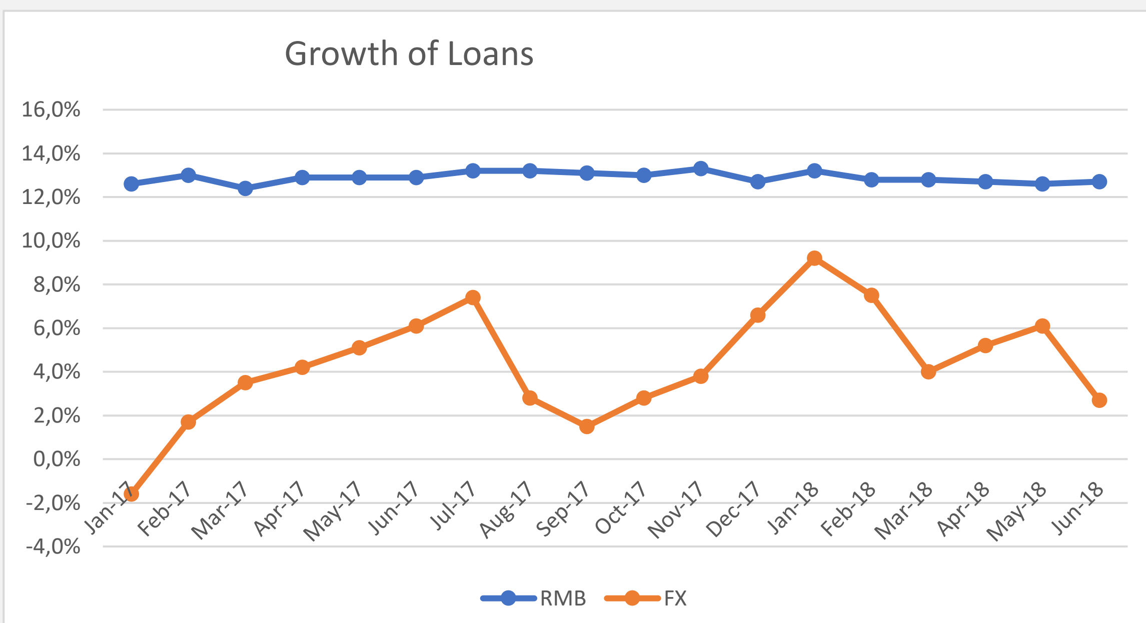

Figure 3: Growth of Loans

Lending by financial institutions grew rapidly

Outstanding loans in domestic and foreign currencies of all financial institutions totaled RMB 134.81 trillion at the end of June, increasing by 12.1% percent year on year. Outstanding RMB loans grew by 12.7% year on year to RMB 129.15 trillion. RMB loans and FX loans increased to RMB 9.03 trillion and USD 17 billion respectively.

Inter-bank market more active

In March, the total volume of deals in the interbank market was 445.32 trillion, implying a 24 percent year on year growth, indicating quickly increasing financial integration in China.

In June, the weighted average interest rate of interbank lending was 2.73%; the weighted average interest rate of repos was 2.89%.

China's foreign exchange reserves stay stable and depreciation of the RMB

China's foreign exchange reserves stood at USD 3.11 trillion at the end of June, and the USD/CNY central parity was set at 6.6166. This is an increase of 3% since the last quarter. The biggest range of depreciation happened at the end June.

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