CFDS At Henan University

MP Report 5

A guide to monetary policy in the PRC

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Monetary Policy Mostly Neutral Despite New Challenges

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 current economic background

From the second quarter 2018 to the second quarter 2019, China's economy grew 6.2%, compared to 6.4% year-on-year growth in the first quarter of 2019. The second quarter economic growth rate was the country's slowest pace since the first quarter of 1992 when quarterly GDP measurement started. The Chinese economy faces a complex situation with increasing external uncertainties, particularly, China's ongoing trade dispute with the U.S. was main factor of downward pressures. So far, the People´s Bank of China (PBoC) has only carefully supported the economy through mildly expansionary policy. Assuming that the global economic climate does not improve, this might change over the course of the current year.

Monetary policy in the second quarter 2019: Overview

Policy Dashboard

On June 25, the Monetary Policy Committee of PBoC held the second quarterly meeting in 2019 (its 85th meeting) in Beijing. Table 1 summarizes the key policy actions of the PBoC during the recent months.

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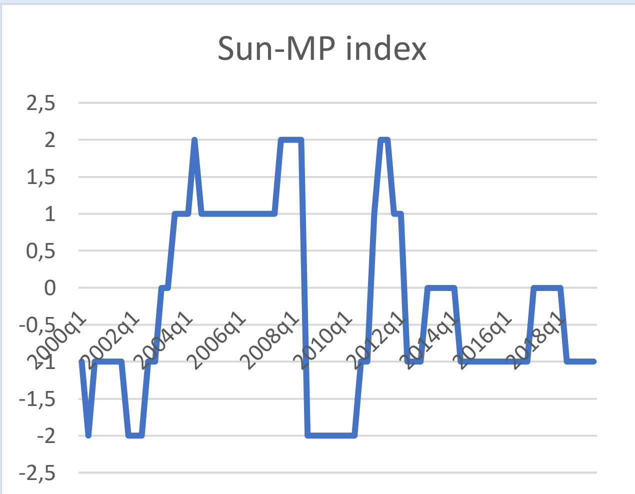
Table 1: Policy Dashboard

May 6th	Require reserve ratio (RRR) reduction for county-level rural commercial banks to match the RRR for rural credit cooperatives
May 15th	PBoC and China Banking and Insurance Regulatory Commission (CBIRC) jointly conduct a pilot study for exchange-traded funds (ETF), to develop index funds in the inter-bank market and stock exchange market
May 27th	PBoC and the State Administration of Foreign Exchange (SAFE) jointly issued new regulation on cross-border capital management for the securities
Jun 14th	PBoC issued the "Notice on offering liquidity support to small and medium-sized banks (No.159 [2019] of the PBoC)
Aug 17th	PBoC announces the reform of the LPR formation mechanism (LPR is an interest rate that commercial banks charge their best clients)
Aug 25th	PBoC releases the announcement on a mechanism to mitigate the impact of LPR reforms on real estate prices

Current monetary policy stance

Despite the difficult global economic environment, the PBoC only initiated mildly expansionary policies, mostly targeted at rural areas and small banks. Given their minor share in the Chinese market, this should not play a major role for the macroeconomy. In total, it thus seems that the PBoC is so far sticking to its long standing strategy of conducting a mildly expansionary and mostly neutral policy. This is in line with both the PBoC's official communication and the comprehensive Sun-MP index, summarizing monetary policy in China, that has been fluctuating between 0 (neutral) and -1 (mildly expansionary) since 2012 (see Figure 1).

Figure 1: SUN-MP-Index



Note: The index is normalized to mimic the direction of interest rate changes as traditional summary indicator for monetary policy, i.e. high values are contractionary: 2 highly contractionary, 0 neutral, 2 highly expansionary

However, it seems that the forceful increase of macroprudential regulation is nearing its end.

China's politburo and state council have replaced the term "deleveraging" with "structural deleveraging" in their official statement, which could suggest a less harsh regulation on debt is planned for the future. Looking at Figure 2 (panel b) that presents the macroprudential indices newly included in our reports, shows that supervision has been loosened (very mildly) for the first time in more than a year. (It should, however, be kept in mind, that the four macroprudential indices are plotting change rather than levels. What looks like a sharp decline, is indeed reflecting

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	Part of banks RRR cut by 0.50%					
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	Part of banks RRR cut by 0.50-1.50%					
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%
2018.10.07	15.50%	14.50%	-1.00%	13.50%	12.50%	-1.00%
2019.01.07	14.50%	13.5%	-1.00%	12.50%	11.50%	-1.00%
2019.06.06	1000 county-level rural commercial banks RRR cut by 0.50-1.50%					

regulation to plateau on its newly increased level.)

In order to facilitate lending to private enterprises the PBoC has cut the required reserve ratio (RRR) four times in 2018 in order to lower financing costs. As a result, the liquidity remained generally adequate although the PBoC made no open market operations since mid-October and financial regulation has substantially tightened over the year in other respects.

Most major changes in policy over the past few months are not related to traditional monetary policy, but mainly pursue the long run strategy of RMB internationalization and financial development.

Overall, at present, the liquidity of the banking system is reasonably adequate; money, credit and AFRE are growing at appropriate paces; and market interest rates remain stable. The main focus of policy has been RMB internationalization and rural development.

Recent policy decisions in detail

Monetary Policy to Maintain aggregate liquidity

The LPR, originally introduced by the PBoC in October 2013, is an interest rate that commercial banks charge their best clients and was intended to better reflect market demand for funds than the benchmark the PBoC sets. However, because LPR still linked with the benchmark lending rate of the PBoC, the LPR generally did not fully reflect the market dynamics. Under the new regulation announced on August 17th, the new LPR will be linked to rates of medium-term lending facility (MLF), which is determined by the broader financial system's demand for central bank liquidity, that now covers 18 banks (compared to previously 10), including two foreign institutions (Citibank and Standard Chartered Bank).

Figure 2: Macroprudential Indices

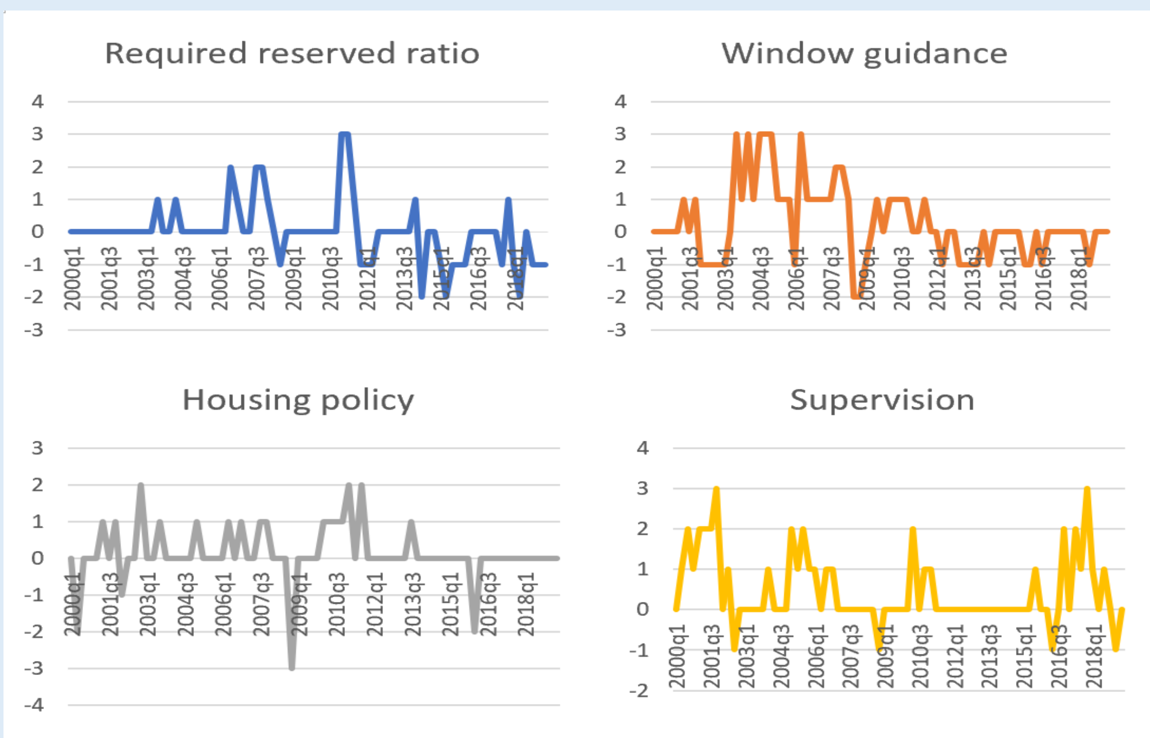
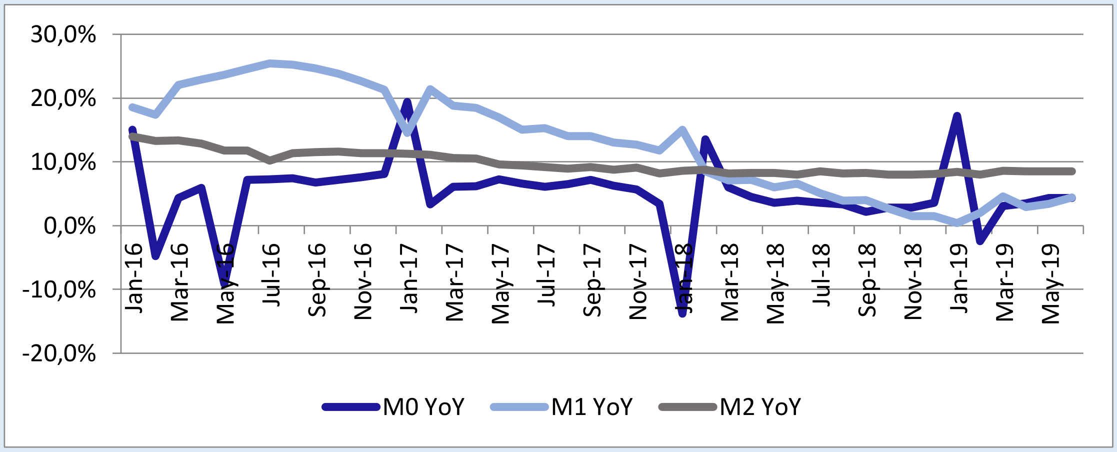
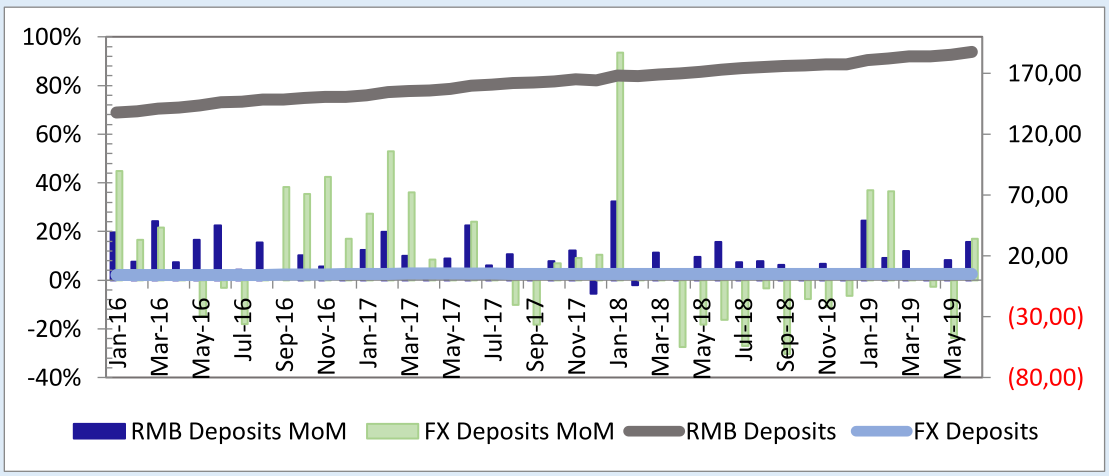


Figure 3: Growth of Money Supply



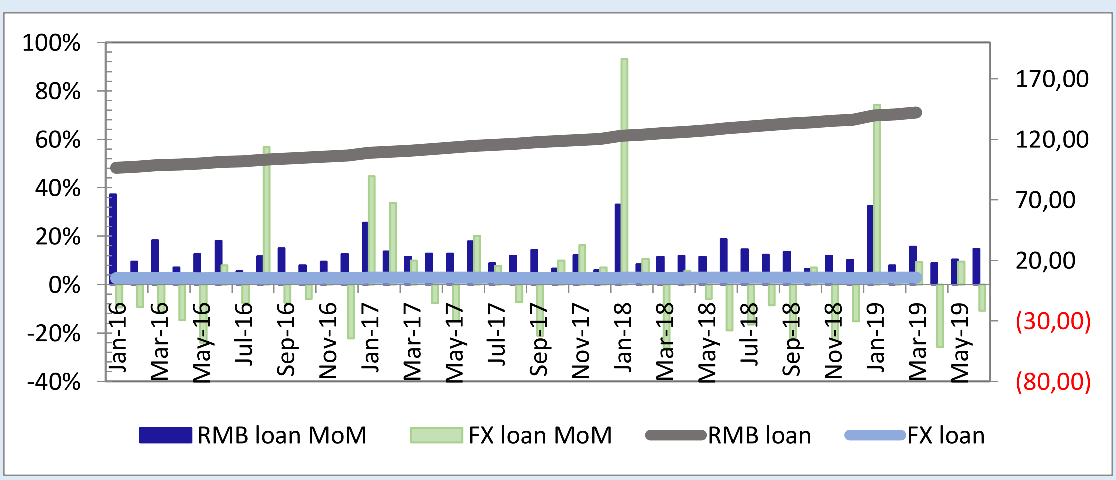
Note: YoY denotes monthly growth rates calculated annually

Figure 4: Growth of RMB and FX Deposits and total amount of RMB and FX Deposits (in trillion RMB)



Note: Growth of RMB Deposits MoM is Month-on-Month

Figure 5: Growth of Loans and total amount of RMB and FX loans (in trillion RMB)



Note: Growth of RMB Loans MoM is Month-on-Month

China´s banks currently price their loans based on the benchmark lending rate that has been unchanged since October 2015, hampering the central bank's efforts to lower borrowing costs. The mechanism of LPR improves the efficiency of interest rate transmission, to help steer borrowing costs lower for companies and support a slowing economy that has been hurt by a trade war with the United States. But we still expect the central bank will cut banks' reserve requirement ratios (RRR) further in coming months, on top of six reductions since early 2018.

While the PBoC wants to channel more funds into the real economy, a potential house price bubble that might be fueled by further credit growth is still a major concern. Therefore, starting from Oct 8, the rate for personal loans (which are still linked to the policy rates) will be made more flexible and market-driven, the interest expense will be basically unchanged for borrowers. For purchasing the first property, individual borrowers of new mortgage loan will pay an interest rate of no less than 4.85 percent - it is the five-year loan prime rate, or LPR, the new reference of bank lending reported by the PBoC. Buyers of a second property should pay an interest rate that is 0.6 percentage point above the LPR, which will be 5.45 percent.

RMB internationalization

On May 27, China´s central bank and foreign exchange regulators laid the groundwork for trading of China depositary receipts (CDRs) on the coming new high-tech-board by issuing new rules on cross-border capital management for the securities. The new rules encourage the use of the Yuan in cross-border payments for business involving depositary receipts. A depositary receipt is a certificate issued by a bank that represents equity in a foreign company.

Summary of Financial Indicators

Growth of monetary aggregates slowed down

At the end of June, broad money supply (M2) stood at RMB192.14 trillion, growing by 8.5 percent year on year, which is slightly faster than the previous year where the growth rate was 8 percent. Narrow money supply (M1) stood at RMB56.77 trillion, increasing by 4.4 percent year on year. The pace of growth decreased by 2 percent compared to the previous year. The amount of currency in circulation (M0) recorded RMB7.26 trillion, increasing by 4.3 percent year on year. The first half of the year saw a net money withdrawal of RMB62.8 billion. The sharp disparity between the relatively low growth of narrow monetary aggregates compared to a much higher growth of broad aggregates such as M2 points to the still ongoing financial deepening in mainland China.

RMB and foreign currency deposits in financial institutions growth rate decelerate

End of June, the outstanding amount of RMB and foreign currency deposits totaled RMB192.79 trillion, up 8.1 percent year on year. RMB deposits recorded an outstanding amount of RMB187.57 trillion, rising by 8.4 percent year on year reflecting an almost constant pace of growth. In the first six months of 2019, RMB deposits rose by RMB10.05 trillion, RMB1.05 trillion more than the increase in the corresponding period in 2018. The outstanding amount of foreign currency deposits was USD760 billion, down 3.7 percent year on year. The negative growth of foreign deposits, despite the ongoing efforts of internationalization, is a sign of the negative impact of the trade war waged by the US.

Lending by financial institutions grew rapidly

Outstanding RMB and foreign currency loans totaled RMB151.6 trillion at the end of June, which is an increase of 12.5 percent year on year. Outstanding RMB loans grew by 13 percent year on year to RMB145.97 trillion, which is a slight decline of 0.4 percentage points compared to the previous month, but an increase of 0.3 percentage points compared to the previous year. Like foreign deposits, outstanding foreign currency loans declined (by about 4.2 percent) to USD818.7 billion.

Inter-bank market more active

In the first two quarters of 2019, lending, cash-bond cash bond transactions and bond repo transactions in the interbank RMB market totaled RMB578.02 trillion, with the daily average rising by 30.9 percent year on year to RMB4.74 trillion. In June, the weighted average rate for interbank lending stood at 1.7 percent, down by 0.54 percentage points month on month and 1.03 percentage points year on year. The weighted average interest rate for bond pledged repos was 1.74 percent, down 0.53 percentage points month on month and 1.15 percentage points year on year.

Foreign reserves fell and RMB depreciates

End of June, the outstanding foreign exchange reserves registered USD3.12 trillion, and the exchange rate for CNY/USD was 6.8747. The RMB did, however, depreciate further since.

Cross-border RMB settlement development

In the first half year 2019, RMB settlement for cross-border trade in goods, cross-border trade in services, other current account items, overseas direct investment and foreign direct investment amounted to RMB2.02 trillion, 777.2 billion, 361.8 billion and 895.6 billion respectively.

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MMP Index

The MMP index is a narrative index that comprehensively measures the PBoC's policy stance based on the information on policy-makers' intentions extracted from the PBoC's official communication. The index monitors 4 PBoC's policy actions: required reserve ratio, window guidance, supervisory pressure, and housing policy index. It is a five-value index on a quarterly basis. The policy stance of -2 refers to strong ease, indicating a strong emphasis on promoting real growth; 2 for strong tightening that indicates a strong policy emphasis on inflation reduction; -1 for ease and 1 for tightening, indicating mild emphasis on real growth and inflation control, respectively; the value of 0 stands for a neutral monetary policy stance.

Jan Klingelhöfer and Rongrong Sun (2018), "Macroprudential Policy, Central Banks and Financial Stability: Evidence from China", International Journal of Central Banking, 14(4): 1-42.