China Economic Watch

China | Putting the final piece into the new monetary policy framework: timing is the key

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China's authorities have recently raised their rhetoric of completing the new monetary policy framework. In particular, many analysts view it as a signal of lifting the benchmark policy rates. We, however, do not envisage that the removal of benchmark policy rates will happen this year given still-large growth headwinds and the lack of alternatives. Instead, we expect two cuts in benchmark policy rates through the rest of the year as the authorities seek to increase their support for growth.

The PBoC is accelerating the pace of establishing a new policy framework

Over the past three decades, China's authorities have been endeavouring to upgrade its monetary policy framework to suit the needs of its increasingly complex market economy. The reforms in this respect proceeded steadily in parallel with other important elements of China's financial reform, including commercialization of Chinese banks, exchange rate liberalization, capital account opening etc. Despite several times of interruption and delay caused by strong external shocks or entrenched China's gradualism, the reform of China's monetary policy framework seemingly comes to its final stage now.

As discussed in our previous report (Monetary Policy: New Framework, New Stance), the existing framework of China's monetary policy features a dual-track policy rate system. On the one hand, the authorities have already established a "corridor" interest rate system. The pledged 7-day interbank market rate (DR007) is the central bank's policy rate under the "corridor" system, whose movement is confined to a narrow corridor by design. The upper bound of the “corridor” is constituted by a series of interest rates of the PBoC's lending facilities at various tenors, through which the PBoC discretionarily inject liquidity to the banking sector. 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%).

Meanwhile, the PBoC continues to announce its benchmark lending and deposit rates, which used to be policy rates of the PBoC. The benchmark policy rates are not market-based. In history, they directly dictated the interest rates of commercial banks offered to their customers, either borrowers or depositors. After years of interest rate liberalization, Chinese commercial banks today are allowed to freely offer interest rates to their customers. However, the interest rate in a loan contract is still stipulated as benchmark policy rate plus or minus certain basis points. As such, a chunk of banks' loans and deposit products are still linked to the benchmark policy rates.

The PBoC has recently raised their rhetoric of completing the new monetary policy framework. In particular, the PBoC reportedly started to inquiry the commercial banks for their opinions about the potential impact of removing benchmark lending rate. In addition, some PBoC senior officials intentionally mentioned the possibility of unifying the dual-track policy rate system on various occasions. For instance, Mr. Sun Guofeng, Head of Monetary Policy Department of the PBoC, said in February that the key part of unifying dual-track policy rate system is to enable the central bank's policy rate, which he referred to DR007, to play a dominant role in the commercial decisions of setting their lending and deposit rates offered to borrowers and depositors.

What prompted the PBoC to accelerate the change?

To complete the reform of monetary policy framework is always on the top of the authorities' reform agenda. However, we suspect that a couple of factors with respect to the recent development in domestic economy and external environment could have prompted the authorities to accelerate the change.

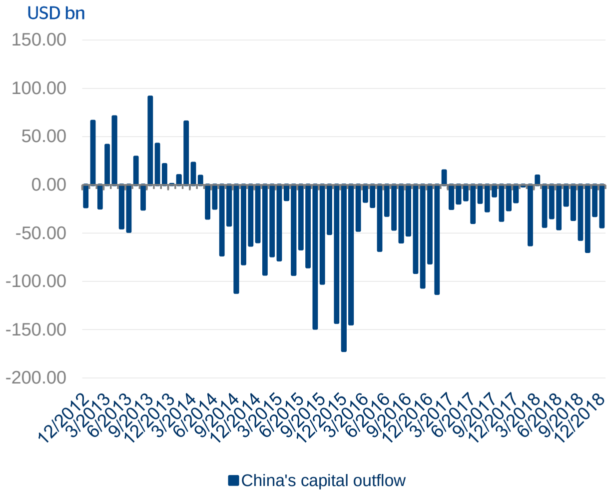
First, some deep seated changes in China's Balance of Payment (BOP) are calling for a price-tool-centred monetary policy framework. During most of the time between 1994 and 2013, China's BOP had "twin surplus" under both the current and capital accounts. In the face of large net inflows, the central bank frequently used some quantitative policy tools, including the rise in required reserve ratio (RRR) and the issuance of central bank bills, to conduct monetary policy. Indeed, these quantitative tools are suitable for the then environment of abundant liquidity brought by large-scaled inflows since they can function as the sterilization tools as well.

Since 2015, the situation of China's BOP has undergone important changes. The market crash in Chinese stock markets and the following RMB devaluation in mid-2015 reinforced the momentum of capital outflows away from the country. Even the authorities tightened the grip of the capital account in the aftermath of financial turmoil; the frequently appeared deficit under the capital account has become part of Chinese economy's "new norm". (Figure 1)

At the same time, the surplus of China's current account is shrinking at a fast pace. In 2007, China's current account surplus reached its record high of 9.9% of GDP, which has been in a continuous decline till today in tandem with the economic rebalancing towards domestic consumption. In 2018, the current account surplus only accounted for 0.39%. Now it is widely anticipated that the ongoing trade tension between China and the US will tip the former's current account into a deficit soon. (Figure 2)

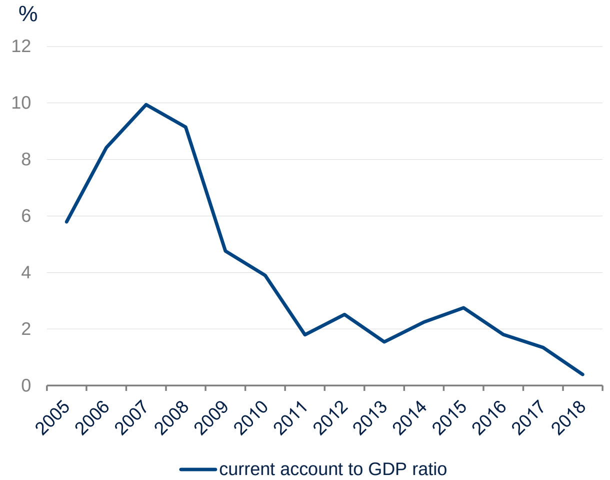
The profound changes in China's BOP have prompted the authorities to accelerate the upgrading of the monetary policy framework to make it suitable for the new environment. In particular, when external inflows cannot provide adequate liquidity, the central bank needs to adjust the size of their own balance sheet to manage the liquidity in the banking sector. Under such a circumstance, the use of traditional quantitative policy tools could have strong knock-on effects on financial markets and even lead to financial instability. Therefore, the authorities are in need of an efficient price tool of monetary policy more than ever.

Figure 1 Cross -border capital movement has turned net outflows compared to net inflows previously



Source: BBVA Research and CEIC

Figure 2 Current account balance has declined over time



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Second, the PBoC is not satisfied with the policy effects of currently monetary easing and tend to believe that the dual-track system hampers the policy transmission. From the second half of last year, both domestic and external growth headwinds have substantially weighed on China's growth. In response, China's authorities have de facto shifted their stance of monetary policy from "neutral" to "loosening". Since then a number of easing initiatives have been enacted including five RRR cuts, large-scaled liquidity injection through reverse repo and other standing lending facilities, as well as a flurry of targeted policy initiatives to encourage banks to extend credit to small-and-medium-sized enterprises (SME).

Despite the easing efforts of the central bank, the policy effects are not satisfactory thus far. For instance, both total social financing and new yuan loans have not been boosted significantly despite of these easing monetary measures. In January and February, the stock of total social financing (TSF) which is a broad gauge of China's credit in the economy increased by 10.2% y/y despite of the authorities' enormously loosening efforts. (Figure 3) Moreover, the weighted average lending rate in the economy remains stubbornly high even though the authorities have manged to keep DR007 at a lower level. (Figure 4)

Figure 3 Although the PBoC implemented easing monetary measures, the total social financial and new yuan loans still weak

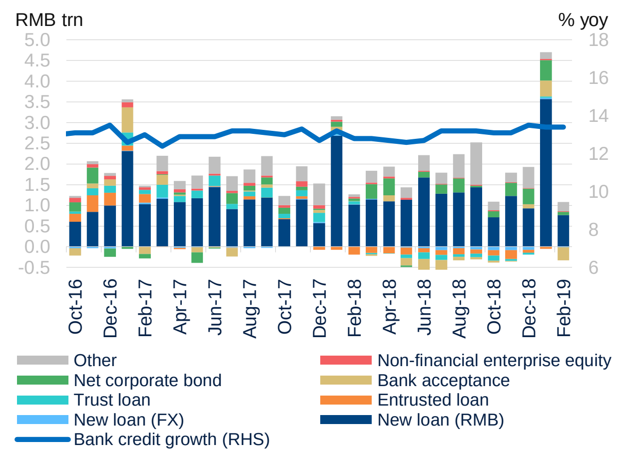

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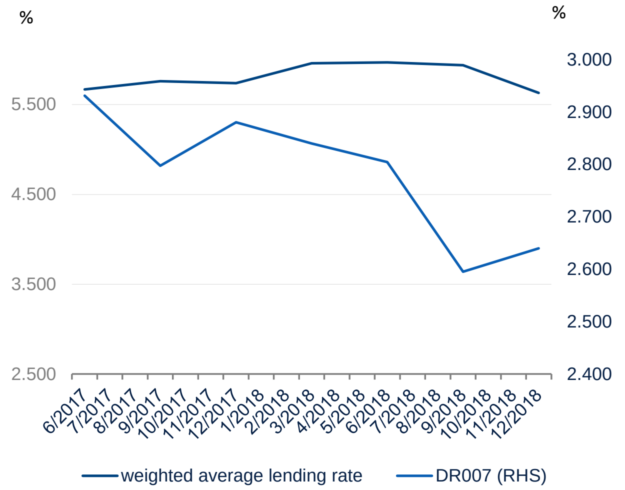
Figure 4 A combination of higher weighted lending rate and a lower money market rate due to the weak monetary transmission mechanism



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The PBoC seems to blame the dual-track policy rate system as one prime culprit of unsatisfactory policy effects. They believe that commercial banks are insensitive to the change of DR007 because a chunk of their loans and deposit products to the benchmark interest rates. That being said, the elimination of the benchmark interest rates might help the central bank to improve the policy transmission.

Timing is the key to the success of the monetary policy framework reform

Although we agree to the point that unifying the dual-track policy rate system is the long-term goal for China's financial reform, we don't envisage that the removal of the benchmark policy rate will happen this year. On the contrary, we anticipate that the authorities will cut the benchmark policy rate this year in coordination with other easing initiatives in support of a fast-slowing economy.

It is notoriously difficult for a central bank to stimulate the economy by easing monetary policy, which was described by some people as a process of "pushing on a string". During previous economic downturns, both the US and Euro zone were unable to use traditional monetary policy tools to put the growth back on track and therefore chose to implement some unconventional monetary policy tools including quantitative easing, forward guidance, negative interest rate, TLTRO etc. That being said, the existence of dual-track policy rate could be one of many reasons why China's monetary policy transmission mechanism doesn't function well. But the lift of benchmark policy rate is unlikely to fix the problem of policy transmission.

Indeed, a more relevant problem to the policy transmission is banks' aggravated risk appetite in the face of increasing growth headwinds. The clampdown of shadow banking activities has forcefully driven a lot of borrowers out of the credit market and led to growth slowdown. The still unsolved trade war with the US not only stalls the export sector but also hits consumers and producers' confidence. At such a juncture, banks' concerns over asset quality may override the authorities' efforts of policy easing so that these risk-averse banks are reluctant to transmit the lower financing costs (from the interbank market) to their clients. (Figure 5)

Figure 5 China's economic growth continued its downward trend and reached historical low in 2018…

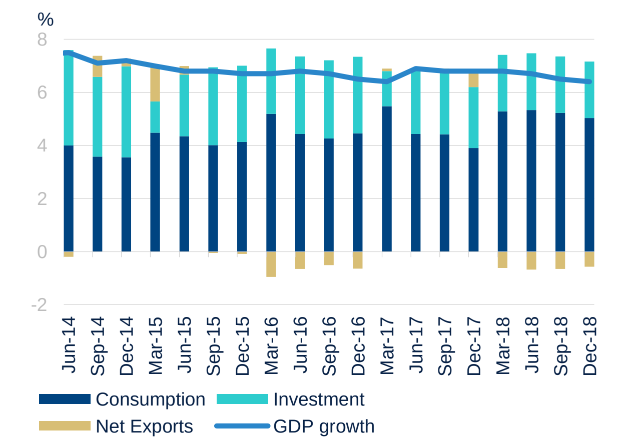

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Figure 6 …while debt level still high

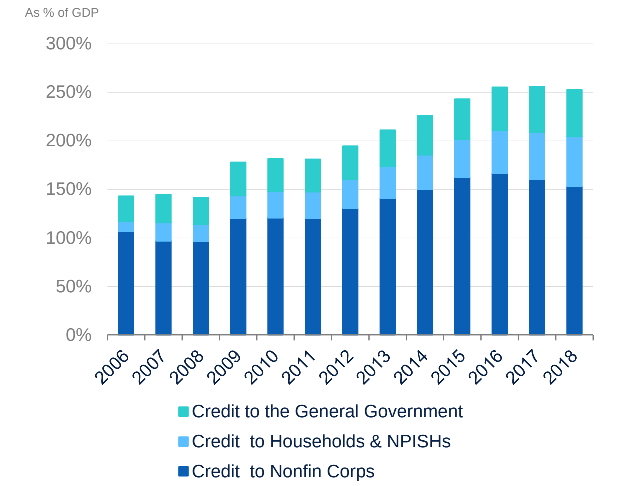

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Figure 7 The DR007and SHIBOR are very volatile from day to day

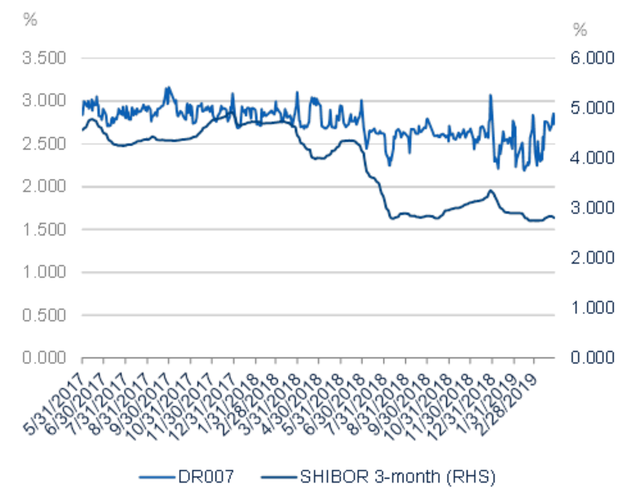

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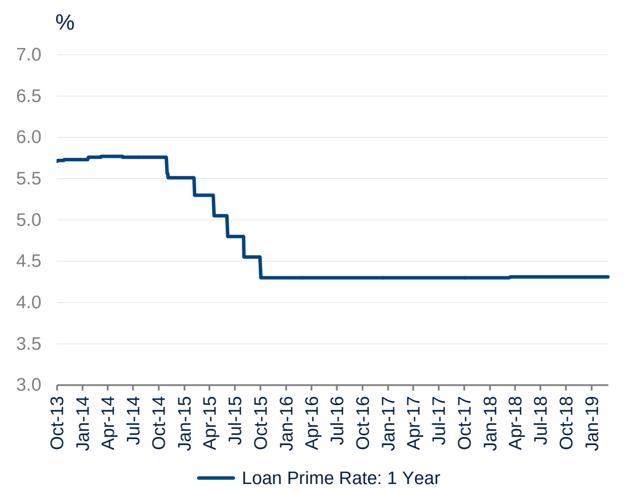
Figure 8 The LPR is very flat in history and it is almost equivalent to the benchmark lending rate



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Instead, given that a large number of loan contracts are still linked to the benchmark policy rate, the downward adjustment of it could effectively lower the aggregate financing cost of the economy. As banks' total outstanding RMB loans stand at RMB 134.7 trillion (or 149.6 % of GDP), a cut in benchmark policy rate could lead to a considerable cost saving for those household and corporate borrowers. Moreover, a cut in benchmark policy rate can send a strong signal of monetary easing to the market participants. Together with other pro-growth measures, benchmark policy rate cuts could reinforce firms' confidence in growth outlook and prospective credit condition as bank loans are the majority form of China's ballooning debt. (Figure 6)

Moreover, even the authorities lift the benchmark interest rates, they need to find new interest rate for commercial banks to price their financial products. Unfortunately, there are no feasible alternatives for the moment. The DR007 is a short-term one and too volatile for pricing long-term loans or deposits. (Figure 7) Another option is to use Loan Prime Rate (LPR) to replace the current benchmark lending rate. Actually, many countries or regions adopt this LPR scheme, such as Hong Kong, the US, Japan etc. However, the LPR in China has a very short history (which was introduced in 2013) and, more importantly, it hasn't played an important role in pricing financial products since its inception. (Figure 8)

In view of abovementioned factors, we envision that the authorities are unlikely to lift it as long as the growth hard-landing remains the prime risk to China's economy. Instead, we expect two benchmark policy rate cuts to come in the second and third quarter of this year to stimulate the economy. A prospected deal between China and the US could lessen the depreciation pressure of the RMB from March, which is to create a good time window for the PBoC to manipulate its policy rate to lower the financing cost of the entire economy.

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