China Banking News

The Chinese Monetary Policy Cheat Sheet

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Introduction

This brief guide is designed to equip analysts, investors and general observers with all the knowledge they need to understand the basic workings of Chinese monetary policy and the decisions of the People's Bank of China (PBOC), which is the Chinese central bank.

The People's Bank of China

The People's Bank of China (PBOC) is the Chinese central bank. Following the launch of China's reform and opening era in 1978, PBOC gradually transitioned away from its earlier role as the sole bank and bursar for a centrally planned command economy, towards becoming more akin to the central banks responsible for monetary policy in market economies.

This evolution reached a turning point in 1995, with the passage of the People's Bank of China Law (中华人民共和国中国人民银行法) by the 8th National People's Congress in March of that year, officially designating PBOC as the Chinese central bank.

According to its official website, PBOC is responsible for the formulation and execution of monetary policy and lending policy, as well as improvements to the monetary policy coordination system and macro-prudential regulation[1].

PBOC lacks the independence of the central bank of Western economies, and is a subordinate ministry of the State Council – China's highest government authority. Monetary policy decisions made by PBOC are submitted to the State Council for filing[2].

PBOC's current governor is Yi Gang, who was appointed to the role in March 2018. Guo Shuqing, formerly the head of the China Banking and Insurance Regulatory Commission (CBIRC), serves as the party secretary of PBOC.

PBOC also has a total of five vice-governors, who currently consist of Pan Gongsheng, Liu Guoqiang, Qu Jishan, Zhang Qingsong and Xuan Changneng[3].

The PBOC Monetary Policy Committee

In July 1997, PBOC established a monetary policy committee that has met on a quarterly basis since the end of 1998[4].

The monetary policy committee's official duties include "discussing the formulation and adjustment of monetary policy, the control targets for monetary policy within set timeframes, the application of monetary policy tools, and providing opinions[5]."

As of March 2023 PBOC's monetary policy committee consisted of 14 members[6] including:

1. Yi Gang, Governor of the People's Bank of China
2. Ding Xuedong, Deputy Secretary-General of the State Council
3. Li Chunlin, Deputy Director of the Development and Reform Commission
4. Xu Hongcai, Vice Minister of Finance
5. Liu Guoqiang, Vice Governor of the People's Bank of China
6. Zhang Qingsong, Vice Governor of the People's Bank of China
7. Kang Yi Director of Statistics Bureau
8. Guo Shuqing Chairman of China Banking and Insurance Regulatory Commission
9. Yi Huiman Chairman of China Securities Regulatory Commission
10. Pan Gongsheng, Director of the State Administration of Foreign Exchange
11. Tian Guoli President of China Banking Association
12. Liu Shijin Vice Chairman of China Development Research Foundation
13. Cai Fang, Chief Expert from the Chinese Academy of Social Sciences
14. Wang Yiming Vice Chairman of the China Center for International Economic Exchanges

The monetary policy committee meets on a quarterly basis, and its decisions require the votes of at least two-thirds of attendants to pass[7].

The PBOC Quarterly Monetary Policy Execution Report

PBOC issues a quarterly monetary policy execution report[8], which serves as the key document for communicating its broader policy intentions to the market.

The reports usually generally released around two months after the quarterly meeting of PBOC's monetary policy committee[9] are convened.

PBOC's Monetary Policy Tools

PBOC employs a range of tools for the execution of monetary policy, the most important of which currently include:
- Open market operations.
- The loan prime rate
- The reserve requirement ratio.
- Structured monetary policy tools.
- The standing lending facility.

Open Market Operations

PBOC defines open market operations (OMO) make adjustments "the main monetary policy tool for the central bank to inject or withdraw base money and adjust market liquidity[10]."

In 1998, PBOC established a primary dealer system for its open market operations, selecting a cohort of the largest commercial banks to serve as system participants.

As of 2023, the list of primary dealers for PBOC's OMO consisted of a total of 51 financial institutions in China, including all six of the big state-owned banks, the two main policy banks, national joint-stock banks and regional lenders[11].

In its execution of OMO, PBOC has recourse to a range of tools. The two most important of these tools are 7-day reverse repos and medium-term lending facilities (MLFs).

The rates for these two tools whenever PBOC conducts OMO are considered by PBOC to be the official policy rates.

Reverse Repos

Repos are a form of collateralised lending that involve a borrower selling securities to a lender, under an agreement to re-purchase the same securities at a subsequent date for a discount.

PBOC makes use of reverse repos with a 7-day term to inject short-term liquidity into the Chinese banking system. It does this by purchasing securities from primary dealers, with an agreement to sell them back at a later date, thus temporarily providing primary dealers with more base money.

PBOC defines the reverse repo as “an operation in which the central bank puts liquidity into the market,” while defining reverse repurchase maturity as “an operation in which the central bank withdraws liquidity from the market[12].”

This terminology can cause confusion for observers, given that the US Federal Reserve makes use of the opposite terminology.

According to the Federal Reserve Bank of New York, a repo transaction “is economically similar to a loan collateralised by securities, and temporarily increases the supply of reserve balances in the banking system[13].”

The Medium-term Lending Facility

PBOC defines the medium-term lending facility (MLF) is a monetary policy tool for the provision of medium-term base money to Chinese financial institutions.

The MLF was first launched in September 2014, and has since emerged as one of PBOC’s two main OMO tools.

According to PBOC, MLF’s are provided to “commercial banks and policy banks that satisfy macro-prudential regulatory requirements via auction.

MLF are a secured form of lending, with accepted forms of collateral consisting of high-quality debt including national bonds, central bank bills, policy finance bonds and high-grade credit bonds.

At the time of its launch in 2014, PBOC said that “the MLF plays the role of the medium-term policy rate.”

According to PBOC, it uses “adjustments to the cost of medium-term funds for financial institutions to influence the balance sheets of financial institutions and market expectations, guiding them to provide low-cost funds to sectors of the real economy in accordance with national policy, and reducing the cost of social financing[14].”

The Loan Prime Rate

The loan prime rate (贷款市场款报价利率) (LPR) is China’s benchmark interest rate and consists of two maturities - the one-year LPR and the five-year LPR.

The LPR is determined based on the loan rates provided by a panel of 18 quoting banks to their best customers.

Each of the quoting banks provide these rates to the National Interbank Funding Centre (NIFC) on the 20th of each month, or the following work day if the 20th coincides with either a weekend or vacation.

NIFC then calculates the average of these rates after first removing the highest and lowest quotes, before announcing the resulting LPR's for that month at 9:15am of the same day.

NIFC was first founded in 1994 as the China Foreign Exchange Trade System (CFETS), and is a body under the authority of PBOC.

The LPR is a frequent object of confusion, with observers and the press mistaking it for a target rate that is explicitly set by PBOC's monetary policy committee, akin to the Fed Funds target rate set by the Federal Open Markets Committee (FOMC) in the US.

As the product of survey results, the LPR is a measure of prevailing interest rates, as opposed to a target rate set by PBOC.

PBOC exercises influence over the LPR, however, by means of the policy rate of MLF, which determines the cost of medium-term funds for Chinese financial institutions.

NIFC states that the "LPR is a quote formed by each quoting bank based on the addition of points to the interest rate for open market operations (referring primarily to the MLF interest rate)[15]".

Thus, the LPR itself lies downstream of the rates for OMO policy rate, with Chinese analysts often speculating on the potential impacts of changes in policy rates upon the LPR.

A present there are a total of 18 quoting banks responsible for contributing to the LPR, including:

1. Industrial and Commercial Bank of China.
2. Agricultural Bank of China.
3. Bank of China.
4. China Construction Bank.
5. Bank of Communications.
6. Postal Savings Bank of China.
7. China Merchants Bank.
8. Industrial Bank.
9. Pudong Development Bank.
10. China Minsheng Bank.
11. Bank of Nanjing.
12. Bank of Taizhou.
13. Shanghai Rural Commercial Bank.
14. Shunde Rural Commercial Bank Bank.
15. Standard Chartered Bank (China).
16. Citibank (China).
17. WeBank.
18. MYbank.

The Required Reserve Ratio

Requirements in relation to deposit reserves are another important monetary policy tool used by PBOC to exert broad control the supply of money within the Chinese economy.

PBOC defines deposit reserves as "funds prepared by financial institutions to guarantee the deposit withdrawal and fund settlement needs of customer deposits."

The required reserve ratio is defined as the ratio of deposit reserves made by financial institutions with PBOC to their total deposits.

PBOC says it makes adjustments to the reserve ratio to “affect the credit supply capacity of financial institutions, thereby indirectly regulating the money supply.”

In its use of the RRR, PBOC takes its cue from the US, referring to it as the “first country in the world to legally require commercial banks to deposit reserves with the central bank[16].”

PBOC has gradually reduced the RRR over the past decade, from 20.5% for large-scale financial institutions in December 2012 to 10.75% as of 27 March 2023[17]. Cuts began to accelerate in early 2018, maintaining a rapid pace throughout the course of the Covid pandemic.

On 27 March 2023, PBOC reduced the RRR by 0.25 percentage points, bringing the weighted average RRR to 7.6%[18].

Structured Monetary Policy Tools

PBOC has recently increased its use of what it refers to as “structured monetary policy tools”, particularly in the wake of the Covid pandemic. These instruments enable PBOC to guide lenders to channel funds to specific areas of the economy, as part of what the Chinese government refers to as “precision monetary policy[19]”.

These tools include:

Agricultural support re-loans (支农再贷款)

Small business support re-loans (支小再贷款).

Rediscounts (再贴现)

Inclusive micro-and-small business loan support tools (普惠小微贷款支持工具).

Collateralised supplementary loans (抵押补充贷款)

Carbon emissions reduction support tools (碳减排支持工具)

Special re-loan to support clean and efficient utilization of coal (支持煤炭清洁高效利用专项再贷款)

Technological innovation re-loans (科技创新再贷款)

Inclusive pension special re-loans (普惠养老专项再贷款)

Special refinancing for transportation and logistics[20] (交通物流专项再贷款).

The Standing Lending Facility

PBOC first launched the Standing Lending Facility (SLF) in 2013 as means of satisfying the longer-term, large-sum liquidity needs of financial institutions including policy banks and nationwide commercial banks[21].

As of June 2023, PBOC was of the view that the SLF “played the role of [setting] a ceiling on the interest rate corridor, and is of benefit to maintaining the stable operation of money market interest rates.[22]”

The SLF currently comes in maturities of overnight, seven-days and one-month.

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[2] http://www.pbc.gov.cn/zhengcehuobisi/125207/3870933/3870939/3870960/index.html

[3] http://www.pbc.gov.cn/hanglingdao/128697/index.html

[4] http://www.pbc.gov.cn/zhengcehuobisi/125207/3870933/3870942/3871092/index.html

[5] http://www.pbc.gov.cn/zhengcehuobisi/125207/3870933/3870939/3870948/index.html

[6] http://www.pbc.gov.cn/zhengcehuobisi/125207/3870933/3870942/3871086/index.html

[7] http://www.pbc.gov.cn/zhengcehuobisi/125207/3870933/3870939/3870960/index.html

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[19] https://www.gov.cn/xinwen/2020-08/07/content_5532911.htm

[20] http://www.pbc.gov.cn/zhengcehuobisi/125207/125213/4634692/4634697/4634721/index.html

[21] http://www.pbc.gov.cn/zhengcehuobisi/125207/125213/125443/125854/2895400/index.html

[22] http://www.pbc.gov.cn/zhengcehuobisi/125207/125213/125443/125857/4930382/index.html