Economic Watch

China | Monetary policy challenges in the post-pandemic era

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When the Covid-19 pandemic unexpectedly hit the global economy in 2020, central banks around the world implemented unprecedentedly loosening monetary policy initiatives to prevent the growth from falling off the cliff. Among the countries, China, due to its effective containment of virus spread at the beginning of the pandemic, is the first one to normalize its monetary policy from May 2020, while other countries are still grappling with the pandemic.

This report investigates the challenges of China's monetary policy in the post-pandemic time. Chief among them is how to ensure a smooth exit of loosening monetary policy while not to cause financial market turmoil. In the medium-to-long term, China's monetary policy needs to face more challenges, including: (i) to smoothen monetary policy transmission mechanism; (ii) to redefine the role of monetary policy in financial stability and (iii) to integrate environmental protection and carbon neutrality target into the existing policy objectives.

Normalization of easing monetary measures in post-pandemic time

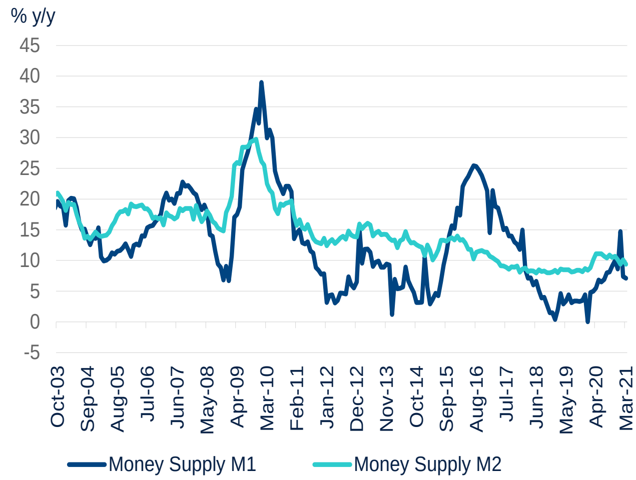
Compared with the ultra-loosening monetary policies unveiled in advanced economies, China's anti-pandemic monetary policy initiatives are milder and more measured (Figure 1 and 2). In particular, the easing measures implemented during the pandemic era include: (i) MLF (medium-lending facilities) rate cut by 30bps; (ii) DR007 (7-days Reverse Repo rate) cut by 30bps; (iii) SLF rate (standing lending facilities) cut by 30bps; (iv) LPR (loan prime rate) cut by 30bps; (v) Excess RRR rate cut from 0.72% to 0.35%; (vi) Three RRR cuts (cumulative 150 bps) which released 1.75 trillion RMB; (vii) Re-lending and re-discount programs:1.8 trillion RMB; (viii) Extension of SMEs loans to RMB 870 billion and support for SME financing program at RMB170 bn.

The PBoC started to exit the above easing measures in May 2020 when the Covid-19 pandemic got controlled in mainland China. Historically, the exit of easing monetary measures in the post-crisis time has always been a global challenge to central banks. China is not an exception in this respect. In February 2021, the normalization progress in China led to the gyration of the interbank interest rate in February 2021, just before the Chinese Lunar New Year as the investors' fear of the authorities' fast tightening climbed to a new high. (Figure 3 and 4) (See our recent Economic Watch: China | Understanding the interbank liquidity crunch and the policy intensions)

The authorities took pains to pacify investors and quell the market panic. They also pledged that the normalization of monetary policy will avoid a "sharp turnaround". The authorities' stance is justified by a number of headwinds down the road, including: the mounting uncertainties of global recovery pace, the slower-than-expected vaccination progress in emerging markets as well as seemingly ever-intensifying relation between China and the USA. In view of these uncertainties, we expect no policy rate hike or RRR hike this year. (Figure5)

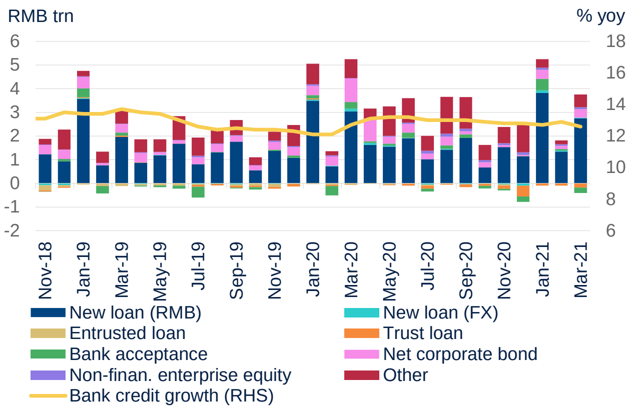
However, the PBoC needs to further enhance its communications with the market in the course of policy normalization. It's a challenging task to normalize the policy amidst of great external uncertainties. The market needs clearer messages from the monetary authorities to avert self-fulfilling market turmoil.

Figure 1. **COMPARED WITH A SIGNIFICANT SURGE OF M2 IN 2008-09 GFC, 2020 M2 ONLY ACCELERATED TO 10.3% AND IS ANTICIPATED TO STABILIZE TO 9% IN 2021**



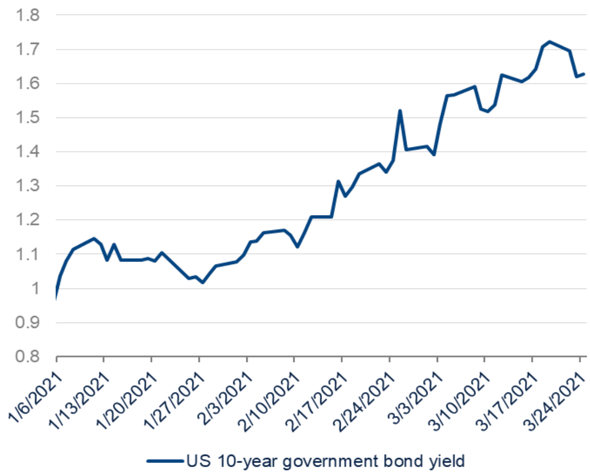
Source: CEIC and BBVA Research

Figure 2. **THE PACE OF TOTAL SOCIAL FINANCING AND NEW YUAN LOANS EXPANSION IN PANDEMIC TIME IS ALSO COMPARATIVELY SOFT**



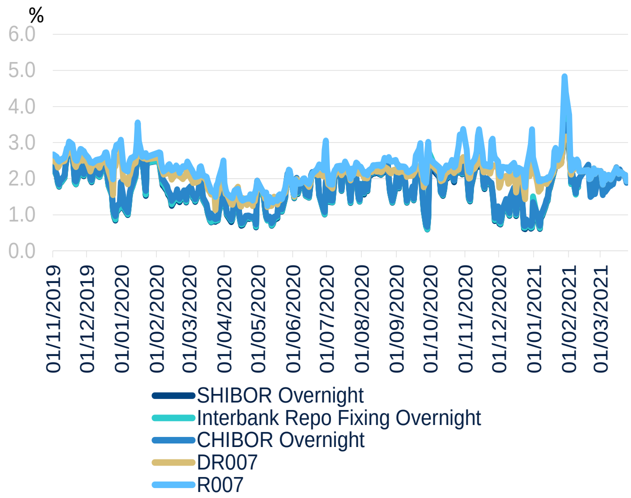
Source: CEIC and BBVA Research

Figure 3. **THE RECENT US LONG-TERM BOND YIELD HIKE INDICATES THE BUMPY ROAD OF POLICY NORMALIZATION**



Source: CEIC and BBVA Research

Figure 4. **IN CHINA, INTERBANK RATE HIKE IN FEBRUARY 2021 ALSO REFLECTED THE MARKET SUSPICION OF CENTRAL BANK'S BEHAVIOUR**

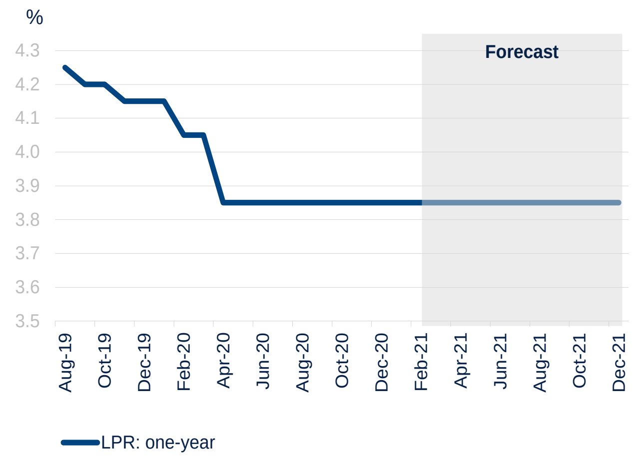


Source: CEIC and BBVA Research

Smoothening monetary policy transmission mechanism

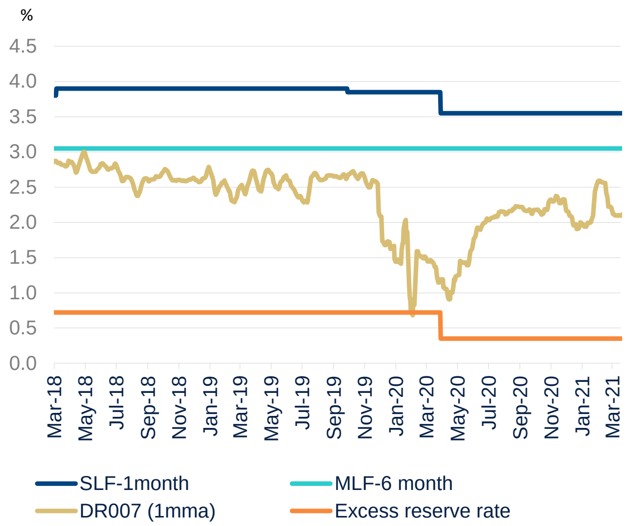
Policy normalization is challenging but it is in essence a short-term issue. In the medium-to-long term, it's more important for the authorities to establish and develop a smooth transmission mechanism of monetary policy conduct framework. After the launch of the interest rate corridor system a few years ago (See our previous report China | Putting the final piece into the new monetary policy framework: timing is the key), the policy transmission has become the prime challenge to China's monetary policy framework.

Figure 5. **NO RRR OR LPR CUT ARE ANTICIPATED THIS YEAR**



Source: CEIC and BBVA Research

Figure 6. **UNDER CORRIDOR SYSTEM FORMED IN 2016-17, THE PBOC ALWAYS DEPENDS ON CREATING NEW POLICY TOOLS TO SOLVE TRANSMSSION PROBLEM**



Source: CEIC and BBVA Research

Traditionally, China has multiple monetary policy targets: stabilizing inflation, promoting economic growth, maintaining employment, promoting financial stability and maintaining Balance of Payments. Since the launch of the corridor system in 2016-2017 (Figure 6), the PBoC has created multiple new policy tools to attain its monetary policy targets: the first group of tools includes a number of the interbank rates when the central bank conducts open market operations, such as policy rate-DR007 (7-days Reverse Repo rate), MLF (medium-lending facilities) rate; SLF rate (standing lending facilities), re-lending and rediscount rate; the second group is the LPR (loan prime rate); the third group is composed of Excess RRR and RRR; and the fourth includes other liquidity management tools such as PSL (pledged supplementary lending), SLO (Short-term Liquidity Operations), etc.

The plethora of policy tools indeed reflects the deficiencies in the existing transmission mechanism, which is related to the underdevelopment of Chinese money and bond markets. For example, the Treasury bond yield curve is not completely developed in Chinese bond market. Therefore, the authorities cannot effectively affect the long-term lending rates of commercial banks or the long-term bond yield only via maneuvering the short-term policy rate (DR007 etc.)

In order to solve this problem, in August 2019, the PBoC conducted the LPR reform that artificially linked the Loan prime rate (LPR), which is the commercial banks' lending rate, to the medium-term lending facility rate (MLF) which is the short-term rate (6 month) controlled by the central bank, plus some adding points.

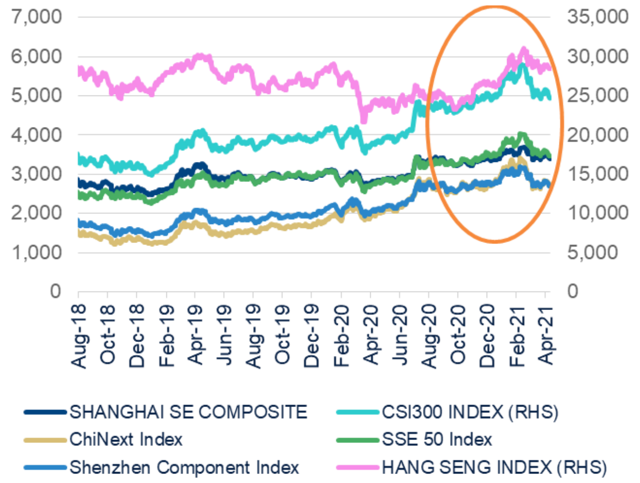
Beyond the above issues, the behaviors of market entities also cause the transmission problem of monetary policy. For instance, some borrowers (i.e. SOEs and local government financing vehicles) are insensitive to financing costs because they are enjoying the implicit guarantees from the central or local governments. As a result, these entities borrow more than they can afford and even actively participate in shadow banking activities. With the distortions of those borrowers, the authorities find it increasingly difficult to achieve their policy goals through the normal transmission channels. It forces the central bank to invent new tools to overcome the transmission problems.

To solve the monetary transmission problem, the authorities needs to take efforts in at least the following three areas. First, the authorities should continue to enhance the central bank communication with the market. After all, the corridor system has been established for only 4 years while LPR reform only 2 years, good communications will help market participants to better understand policy intentions. Second, the central bank should further increase the depth and width of its bond market. It is a wise idea to invite more foreign investors to trade on its onshore bond market, in particular under the current circumstance, as many other countries' government bonds become unattractive due to the ultra-easing monetary policy. Last but not least, the central bank should work with other government agencies to root out the implicit guarantee provided by central or local governments. A number of high-profile bond defaults in China's domestic bond market and loan market have appeared recently, helping to put real market disciplines on the borrowers and thereby improve the policy transmission.

The role of monetary policy in financial stability

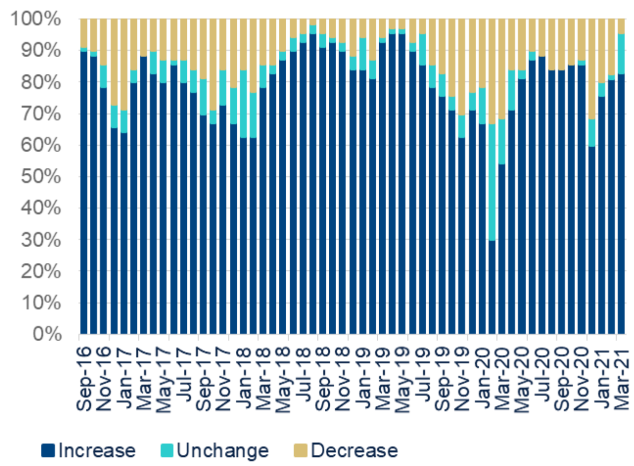
Financial stability is the main challenge in the post-pandemic time. Due to the large amount of liquidity injection during the pandemic period, China's stock and housing market witnessed a remarkable run-up. The stock market experienced certain correction after the Chinese Lunar New Year holiday. But the housing market still appears to be overheated, in particular among the tier-1 cities. (Figure 7 and 8) In addition, the macro leverage ratio rose to a new high in the aftermath of anti-pandemic stimulus package. (Figure 9 and 10)

Figure 7. **STOCK MARKET SURGED AFTER CHINA'S PANDEMIC GOT CONTROLLED IN MAY 2020**



Source: CEIC and BBVA Research

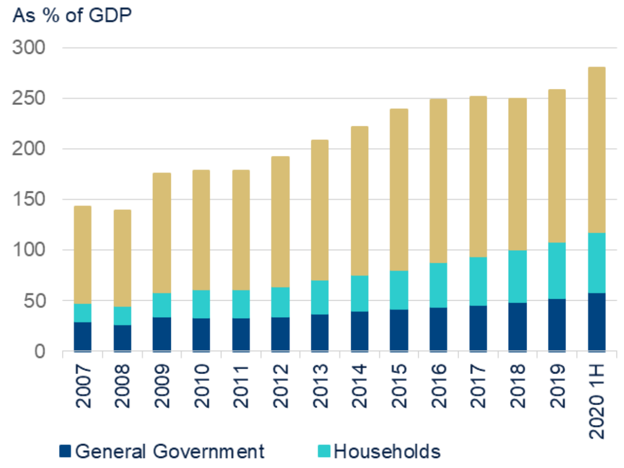
Figure 8. **MORE AND MORE CITIES REPORTED HOUSING PRICE INCREASING IN THE RECENT MONTHS**



Source: CEIC and BBVA Research

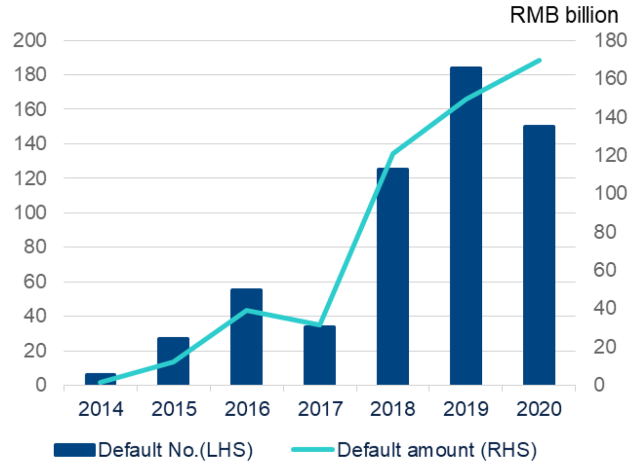
Whether and how monetary policy could help maintain financial stability is a long-lasting open question. The market has been discussing and investigating whether and how to include asset prices into the monetary policy target in a bid to maintain financial market stability. Traditionally, people believe that monetary policy should only target on inflation, leaving financial stability issue to macro-prudential policy and financial regulations. However, macro prudential policy and regulations have a very long adjustment cycle, which could be too late to deal with the fast run-up of asset prices. China's property market is a vivid example in that it has maintaining a strong momentum despite numerous rounds of implemented macro-prudential measures over the past decade. More importantly, the authorities are keen to curb the fast accumulation of debt while monetary policy is set to play an important role in this process. However, it remains an open question how the authorities should use monetary policy tools in attaining their goals of curtailing debt growth.

Figure 9. **MACRO LEVERAGE RATIO HAS BEEN INCREASING IN 2020, INCLUDING GOVERNMENT, HOUSEHOLD AND CORPORATE DEBT**



Source: CEIC and BBVA Research

Figure 10. **SOE DEFAULT AT END-2020 AND RECENT HUARONG CASE INCREASED RISKS FOR FINANCIAL STABILITY**



Source: CEIC and BBVA Research

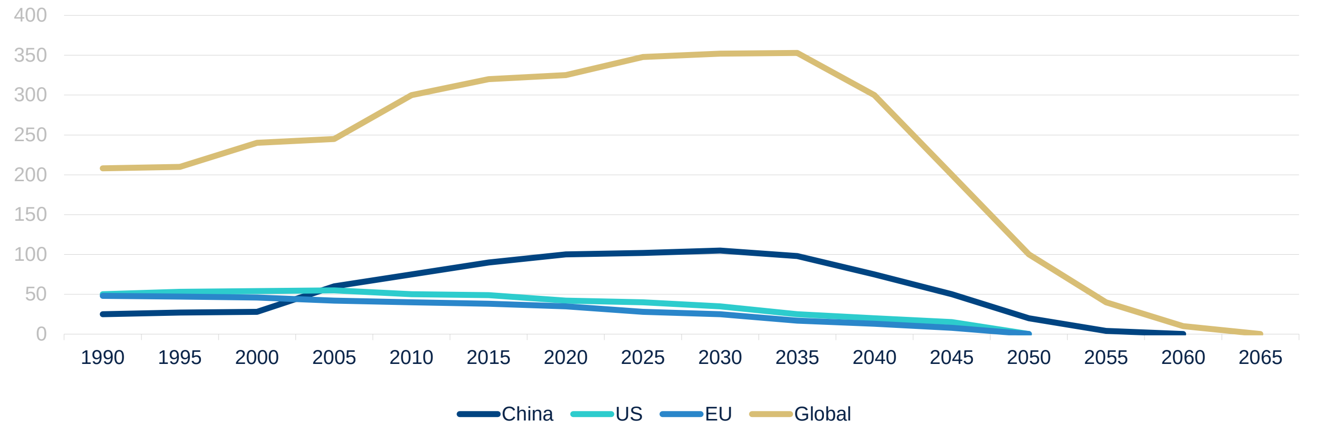
Carbon neutrality and monetary policy

Chinese government has already pledged to achieve carbon emission peak in 2030 and carbon neutrality in 2060. The 30 years gap between the promised emission peak and carbon neutrality constitutes a more challenging task to China. For most of advanced economies, the gap is as long as around 45 years since they already peaked their carbon emission at the beginning of new Millennium and promised to achieve carbon neutrality by 2050. (Figure 11)

The ambitious target determined that the PBoC will take a proactive stance to facilitate the government to achieve the carbon neutrality on time. Several central bank officials have indicated that the PBoC will deploy a number of initiatives with regard to reducing carbon emission, including: to promulgate the list of Green Bond supported projects in this month, to guide the financial markets to support Green Economy projects, to improve the standard of Green credit and Green bond evaluation, to consider climate change and carbon emission factors in commercial banks' stress test, and to create favorable interest rates and special re-lending tools to support enterprises that meet carbon emission targets.

To a large extent, the PBoC's stance signaled that facilitating carbon neutrality will become part of monetary policy mandate in the long run. Such a stance is in a stark contrast to the central bankers of advanced countries, who prefer to accommodate the potential shocks in the way to achieve carbon neutrality while not to change the mandate of monetary policy.

Figure 11. **GLOBAL AND MAIN ECONOMIES' CARBON EMMISION PATHS (TONS OF CO2)**



Source: BBVA Research

However, the PBoC's interventionism could bring new challenges to their monetary policy conduct. For example, to encourage "Green" finance, the PBoC could introduce more noises to the general price level. It remains a question whether the PBoC should be more tolerant of small price rise caused by the efforts of curbing carbon emission or just stick to the traditional role of pursuing inflation stability.

In sum, China's monetary policy faces several challenges in the post-pandemic world. Chief among them and the most urgent one is the ongoing monetary policy normalization progress and to circumvent market's suspicion towards central bank's timing of exiting easing measures. After all, monetary policy normalization while avoiding financial market turmoil in the post-crisis time has been a long-lasting challenge to world's central banks. At the same time, we also need to investigate some more medium-to-long term challenges, such as to smoothen monetary policy transmission mechanism, to position monetary policy in the role of maintaining financial stability such as to deal with asset bubbles and debt overhang problem, as well as to incorporate carbon neutrality into monetary target, etc. In the short term, a neutral but still accommodative monetary policy is the main stance throughout this year to foster post-pandemic economic recovery (see our recent Economic Watch: China | What will be the monetary policy stance in 2021?); beyond that, a series of more long-term and structural issues on monetary policy conduct also need to be carefully managed and pressed ahead.

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