China | Stocktaking China's new toolkit in its monetary policy framework

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We have been keeping a close watch on the evolution of China's monetary policy framework. In 2016, we introduced the PBoC's newly established "corridor system" (China Economic Watch: Looking for new monetary policy tools in the liberalized-interest-rate environment) while In 2019, we comprehensively explained the PBoC's important reform to eliminate China's long-lasting "dual track" interest rate system and to make the MLF (medium lending facilities) rate and one-year Loan Prime Rate (LPR) as the new policy rate (China Economic Watch: China | LPR: China's market-based "policy" rate).

The PBoC continued to upgrade and improve its monetary policy framework so as to smooth monetary policy transmission mechanism from the policy rate to market interest rates and ultimately to the real economy. The relevant reform measures gained traction again after Mr. Pan Gongsheng became the new governor of the PBoC in July 2023.

Governor Pan's upgrading of China's monetary policy framework concentrates on three dimensions as below. In addition to enhancing the transmission channel from key policy rates to the real economy, Governor Pan's efforts also open the way for the PBoC to pursue its balance-sheet expansion to counter cyclical growth slowdown.

1. **Promoting 7-day reverse repo as the new monetary policy rate in place of MLF (medium lending facilities)**. Starting from July 2024, the PBoC officially promoted 7-day reverse repo rate as the new policy rate to replace the previous policy rate MLF and one-year LPR. It suggests that the central bank will only control short-term policy rate in the future and let the market to decide the medium and long-term market rates, which is similar to the monetary policy framework as of in the advanced economies. At the same time, the PBoC has already started to fade out the role of MLF (medium lending facilities) as the policy rate.

2. **Upgrading the "corridor system".** The PBoC attempts to narrow the "corridor" of interest rate by defining its new upper bound and lower bound. In so doing, the PBoC confines the 7-day reverse repo rate within a desirable and narrower range.

3. **Developing new monetary policy tools:** (i) allowing the PBoC to directly buy and sell in the secondary market as a new base money supply channel; (ii) Open market operaions Buyout Reverse Repo; (iii)creating swap facilities with securities, mutual funds and insurance companies, to support these institutions to use qualified collaterals in their hands in exchange for high liquidity assets from the PBoC, such as

treasury bonds and central bank bills; and (iv) Re-lending facilities for qualified large shareholders to repurchase the shares of listed firms.

Promoting 7-day reverse repo as the new policy rate

China's policy rate setting has been gradually evolved in the past decades amid several rounds of interest rate liberalization reforms. Interest rate liberalization used to be an essential part of China's price reforms, which were at the heart of the country's transition from a planned to a market economy in the financial industry.

China's current interest rate system is complex, which can be grouped into four categories:

(i) Interest rates for central bank operations, including: (a) lending rates of refinance facilities, such as central bank relending rates, rediscount rates and Standing Lending Facility (SLF) rate; (b) deposit rates for required reserves and excess reserves; (c) open market operation (OMO) rates, including central bank repo rates, central bank bill rates etc.

(ii) Interest rates of commercial banking products, particularly lending rates and deposit rates.

(iii) Interest rates in the money market and bond market. The former include China Interbank Offered Rates (CHIBORs) which was introduced as the average transaction price in the unified trading platform in Shanghai in 1996 to enhance the surveillance on interbank lending activity, and Shanghai Interbank Offered Rates (SHIBORs) which is simple averages for different tenors of interest rates quoted by 16 eligible banks in the Shanghai money market to enhance the efficiency of price discovery in the interbank market, introduced in January 2007.

(iv) Interest rates in other financial markets, such as interest rates in the shadow banking sector.

In 1990s, starting from 1993, the concentration of the interest rate liberalization reform was to liberalize interbank rate, bond market repo rate, rediscount rate, etc. In 2000s, the focus changed to expand the ceiling and floor for deposit rate and lending rate. During this time, the PBoC has expanded the deposit and lending rate bands for quite a number of times.

At the end of 2000s, the evolvement of interest rate liberalization eventually formed a typical "dual track" interest rate system. "Dual track" means that ceilings imposed by PBoC on deposit rates in the banking system are a notable binding constraint on the freedom of price discovery in financial markets, while interest rates in the money and bond markets were market determined. However, the level and movement of the interests in money market and in bond market are constrained by regulated deposit rates, due to the dominance of the banking sector in overall financial intermediation.

Finally, on July 20, 2013, the PBoC formally dropped the control of lending rate and in 2015, the PBoC eventually liberalized the deposit rate ceiling, indicating the completion of deposit rate and lending rate liberalization. After that, the PBoC started to introduce the interest rate "corridor system" and promote Medium-term facility rate (MLF) and one-year lending rate (which is equivalent to MLF plus some adding points) as the new policy rate. (see our previous economic watch: China Economic Watch: Looking for new monetary policy tools in the liberalized-interest-rate environment; and China Economic Watch: China | LPR: China's market-based "policy" rate)

In this round of policy rate reform, the purpose of promoting 7-day reverse repo as the new policy rate to replace previously used MLF rate (medium-term lending facilities) is to further promote interest rate marketization and liberalization, through making the central bank only control and influence the short-term policy rate and let the market to decide the medium to long term market rates, which is similar to the interest rate determination mechanism as of in the advanced economies.

That means, instead of controlling the comparatively longer-term rate (such as one-year MLF or one-year LPR), the PBoC in the future only control the short-term rate (7-day reverse repo rate) and to gradually downplay the policy rate role of MLF at the same time, thus letting the market to determine the longer-term rates.

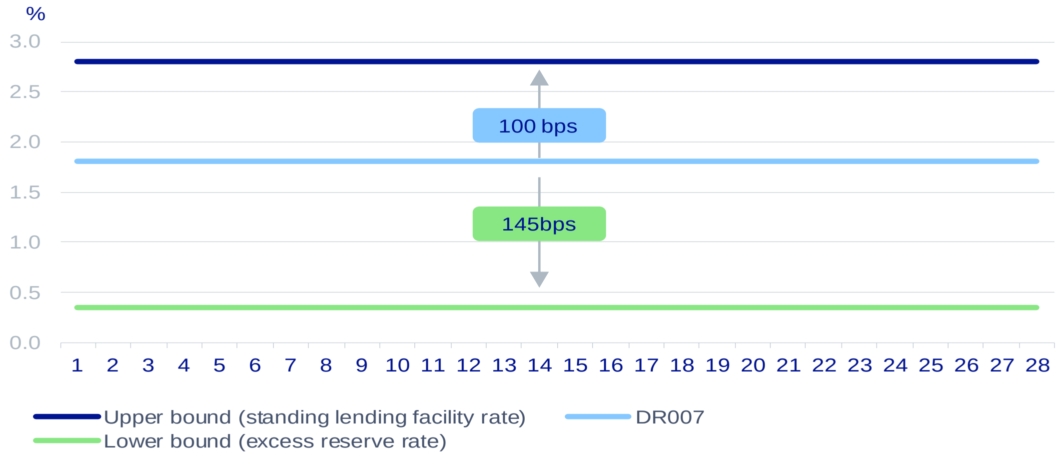
Upgrading the "corridor" system

In our previous Economic Watch China Economic Watch: Looking for new monetary policy tools in the liberalized-interest-rate environment , we introduced the newly established "corridor system back to 2016.

At that time, the PBoC has explicitly indicated to use Standing Lending Facility (SLF) rate and Medium-term Lending Facility (MLF) as the upper bound of the corridor, and the excessive reserve interest rate as the lower bound rate. Inside the "corridor", the pledged 7-day Repo rate (DR007) was actively traded in the interbank market but with much lower volatility than SHIBOR, another potential candidate for the policy rate at that time. (Figure 1 describes the original version of the corridor system back to 2016)

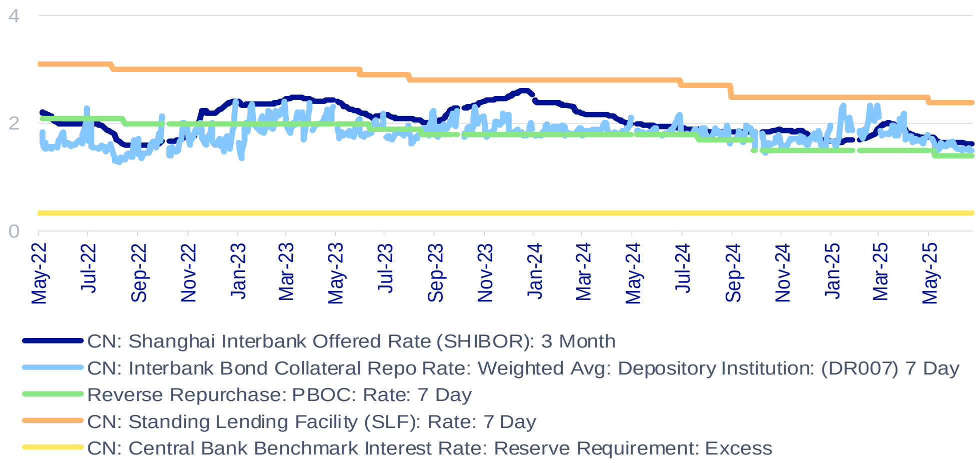
However, this original version of "corridor system" has some shortcomings, chief among them is that the upper bound and the lower bound have been too wide which cannot accurately confine the policy rate. For instance, for a long period of time, the upper bound (SLF) and the lower bound (excess reserve rate) difference has reached 245 bps, which is too wide compared with the "corridor" range in the advanced economies which is normally 25-50 bps. In addition, the distance between DR007 and the upper bound is 100 bps, between DR007 and the lower bound is 145 bps, which means the original version of the "corridor system" is asymmetric. Altogether, the wide "corridor" gives the market very weak signal of where the policy rate will go, thus, significantly weakening monetary policy transformation mechanism and market communications.

Figure 1: The original version of the "corridor system" (since 2023 August 15)



Source: CEIC and BBVA Research

Figure 2: The current "corridor system"



Source: CEIC and BBVA Research

In addition to the width of the "corridor", there are also some other issues of the current version of "corridor" system that need to be carefully evaluated: (i) The upper bound (SLF rate) has not played an effective role as the "upper bound" to confine the policy rate, because financial institutions would rather take a higher interbank offered rate instead of applying for SLF, because the procedure for SLF application is complicated and time consuming. (ii) The scale of SLF is very small, and its effect is thus very limited. (iii) The lower bound (excess reserve rate) also did not play an effective role to confine the policy rate, because the DR007 has never touch the excess reserve rate, but instead, closer to the upper bound with the asymmetric characteristic stated above.

Thus, narrowing the "corridor" becomes the new direction of updating the monetary policy framework.

In order to solve this issue, the PBoC introduced overnight repo and reverse repo rate on top of the existed 7-day reverse repo. The PBoC announced this new open market operation tool on July 8 2024, which helps the central bank improve liquidity management and better guide market interest rates. This new monetary policy tool helps supply base money when there is a liquidity shortage and withdraw liquidity when there is an excess, helping to stabilize fluctuations in the money market.

The operations, with a term of overnight, will be conducted from 4 pm to 4:20 pm on working days as needed, in addition to its traditional morning operations of 7-day reverse repos operations. The interest rates of the temporary repos and reverse repos will be 20 basis points below and 50 basis points above the seven-day reverse repos operations, or 1.6 percent and 2.3 percent, respectively.

Under this circumstance, many market participants believe that the overnight repo and reverse repo will implicitly become the de facto upper and lower bound of the 7-day reverse repo which is the new policy rate. This indicates that the width of the interest rate corridor will be significantly narrowed from 245 basis points to 70 basis points, which will help reduce the volatility of short-term market interest rates and more clearly convey the central bank's monetary policy signals. Although this market belief is not recognized by the PBoC, at least, it provides a direction of narrowing the "corridor" bounds.

Introducing new monetary policy tools

The recently established monetary policy tools to be included in the PBoC's toolbox include the following four, not only including aggregate monetary policy tools but also structural tools:

(i) allowing the PBoC to directly buy and sell in the secondary market as a new base money supply channel; (ii) Open market operaions Buyout Reverse Repo; (iii)creating swap facilities with securities, mutual funds and insurance companies, to support these institutions to use qualified collaterals in their hands in exchange for high liquidity assets from the PBoC, such as treasury bonds and central bank bills; and (iv) Re-lending facilities for qualified large shareholders to repurchase the shares of listed firms.

(i) Treasury bond buy and sell in the secondary market

In August 2024, the PBoC started to buy and sell treasury bond in the secondary market amid open market operations, indicating that the central bank is allowed to use treasury bond buy and sell as the monetary policy tool as a way to inject base money into the market and to conduct the liquidity management. It should be deemed as an additional monetary policy tool to supplement the central bank's toolbox in China.

Started from August 2024, the PBoC conducted the treasury bond buy and sell in the secondary market in a monthly basis from August 2024 to December 2024, with the net bond purchase ranging from RMB 100 billion to RMB 300 billion. However, they stopped this operation from January 2025, given that China's long-term bond yield in the market became extremely low due to the pessimistic expectation of long-term growth. (Figure 3)

Compared with the existed monetary policy tools, the advantage of buying and selling treasury bond in the secondary market is to improve the efficiency of monetary policy transmission mechanism. On top of OMO and MLF etc., treasury bond buy and sell should be a good supplement to help the central bank not only to adjust base money supply but also to influence short-term, medium-term and long-term bond yield as well as the yield curve.

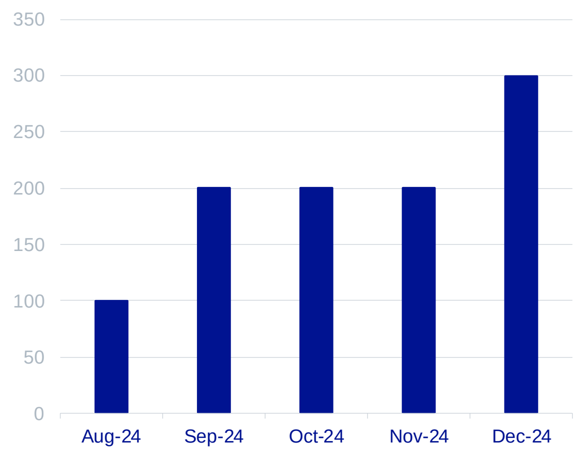
Allowing the central bank to buy and sell treasury bond in the secondary market bear a resemblance to Quantitative Easing (QE) which were widely adpoted in advanced countries in the aftermath of 2008-2009 global financial crisis. The difference is that the PBoC starts to buy treasure bonds even before the zero-bound of policy interest rate is hit. For the moment, it should be deemed as a conventional monetary policy tool of liquidity management in the market given that it also permits the PBoC's to sell treasure bonds in the market. However, the introduction of this policy tool has paved the way for the PBoC to substantially expand its balance sheet (through massive purchase of treasury bonds) so as to stimulate the economy. In that sense, this new policy tool has the potential to become the percusor of "the Quantatitative Easing (QE) with Chinese Characteristics". More importantly, it could take place when the policy rate still remains positive.

(ii) Securities,Funds and Insurance companies Swap Facility (SFISF)

Since October 2024, the PBoC also created swap facilities with securities, mutual funds and insurance companies, to support these institutions to use their bond, stock ETF and CSI 300 stocks etc. as the collateral to exchange for high liquidity assets with the PBoC, such as treasury bond and central bank bills.

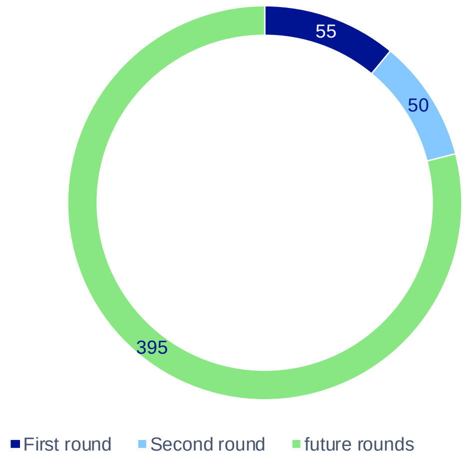
The market believes that China's SFISF is very similar to the US FED's Term Securities Lending Facility (TSLF) which allows the primary dealers to use their low liquidity securities as a pledge to exchange with the FED for high liquidity treasury bonds in a bid to support financial markets. The initial quota for SFISF is set at RMB 500 billion. The scale of the first round operation SFISF was RMB 55 billion in October 2024 and the second round was RMB 50 billion in January 2025. (Figure 4)

Figure 3 TREASURY BOND NET BUY&SELL IN SECONDARY MARKET



Source: BBVA Research and CEIC

Figure 4. THE CONDUCT OF FINANCIAL INSTITUTIONS SWAP FACILITIES



Source: BBVA Research and CEIC

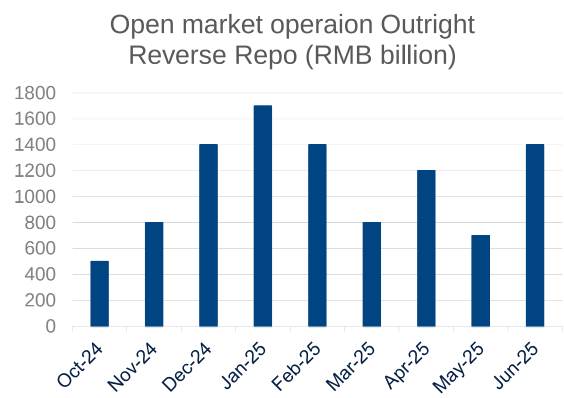
(iii) Open market operaions Outright Reverse Repo.

Outright reverse repo operation is a tool the central bank introduced on October 28, 2024 to manage liquidity in the banking system. They are carried out once each month with a tenor of no more than a year.

The scale of Outright Reverse Repo looks much larger than the other new monetary policy tools and has been conducted in a continuous manner. For instance, from October 2024 to June 2025, the PBoC has conducted the Outright Reverse Repo for 9 months, with the scale ranging from RMB 500 billion to RMB 1,700 billion. (Figure 5)

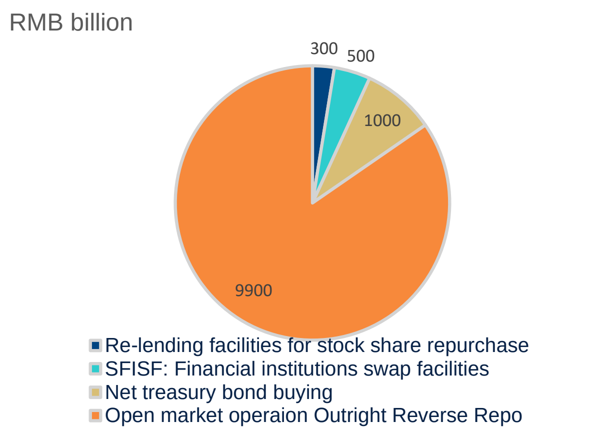
The move is expected to ensure sufficient liquidity in the banking system, keep fluctuations in money markets under control and anchor market expectations. That means, the stepped-up medium-term liquidity injections signal a broader use of quantitative tools to bolster growth.

Figure 5. OUTRIGHT REVERSE REPO CONDUCT



Source: BBVA Research and CEIC

Figure 6. THE COMPARISON OF THE INITIAL SCALE (OR USED SCALE) OF NEW MONETAYR POLICY TOOLS



Source: BBVA Research and CEIC

(iv) Re-lending facilities for stock share repurchase and increase in shareholding for high-quality listed firms.

In order to establish a long-term mechanism to enhance the inherent stability of the capital market, to further maintain the stable operation of the capital market, and boosting market confidence, the People's Bank of China establishes a re-lending program for share repurchase and increase in shareholding, aiming to direct financial institutions to provide loans to listed companies and their principal shareholders. This also belongs to the structural monetary policy tools.

Loan funds shall be used for designated purposes and operated in a closed-loop manner, support share repurchase and increase in the holding of shares of listed companies respectively, and propel listed companies to proactively use tools such as share repurchase and increase in shareholding for market value management.

The scale of the relending facilities for stock share repurchase is RMB 300 billion. And we also provide the comparison of the initial scale (or the already used scale) for the four new monetary policy tools in Figure 6.

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