Topic 2 Monetary Policy Transition in China

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Monetary Policy Transmission in basic textbooks

The interest rate channel:
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The credit channel

Other transmission channels

Monetary policy strategy

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Textbook theories

IS-LM-AS framework
The interest rate channel: Money supply changes affect the interest rate, which affect investment and aggregate demand
Money market transactions affect the short-term interest rate, but in many cases, short-term and long-term rates move in the same direction
Monetary Policy Transmission in basic textbooks I

- IS-LM-AS framework
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- IS-LM-AS framework
- The interest rate channel: Money supply changes affect the interest rate, which affect investment and aggregate demand
- Money market transactions affect the short-term interest rate, but in many cases, short-term and long-term rates move in the same direction
Monetary Policy Transmission in basic textbooks II

Central banks determined the monetary base
The aggregate money supply is determined by the monetary base times a multiplier
Money Creation
Central banks determined the monetary base
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The aggregate money supply is determined by the monetary base times a multiplier
Monetary Policy Transmission in basic textbooks II

- Central banks determined the monetary base
- The aggregate money supply is determined by the monetary base times a multiplier
- Money Creation
The Term Structure of Interest Rates: the Expectation Theory

Bonds of different maturities are perfect substitutes. That means the expected return of holding both bonds for two years should be the same. The interest rate on a long-term bond is equal to the average of the expected short-term rates over the life time of the long-term bond.

Example: current 1-year bond rate is 5%, the market participants expect it to be 3% next year, then the current 2-year bond rate is 4%.
The Term Structure of Interest Rates: the Expectation Theory

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The Term Structure of Interest Rates: Segmented Market

Bonds of different maturities are not substitutes
People prefer short-term bonds—the yield curve is upward
Bonds of different maturities are not substitutes
The Term Structure of Interest Rates: Segmented Market

- Bonds of different maturities are not substitutes
- People prefer short-term bonds—the yield curve is upward sloping
The Term Structure of Interest Rates: the Liquidity Premium Theory
Bonds of different maturities are substitutes but not perfect
The Term Structure of Interest Rates: the Liquidity Premium Theory

- Bonds of different maturities are substitutes but not perfect
- Long-term bond rate = average short-term bond rates + a liquidity premium
The Term Structure of Interest Rates: the Liquidity Premium Theory

- Bonds of different maturities are substitutes but not perfect
- Long-term bond rate = average short-term bond rates + a liquidity premium
- What if the yield curve is downward sloping?
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The Interest Rate Channel in Developed Economies

Central banks do not change interest rates by changing the money supply. No relationship between monetary base and the level of short-term interest rates in the U.S., Euro-area, Japan. Modern central banks set the overnight interest rates by managing people's expectations.
Central banks do not change interest rates by changing the money supply.
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The Interest Rate Channel in China

RMB denominated loan and deposit rates are regulated by the PBC. The benchmark deposit and loan rates are set by PBC. Deposit rates can be 1.1 times of the benchmark rate, loan rates can be 0.8 times of the benchmark rate. Current (as of June 8, 2012) benchmark demand deposit rate is 0.40%, three-month deposit rate is 2.85%. Benchmark five-year-and-beyond loan rate is 6.80% (other benchmark rates are available from the PBC's website).
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Interest Rate Deregulation

Reasons for regulation

Perfect competition is not efficient for the banking sector

Too much competition in banking sector can cause instability

But the efficiency loss from a regulation can be larger—no competition can be worse

Competition may also enhance financial stability
Interest Rate Deregulation

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Process of Interest Rate Deregulation: Inter-Bank Borrowing and Bond

June, 1, 1996, upper-limit of the inter-bank rate was abandoned.

1996, interest rates of government bond traded in exchanges were determined by auction.

June, 5, 1997, on the inter-bank market repo rates were liberalized but haircut/margin is determined by PBC.

Interest rate of bond issued by policy lender was liberalized in 1998.

1999, the fiscal department sold bond in the inter-bank market with auctioned interest rate.
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Process of Interest Rate Deregulation: Foreign Currency Loan and Deposit

Sept. 2000, foreign currency denominated (FCD) loan rate was liberalized, so was the interest rate for FCD deposit larger than 3 million.

2003, lower limit of small-size FCD deposit was abandoned and number of regulated currency deposit was reduced to 4 (Euro, USD, HKD, JPN Yen).

2004, rate of FCD deposit with maturity more than 1 year was liberalized.
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Process of Interest Rate Deregulation: RMB Loan Rates

The band on RMB rates varied several times before 2003. In 2003, in some areas, loan rates of rural credit cooperatives can be 2 times the benchmark loan rates and in 2004, this policy spreads to the whole country. Jan, 2004, loan rates of urban credit cooperatives and commercial banks can be 1.7 times the benchmark rates. Oct, 2004, the upper limit on loan rates (except the cooperatives) are abandoned.
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Sequence of the Reform

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Monetary policy strategy

Sequence of the Reform

Loan rate first then the deposit rate, why?

Competition between banks starts from deposit rate—stability and monopoly concern

But when demand for fund is high, screening tech and monitoring tech is low, and there is agency problem inside the bank, freely set loan rate can be bad

What really matters: banks have the right incentive and right techniques
Sequence of the Reform

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Monetary Policy Transmission: Credit Channel

Bank lending channel: liquidity in interbank market—loan supply—investment

Balance sheet channel (the financial accelerator): collateral value/net worth of firms—size of loan/borrowing cost—investment

China: PBC has more direct influence on loans through "Window Guidance"

It is more powerful but government replaces market in making decision, does it always have enough and correct information?

Financial disintermediation
Monetary Policy Transmission: Credit Channel

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Monetary Policy Transmission: Risk Taking Channel

Interest rate and credit availability can not only affect investment but also speculation. When incentive is not right, it also finances to bad projects, short-termism, or corruption of loan officers.
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Monetary Policy Transmission: Risk Taking Channel

- Interest rate and credit availability can not only affect investment but also speculation.
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Monetary Policy Transmission: Exchange Rate

Currently China's exchange regime is still not flexible enough. How flexible should it be? Consequences?
Currently China’s exchange regime is still not flexible enough
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How flexible should it be?

Consequences?
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Rule vs. Discretion

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Monetary policy strategy

With discretionary monetary policy, the central bank always has an inflation bias. Because they would want to have a higher than potential output level. Set a rule for the monetary authority can avoid this.
Rule vs. Discretion

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The inflation bias

Source: Carlin and Soskice (2005)
Policy Strategy

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Policy Strategy

Two nominal targets: monetary target/exchange rate target

International practice

Taylor rule: the USA?

Inflation targeting: UK, Sweden, New Zealand etc

Price-level-Path targeting: Canada (officially it is an inflation targeting country)

Euro-area: two-pillars
Policy Strategy

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Inflation Targeting

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Inflation Targeting

A commitment: quantitative target, a number or a band

Transparency and accountability

Forecastability of the target

Why abandon monetary targeting?

Gerald Bouey “We didn’t abandon monetary aggregates, they abandoned us.”

China’s problem: a precise measure of inflation and its forecastability?
A commitment: quantitative target, a number or a band
Inflation Targeting

- A commitment: quantitative target, a number or a band
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- Gerald Bouey "We didn’t abandon monetary aggregates, they abandoned us."
- China’s problem: a precise measure of inflation and its forecastability?
Price-level-Path Targeting (PLPT)

Initial price level + targeted inflation rate

Inflation targeting: foregones are foregones

Price-level-Path targeting: you have to revise inflation if price-level is not on target

People update price information with a lag, which can generate distortion. With price level targeting, this problem can be mitigated

PLPT is stabilizing: if inflation suddenly rises, price will not be on target, then the central bank will lower the inflation target and people knows it
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Asset Price Movements
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- Classical view: asset prices are irrelevant for monetary policy except when they can forecast and affect inflation
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- New trend: macro-prudential policies