New normal, new tools

China’s monetary policy is in a state of transition. The People’s Bank of China (PBOC) last cut benchmark rates in October 2015, and the last change in the reserve requirement ratio (RRR) was in March this year. Despite sustained outflow pressure and policymakers’ insistence that growth faces "big" downward pressure, the PBOC has been on hold. The PBOC’s reluctance to use its traditional tools reflects how its policy options are changing as it creates a new monetary policy framework. But, perhaps more importantly, it also reflects the partial melding of fiscal and monetary policy in China. **The PBOC’s actions reflect its new set of goals; instead of merely driving rates lower, it is now attempting to keep rates steady at their low levels and stimulate the economy through direct lending to policy banks that ensure the money is used for investment projects**. It also reflects the turmoil China experienced last year and the beginning of this year; outflow pressures and a bubbly housing market makes an RRR or benchmark cut more risky. The PBOC has said it does not want interbank rates to fall too much as it makes it cheaper to short the renminbi, additionally concerns of a housing bubble and speculative activity across a range of markets have weighed on policymakers’ decision to refrain from rate cuts.

According to media reports, the PBoC has already injected RMB 3.4trn of funding into three policy banks (China Development Bank, the Export and Import Bank of China, and the Agricultural Bank of China) and roughly RMB 2trn out of that amount will be used for policy lending. These injections year-to-date nearly equal the total amount of policy bank lending in 2015. **Re-lending through policy banks ensures the money is spent on investment projects and more closely resembles quasi-fiscal policy**. Despite significant rate cuts over 2014/2015, the easing failed to significantly stimulate growth, partly because loan demand has fallen to historic lows (see Chart 10) but also because commercially-oriented banks are more reluctant to lend. Alternative policy tools such as policy bank capital injections overcome these issues by guaranteeing the money is lent and spent, and it does this without cutting rates and sparking RMB outflows.

Another part of the PBOC’s revamped monetary policy framework is creating a new interest rates corridor. With lending and deposit rates officially deregulated, the PBOC is relying on reverse repos and lending facilities to manage liquidity and set domestic rates. This is evident both in the gross amount of injected funds (see Chart 11) and in the fact that, despite net capital outflows in Q2 and Q3 of nearly US $130bn, the PBOC has refrained from cutting the RRR to release more liquidity despite the fact that 50bps of RRR cuts could have been warranted. The heavy use of open market operations and lending facilities has doubled the PBOC’s claims on banks from end-2015 to RMB5.6trn, with these claims now substantially exceeding banks’ excess reserves held at the PBOC. **The emerging monetary policy framework will likely force revisions to most forecasts, which called for further substantial cuts to both the benchmark rates and RRR**. The success of its open market operations and lending facilities in maintaining ample liquidity and stimulating growth suggest we may see less rate cuts than previously expected.