Developing a Modern Monetary Policy Framework

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Abstract: A modern central banking system is built on a sound modern monetary policy framework, which is essential for driving high-quality development, modernizing the national governance system and capacities, and enhancing international macroeconomic policy coordination. As the modern monetary policy framework consists of optimized monetary policy goals, innovative monetary policy tools, and smooth monetary policy transmission mechanisms, the central bank needs to innovate monetary policy tools, ensure unimpeded policy transmission, achieve monetary policy goals, and integrate these three respects into an organic whole. Specifically, the PBC needs to improve the modern monetary policy framework, design effective cross-cyclical policies, maintain a normal monetary policy, keep the growth of money supply and aggregate financing to the real economy (AFRE) basically in line with nominal economic growth, and build institutional mechanisms enabling effective financial support for the real economy, so that the country can take a solid first step toward the new development paradigm and open a new chapter.

Keywords: monetary policy framework, new development paradigm, cross-cyclical policy design

It was proposed at the Fifth Plenary Session of the 19th CPC Central Committee "to establish a modern central banking system". To achieve this goal, we need to build a modern monetary policy framework that can support high-quality economic development and facilitate China's transition to the new development paradigm with the domestic circulation as the mainstay and domestic and international circulations reinforcing each other.

1. The significance of a modern monetary policy framework

Since 1984 when it began to function exclusively as the central bank, the PBC has been, under the leadership of the CPC Central Committee and the State Council, improving China's monetary policy framework as appropriate for the economic and financial development. Monetary policy has been a priority for the CPC Central Committee with Comrade Xi Jinping at the core ever since the 18th CPC National Congress. As Xi stressed, "All our efforts will be in vain if we can't manage our money." This statement underscores the significance of the central bank's money management to the overall economic development. In consideration of China's new development stage, philosophies, and paradigm, the Fifth Plenary Session of the 19th CPC Central Committee made strategic plans for building a modern central banking system, which makes the development of a modern monetary policy framework imperative.

Developing a modern monetary policy framework is an intrinsic demand of high-quality development. The key to China's transition to high-quality development is to shape and create new demand through innovation and high-quality supply. In this context, the modern monetary policy framework should provide strategic support, under which there should be neither indiscriminate stimulus as it would lead to structural distortions, asset bubbles, high inflation and currency depreciation, nor credit squeeze, which would trigger risks. It should help maintain a reasonable amount of money supply, introduce incentive-compatible mechanisms to guide banks' money creation activity, and thus support high-quality economic development and ensure that China's modernization progress advances smoothly.

Developing a modern monetary policy framework is a major task in modernizing the national governance system and capacities. A modern central banking system is the aggregate of the modern monetary policy framework, the financial infrastructure service system, the system for controlling systemic financial risks, and the governance mechanisms for international financial coordination and cooperation. Notably, the modern monetary policy framework is an essential component of the modern central banking system. In the modern credit money system, banks create deposits through asset expansionary activities such as lending, hence they are the direct creators of money; the monetary policy framework is a means by which the central bank influences money creation by banks and is therefore a major institutional mechanism for managing money. The PBC has achieved milestone progress in conducting monetary policy operations within the institutional framework and improving the monetary policy framework. However, there is still room for improvement in anchoring monetary aggregates and in developing long-term mechanisms for liquidity, capital, and interest rate constraints on money creation by banks. This requires a modern monetary policy framework consistent with the modernization of the national governance system and capacities.

Developing a modern monetary policy framework is necessary for enhancing international macroeconomic policy coordination. "Strengthening international macroeconomic policy coordination" was one of the objectives proposed at the Fifth Plenary Session of the 19th CPC Central Committee. Following the 2008 global financial crisis, the central banks of major developed economies introduced unconventional monetary policies such as zero or negative interest rate, as well as quantitative easing measures including the large-scale purchase of government bonds and other assets. These macro policies have more spillover effects. China as a major economy naturally has strong monetary policy spillovers. Accordingly, amid this once-in-a-century upheaval, we need to strengthen the coordination of international macroeconomic policies, take advantage of the positive spillover effects from abroad while preventing the negative effects, and make use of our own spillover effects to gain strategic initiative. All this hinges on a modern monetary policy framework that should be developed in a faster pace.

2. Implications of a modern monetary policy framework

A modern monetary policy framework consists of optimized monetary policy goals, innovative monetary policy tools, and effective monetary policy transmission mechanisms. To build it, the central bank needs to develop a new suite of monetary policy tools, make continued efforts to ensure unimpeded policy transmission, achieve monetary policy goals, and integrate these three respects into an organic whole.

2.1 Optimizing the system of monetary policy goals

2.1.1 Adhering to the ultimate objective of monetary stability

Prioritizing monetary stability and putting greater emphasis on employment. The *Law on the People's Bank of China* charges the PBC to "maintain the stability of the value of the currency and thereby promote economic growth." This means, first, that the PBC should keep the value of currency stable, in terms of both the domestic prices and the RMB exchange rate, the latter of which should be basically stable at an adaptive and equilibrium level to provide a conducive monetary and financial environment for economic development. Second, it means that PBC policies should serve the real economy, one aspect of which is employment. Accordingly, the PBC should take a systematic, holistic, and forward-looking view and make strategic and coordinated plans to dynamically balance its various objectives.

2.1.2 Improving how intermediate targets are anchored

The intermediate targets for monetary policy should be set such that the growth of broad money supply (M2) and aggregate financing is basically aligned with nominal economic growth. In the past decades of high-speed development, China's economy had a high potential growth rate and the actual growth rate also tended to stay close to that figure, making it viable to pre-establish a target growth rate for M2 and aggregate financing or to estimate it based on the preceding year's actual value. However, as China enters the stage of high-quality development and the growth potential trends downward, continuing to set the target growth rate based on preceding-year figures as before can cause money and credit to deviate from the economic reality, creating an excessively loose monetary environment and destabilizing the macro leverage ratio. Therefore, in this new development stage, it is necessary to optimize how the intermediate targets for monetary policy are anchored so that the growth of M2 and aggregate financing is basically aligned with nominal economic growth, and to treat this objective as a major component of a modern monetary policy framework. This optimized anchoring approach will (i) facilitate cross-cyclical policy design to stabilize monetary aggregates across economic cycles and support high-quality development with an appropriate growth of money supply; (ii) provide a more rational anchoring point for the implementation of monetary policy, so as to narrow the gap between the M2 and aggregate financing growth and the nominal economic growth (which reflects the potential output) according to macroeconomic trends, thereby improving countercyclical adjustment; and (iii) strike a long-term balance between stabilizing growth and controlling risks to ensure that the growth of money supply and aggregate financing is mostly in line with debt growth. This anchoring approach essentially embeds the mechanisms for stabilizing the macro leverage ratio into the intermediate targets for monetary policy.

There are three things to note when putting this anchoring approach for intermediate targets into practice. First, "basically align" does not mean "completely equal." M2 and aggregate financing may grow at a slightly slower or faster pace than the nominal economic growth, depending on the economic situation and the needs of macroeconomic governance, thus reflecting countercyclical adjustments. **Second, the nominal economic growth, potential output, and economic growth targets should be considered as a whole.** In the stage of high-quality development, actual economic growth is mostly consistent with the nominal economic growth which reflects the potential output. However, a severe economic shock may cause the two to diverge, in which case the monetary policy should try steering the economic growth back to its potential level in reference of the nominal growth rate. Economic growth targets should also be taken into account in practice. **Third, "basically align" is a medium to long-term goal rather than a short-term target.** In practice, basic alignment should be measured on a yearly basis, rather than quarterly or monthly, to ensure the continuity, stability, and sustainability of monetary policy.

In recent years, the PBC has achieved basic alignment of the average growth rate of M2 and aggregate financing with the nominal economic growth rate, and the two were mostly equal in 2018–2019. The 2019 Central Economic Work Conference put forward that money, credit, and aggregate financing should grow at a pace commensurate with the economic development. The target growth rate for M2 and aggregate financing was raised significantly in 2020 compared with the year before in response to the COVID-19. But as the economy recovers, the 2020 Central Economic Work Conference reverted to keeping the growth of money supply and aggregate financing basically aligned with nominal economic growth, indicating that the intermediate targets for monetary policy in China are taking shape. As China transitions to the stage of high-quality development, which is more innovation-driven than before, the growth of money needed in the development of the real economy tends to be increasingly congruous with the nominal growth rate. This is a principle that should be upheld.

2.1.3 Achieving operational targets with the central bank's policy rate system

Improving the central bank's policy rate system with the open market operations (OMO) rates serving as short-term policy rates and medium-term lending facility (MLF) rates as medium-term policy rates to achieve operational targets. Internationally, a central bank usually achieves its monetary policy operational targets in two ways. The first is to see market rates as the operational target and keep them close to the operational target through liquidity adjustments. The other is to treat the rates for monetary policy instruments as central bank policy rates as well as the operational target, thus essentially combining the two types of rates and the operational target as one. This latter approach proved to be advantageous in making monetary policy more effective and policy transmission more efficient, and it is becoming the mainstream in the wake of the 2008 global financial crisis. The PBC influences market rates through its policy rate system. The loan prime rate (LPR) is formed by adding some basis points (as determined by the market) to the MLF rate, and then banks would set their actual lending rates based on the LPR. This creates a market-based rate formation and transmission process that allows the PBC to regulate money supply and resource allocation, thereby achieving monetary policy goals.

2.2 Creating innovative monetary policy tools and improving the long-term mechanism for adjusting liquidity, capital, and interest rate constraints to influence money creation activities

Banks are a pillar of China's financial system and play a dominant role in the transmission of monetary policy. More recently, the PBC has been using the three external constraints of liquidity, capital, and interest rate to guide banks' money creation activities and to improve how money supply is managed. To this end, the PBC has been enriching its monetary policy toolkit, making macro-prudential assessment (MPA) more effective in providing incentives and constraints, providing forward-looking guidance for the money creation activities of banks, and keeping the growth of M2 and aggregate financing basically aligned with nominal economic growth. The PBC has also introduced incentive-compatible mechanisms, optimized its structural monetary policy tools, and dynamically adjusted its support priorities according to the needs in each stage of economic development, so as to promote economic sustainability and resilience.

First, the PBC has stabilized the aggregate money supply and optimized its structure so as to ease liquidity constraints. Under the required reserve system, banks need to set aside additional required reserves to meet the statutory requirements after creating deposits through asset expansion. In charge of the base money supply, the central bank can influence the money creation of banks through the "source." Since 2018, the PBC has lowered the required reserve ratio (RRR) ten times, releasing around RMB8 trillion of long-term liquidity. It has also flexibly conducted MLF and open market operations to keep liquidity at a reasonable and adequate level. In addition, the PBC linked the volume and price of liquidity with money creation of banks, designed incentive-compatible mechanisms, and innovated structural monetary policy tools including targeted RRR cuts, targeted medium-term lending facility (TMLF), central bank lending and central bank discounts. It enhanced targeted support for private enterprises, MSBs, and other key areas and weak links. In 2020, with a multi-level and multi-phase approach, the PBC rolled out RMB300 billion of central bank lending to help control the pandemic and ensure adequate supplies, RMB500 billion to support work and production resumption, and another RMB1 trillion of inclusive central bank lending and discounts. Furthermore, the PBC introduced two instruments directly benefiting the real economy, namely a support instrument to defer the repayments of inclusive loans to MSBs, and a support scheme for unsecured inclusive loans to MSBs. These measures contributed to the coordination of pandemic containment and economic and social development.

Second, the PBC has adopted perpetual bonds as a breakthrough to encourage banks to replenish capital through diversified channels so as to ease capital constraints. Bank capital is a vital linkage between the financial system and the real economy. In 2018, inadequate capital put a strong constraint on banks' lending activities and reduced their capacity to respond to risks and to support the real economy through money creation. To address this issue, the PBC matched the maturity of perpetual bonds to the bank's registered duration, which resolved apparent conflicts between legal and regulatory rules under the current legal, regulatory and accounting frameworks. The PBC created central bank bill swaps (CBS) to shore up liquidity and stabilize bank expectations. As of the end of 2020, banks in China had issued over RMB1.2 trillion of perpetual bonds, which vigorously supported loan issuance to serve the real economy. Moreover, based on bank classifications, the PBC tailored policy measures with particular attention given to helping small and medium-sized banks replenish capital.

Third, the PBC has facilitated a marked decline in the overall financing costs for enterprises so as to ease interest rate constraints. Banks create deposits through loans, and loan demands are needed in this process, which are not only affected by the condition of the real economy, but also constrained by loan rates to a great extent. Since Q4 2018, the PBC has guided a 0.35 percentage point reduction in MLF rates and OMO rates accumulatively, and successively lowered the standing lending facility (SLF) rates, central bank lending rates and central bank discount rates, driving an across-the-board reduction in market rates as well as loan rates and supporting a reasonable growth of loan demands. Loan rate for enterprises recorded 4.62 percent in November 2020, a decrease of 0.50 percentage points from December 2019 and the lowest since record tracking started in 2015. In 2020, the PBC urged financial institutions to lower interest rates, reduce fees, and defer repayments of loan principal and interest, which waived a total of RMB1.5 trillion of profits in favor of the real economy without undermining the business sustainability of those institutions.

2.3 Leveraging reforms to improve the transmission of monetary policy

Advancing market-oriented interest rate reform to smooth the transmission of monetary policy and to remove the implicit floor of interest rates. Targeting the key bottleneck in the market-based transmission of interest rates, the PBC reformed and improved the formation mechanism for LPR in August 2019. Financial institutions have adopted the LPR as their main reference in pricing new loans since the beginning of 2020. From March to August 2020, outstanding floating-rate loans completed the switch of the pricing benchmark according to market-oriented and law-based principles. These developments contributed to the incorporation of LPR into the funds transfer pricing (FTP) frameworks of banks, which cleared away the implicit floor of loan rates and guided banks to allocate more financial resources to MSBs and private firms. Thus, actual loan rates were lowered by means of market-oriented reforms. The PBC has been gradually developing market-based interest rate formation and transmission mechanisms which are adaptive to the demand of high-quality development. It improved the market-oriented transmission path for interest rate adjustments, featuring “MLF rate → LPR → loan rate”. In addition, it has continued to take the benchmark deposit rate as a “ballast” in China’s interest rate system, strengthened the self-regulation of deposit rate pricing, reduced innovative but non-conformant deposit products, and promoted healthy competition in the deposit market.

Steadily advancing market-oriented RMB exchange rate reform to break the implicit ceiling on exchange rates. In recent years, the PBC has been committed to ensuring that market forces play a decisive role in the formation of RMB exchange rates. By maintaining strategic focus, enhancing expectation guidance, and keeping a balance between internal and external equilibria, and with attention mainly focused on domestic conditions, the PBC has kept the RMB exchange rate basically stable at an adaptive and equilibrium level. Whether the USD/RMB exchange rate would go beyond 7 was a major topic of interest to market players and the public, who worried that a “yes” answer there would lead to expectations of further depreciation of RMB. In response, starting from end-2018, the PBC has issued central bank bills in Hong Kong as a regular mechanism, which contributes to optimizing the structure of the offshore RMB market and developing a long-lasting mechanism to stabilize expectations on offshore RMB exchange rate. In August 2019, with stable market expectations, market forces drove the USD/RMB exchange rate beyond the 7-yuan-per-dollar threshold for the first time, which then restored equilibrium and quickly came back down from 7. Thus, the flexibility of the RMB exchange rate was remarkably enhanced, which alleviated external constraints and strengthened the autonomy of China’s monetary policy. In 2020, the improving economic fundamentals strengthened the RMB against the USD with the annual average exchange rate on par with that of 2019. In the last two years, the annualized USD/RMB volatility rate exceeded 4 percent, generally at the same level as the other major currencies. It reflects that the RMB exchange rates serves as an “auto-stabilizer” for the macro economy and helps to promote a balance between the internal and external equilibrium.

3. Key measures to develop modern monetary policy framework

The 14th Five-Year Plan (for 2021–2025) covers the first five years after China completes the building of a moderately prosperous society in all respects and achieves its first Centenary Goal. Amid and riding on the momentum of this new stage of development, China will embark on its journey toward fully building a modern socialist country and the second Centenary Goal. This is of special importance for the modernization of China. In the 14th Five-Year Plan period, China is still in an important period of strategic opportunities, but those opportunities as well as challenges are also changing. While relishing in the fact that China’s economic fundamentals are promising in the long run, we should be wary of the complex environment created by the fast-evolving changes unseen in a century and the combination of conflicts, of the unbalanced or inadequate development within the country, and of the enormous challenges standing before the reform of key areas. Against this background, monetary policy, as one of the main policies of macroeconomic governance, must follow Xi Jinping’s Thought on Socialism with Chinese Characteristics for a New Era and the directives of the Fifth Plenary Session of the 19th CPC Central Committee and the Central Economic Work Conference. The PBC will, in line with the decisions of the CPC Central Committee and the State Council and based on rational decision-making and creative problem-solving, develop the modern monetary policy framework, maintain a normal monetary policy, design effective cross-cyclical policies, and improve the mechanisms for money supply management and for market-based interest rate formation and transmission, so that China can take a solid first step toward the new development model and welcome a new chapter of progress.

First, the PBC will enhance the mechanisms for money supply management. The sound monetary policy should be flexible, targeted, and appropriate, prioritizing monetary stability and putting greater emphasis on employment. For this purpose, the PBC will further improve the long-term mechanism for the central bank to adjust liquidity, capital, and interest rate constraints regarding banks' money creation, and keep the growth of money supply and AFRE basically in line with that of nominal economic growth. The intensity, pace, and priorities of policy responses will be flexibly adjusted according to the circumstances. It will avoid broad and indiscriminate stimulus measures, which could create an overheated economy and inflation, as well as credit squeeze, so as to adapt to the needs of economic and social development. In addition, the PBC will properly handle the relationship between economic recovery and risk prevention, and keep the macro leverage ratio basically stable.

Second, the PBC will build institutional mechanisms for the financial sector to effectively support the real economy, and optimize its structural monetary policy tools. The PBC will continue to focus efforts on banks, the direct money creators, and, by managing the debt instruments corresponding to its claims on banks, introduce incentive-compatible mechanisms and continuously improve the methods, channels, and instruments for the issuance of base money in order to keep liquidity at a reasonable and adequate level on the one hand and reinvent the system of structural monetary policy tools for targeted liquidity support on the other. Furthermore, the PBC will build institutional mechanisms for the financial sector to effectively support the real economy and encourage financial institutions to ramp up support for areas consistent with the new development philosophy—including financial support to technological innovation, MSBs, green development, and other priorities—to promote endogenous engines for growth. In addition, structural tools should coordinate and synergize with aggregate tools, with the duration of the former consistent with the context-sensitive objectives they serve so that they can soundly adjust and facilitate the exit from the emergency policies introduced in extraordinary times.

Third, the PBC will improve the market-based interest rate formation and transmission mechanisms. This entails enhancing its policy rate system, in which the OMOs rates act as short-term policy rates and MLF rates as medium-term policy rates, and the interest rate corridor; promoting the reform of money market benchmark rates; and steering the stable movement of market rates around the pivotal policy rates. Actions will also be taken to deepen the LPR reform, consolidate the progress made on lowering the actual loan rate, and advance the market-oriented reform of deposit rates, thus ensuring policy rate changes are transmitted more effectively to loan and deposit rates through various market rates and bringing into play the important role of market-based rates in the allocation of financial resources. The PBC will promote the function of self-regulatory mechanism for market rate pricing, regulate the conduct of deposit rate pricing, and reinforce the requirements that lending entities of all types give explicit indications of annualized loan rates, with a view to safeguarding the fairness of pricing, maintaining a level playing field in the market, and protecting the rights and interests of consumers.

Fourth, the PBC will advance the market-oriented RMB exchange rate reform and strike a balance between internal and external equilibrium. The PBC will improve the managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies, strengthen the flexibility of the RMB exchange rate, and explore the role of the exchange rate as an automatic stabilizer in adjusting macro economy and the balance of payments. Enterprises will be guided to be neutral in financial management and to manage exchange rate risks with foreign-exchange hedging instruments, while financial institutions will be guided to always be risk neutral and to provide exchange rate risk management services for import and export companies with authentic needs and consistent with risk neutral principles. The PBC will attach importance to guiding expectations and enhance macro-prudential management of cross-border capital flows in order to keep the RMB exchange rate basically stable at an adaptive and equilibrium level.

Fifth, the PBC will improve macroeconomic governance and promote optimized objectives, appropriate division of duties, and efficient synergy between monetary policy and other macroeconomic governance policies. The PBC will uphold the current relationship between central bank and fiscal “wallets” and their respective positioning, with appropriate division of duties and efficient synergy between the two. It will prevent monetization of fiscal deficit, and safeguard banks’ normal market-oriented function of money creation. In line with the strategic direction outlined in national development plans, the PBC will facilitate monetary and fiscal policies to work in close concert with policies on employment, industry, investment, consumption, environment protection, and regional policies. The PBC will also enhance international monetary policy coordination, improve its capacity to take part in international financial governance, and safeguard the stability of the global economy and financial markets.