

CHINA'S CENTRAL BANK AND MONETARY POLICY'S ROLE IN ITS ECONOMY

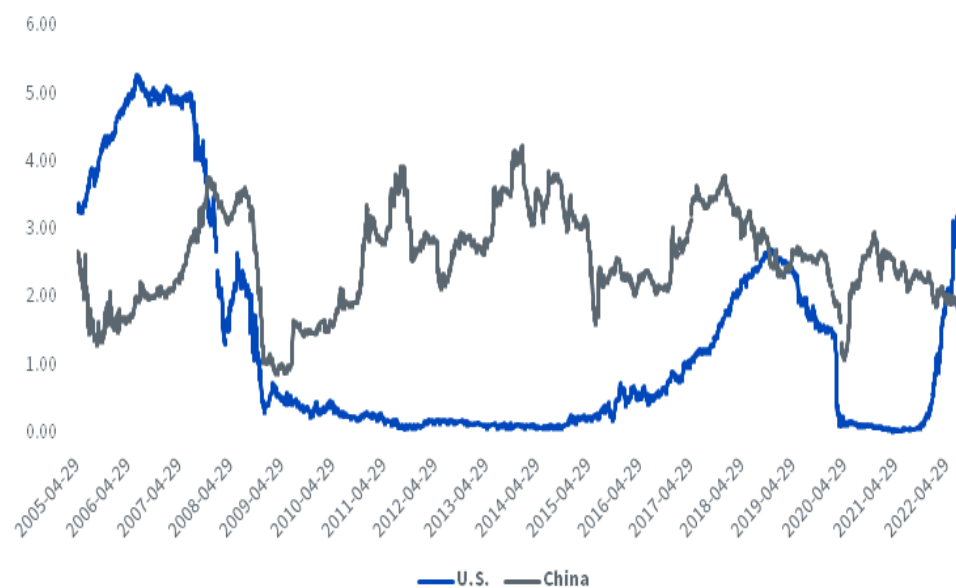
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In the grand scheme of geopolitics, only the [Federal Reserve](#) truly has an independent [monetary policy](#).

But among other [central banks](#), China's has a relatively high degree of freedom. As is standard among Chinese institutions, the [People's Bank of China \(PBOC\)](#) is a ministry of the government. Unlike the Fed, its monetary policy is always secondary in driving China's economy.

Currently, the U.S. and China are on opposite sides of the monetary cycle, with the [Fed tightening](#) and the PBOC easing.

U.S. and China on Different Cycles: 1-Yr Govt Treasury Yield



Source: Datayes.

Below is a framework for understanding how the PBOC functions and its current easing cycle.

1. The PBOC's monetary policy framework

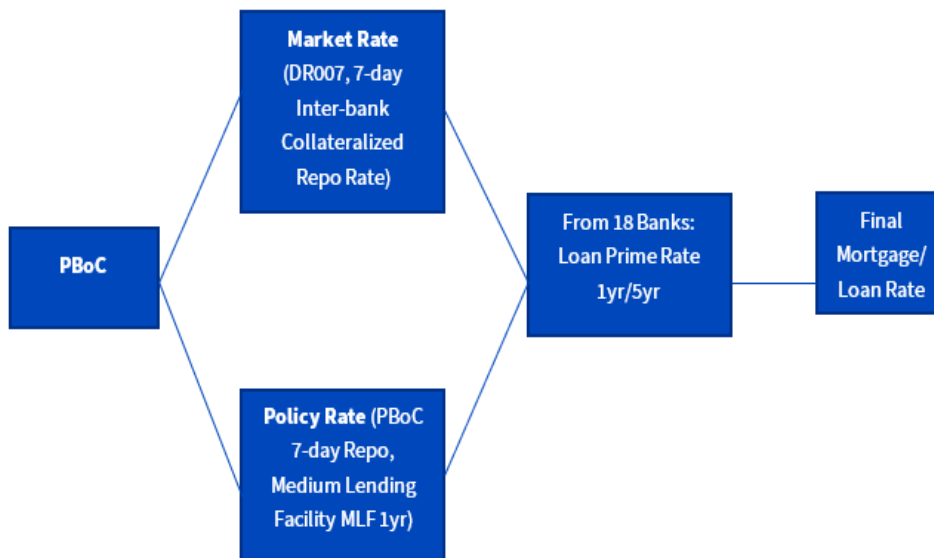
Among China's government ministries, the PBOC is quite professional. Like China's economy, the PBOC's monetary policy principle has evolved to be part market-driven, part discretionary-policy-driven. It also tells the public how it makes monetary policy through a quarterly report. There is a seven-day inter-bank collateralized [repo rate](#) (DR700) that's all market-based and a [medium-term lending facility \(MLF\)](#) rate that's policy-based.

From the market rate (DR007) and policy rate (MLF), it surveyed 18 banks' rates for [prim](#)

e loans, formulating a [loan prime rate](#). Most of these banks are state-owned, so the PBOC could offer guidance, though it tried to allow the market rate to dominate as much as possible. Based on the loan prime rate, the final mortgage and loan rates are decided by banks.

PBOC Current Monetary Policy Principal

Market Rate + PBOC Guidance → Loan Prime Rat (LPR) → Final Loan Rate



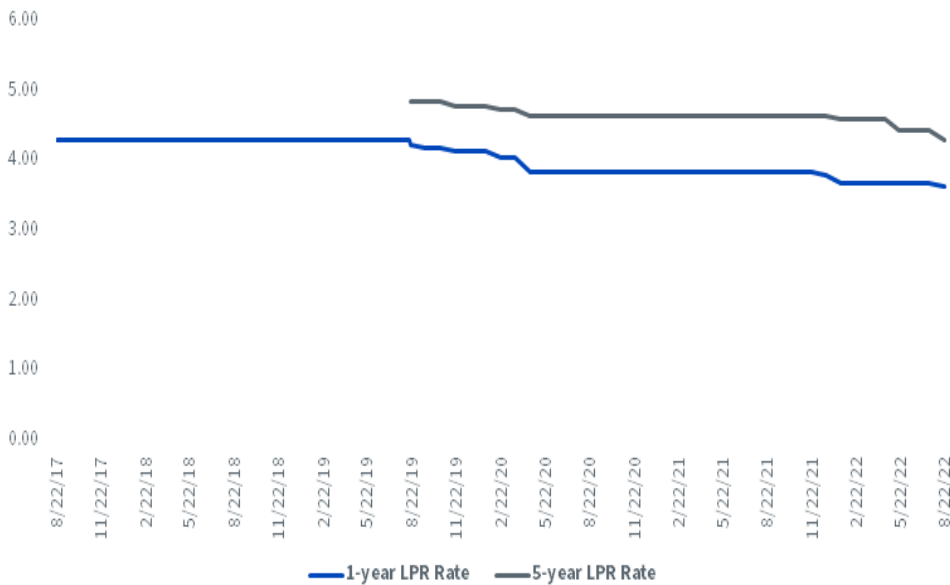
From 2022 PBOC Q1 Monetary Policy Report.

2. Current monetary easing cycle

The PBOC has been reducing rates over the last year, as China’s economy slowed significantly since 2021 Q4 due to a real estate contraction and Covid Zero’s impact on consumption.

But the PBOC reduced rates in a very incremental fashion, 5 or 10 [basis points \(bps\)](#) at a time, because China’s total leverage in the economy was already similar to the U.S. after doing a big bang stimulus during 2008/2009.

China's Loan Prime Rates



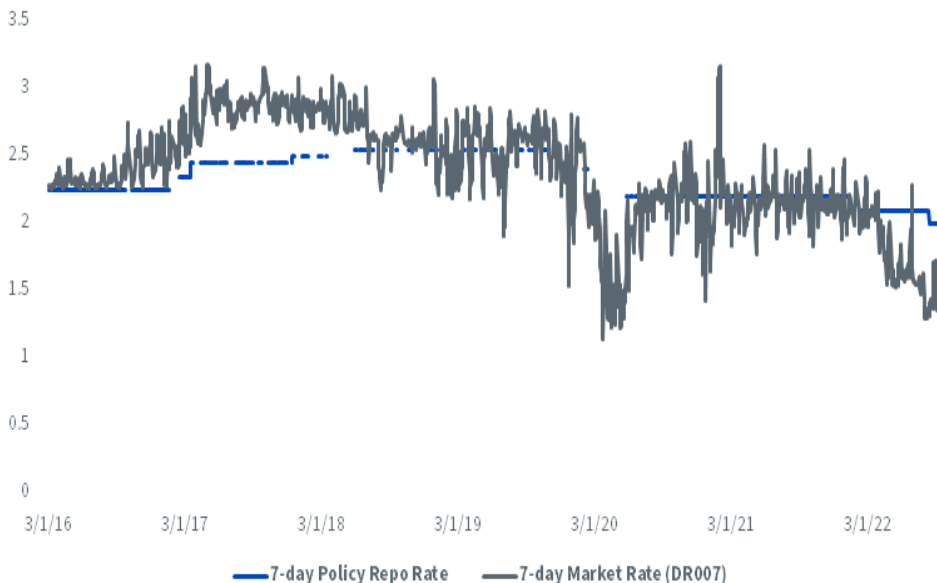
Source: The PBoC.

3. Will the PBoC reduce rates again this year, and will the Chinese currency [RMB](#) crash?

There is a high chance it will make one very incremental rate reduction—but no one should expect it to get in the front seat and drive the economy like the Fed. Usually, the PBoC needs to see at least two things to act: the market rate (DR700) significantly moving away from the policy rate (seven-day repo rate) and the economy being so bad that sentiment may significantly shift if the PBoC doesn't do something.

Currently, the seven-day market rate is again lower than the policy rates by about 50 bps. If the economic data being released falls significantly below expectations, there is a chance the PBoC will act.

Recently, China's Policy Rate Has Been Higher Than Its Market Rate



The PBoC's other task is to manage the currency (RMB) [volatility](#). The PBoC has ample tools to manage currency. However, with the Fed raising rates, China's currency will likely continue losing value against the U.S. dollar. But it is unlikely to see a crash, as China's exports are still robust, and the trade-weighted yuan has not changed much

recently. We plan to dig deeper into this issue in future blog posts.

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DEFINITIONS

Federal Reserve: The Federal Reserve System is the central banking system of the United States.

Monetary policy: Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Central bank: Refers to the the monetary authority of any country.

People's Bank of China (PBOC): is the central bank of the People's Republic of China with the power to control monetary policy and regulate financial institutions in mainland China.

Fed tightening: Refers to the Federal Reserve enacting monetary policies that have the overall impact of reducing the availability of credit, which is widely thought to have the potential to slow economic growth.

Repo rate: The interest rate at which the central bank of a country lends money to commercial banks.

Medium-term lending facility (MLF): A type of People's Bank of China lending to Chinese banks typically with maturity from three months to one year.

Prime: Prime is a classification of borrowers, rates, or holdings in the lending market that are considered to be of high quality. This classification often refers to loans made to high-quality prime borrowers that are offered prime or relatively low interest rates.

Prime rate: The term prime rate refers to the interest rate that commercial banks charge their most creditworthy customers. The Federal Reserve (Fed) sets the federal funds overnight rate which serves as the basis for the prime rate, which is the starting point for other interest rates. It is the most commonly used benchmark used by banks and other lenders when setting their interest rates for various products, such as credit cards and home loans.

Basis point: 1/100th of 1 percent.

Renminbi (RMB): is the official currency of the People's Republic of China.

Volatility: A measure of the dispersion of actual returns around a particular average level.