UNDERSTANDING CHINA’S MONETARY POLICY

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EAI Background Brief No. 1249

Date of Publication: 25 May 2017
Executive Summary

1. In March 2017, the Chinese government reportedly announced at the 12th National People’s Congress that it will maintain a “prudent” monetary policy (i.e. policy will be kept “neither too tight nor too loose”) and reiterated its commitment to a neutral and stable monetary policy stance.

2. China’s monetary policy has multiple objectives that are similar to the government’s macroeconomic policy objectives of maintaining growth and employment, low inflation, external balance, a stable currency and financial stability.

3. Its prudent monetary policy is expected to exhibit a “tightening bias” when financial risk concerns persist. The People’s Bank of China is likely to pursue a policy of cautious and targeted tightening to contain financial risks given a slowing economy, high corporate debt levels and rising capital outflows.

4. Although the government has set deleveraging and prevention of systemic financial risk as one of the top priorities, monetary and credit policies are expected to stay accommodative to support economic growth and stability in the run up to the 19th Party Congress.

5. Developing an effective monetary policy framework is particularly crucial. Monetary policy plays an important role in maintaining macroeconomic and financial stability, promoting effective financial intermediation (i.e. allocation of resources) and buffering the economy against domestic and external shocks.

6. China’s monetary policy framework has evolved over time but financial liberalisation in recent years has changed the landscape within which monetary policy operates and posed new challenges to policy management.

7. Capital account opening, higher US interest rates and exchange rate pressures have made the central bank’s monetary policy management even more challenging.
8. China’s current monetary policy framework is still largely characterised by quantitative and administrative management. As the Chinese economy becomes more developed and market-oriented, market-based monetary policies are needed to enhance macroeconomic stability.

9. More structural reforms (such as reforms to the state-owned enterprises, exchange rate, liberalisation of services sector, etc) are needed for the monetary policy to be more focused and effective.