A PBoC Primer from Yi Gang

The People's Bank of China recently posted the translation of a lengthy (~10,000 word) December speech by Governor Yi Gang entitled "*Policy Framework: Supporting the Real Economy and Striking a Balance between Internal and External Equilibrium.*"

The Speech provides useful template for a primer on the PBoC's role in the economy and the current policy stance. Below are my comments on some excerpts from Yi (italicized, bolding mine). The entire speech can be found here.

Governor Yi confirms that Chinese monetary policy remains quantity-oriented, with Total Social Financing in a central role:

> *As I said, the ultimate goal of China's monetary policy is to maintain currency stability. Then how? To this end, we need to set an intermediate goal first. In China, we consider M2 as the intermediate goal of the monetary policy as it is predictable and controllable measure. However, international experiences show that as an economy becomes more and more developed and market-oriented, the correlation between M2 and the real economy will be on the decline.* ***Therefore, in 2012 we adopted the concept of the scale of social financing as a reference indicator*** *to measure the financing offered by the financial sector to the real economy, and the indicator includes loans, bonds, stock, and trust, etc.*

The shift to a more market-oriented interest-rate targeting regime remains some way off:

> *At present, the focus of China's monetary policy is gradually shifting from quantity control to price control. You may ask, is the PBC focusing on quantity control or price control? My answer is, we are in a transition from quantity to price control, and both tools are employed during this process. Price control has been more important than it used to be; while at the same time, with the impact of our basis and systems as well as people's thinking pattern,* ***quantity control is not yet discarded and remains very important***

Yi acknowledges the obvious problem with centrally planning credit volumes:

> *Quantity control is a simple tool, as quantity can be specified clearly. However, it still has drawbacks, and* ***its biggest problem is that the specified quantities may be wrong and fail to conform to market conditions****. The quantities are usually specified by the central government, and they may not apply to local conditions*

Next, Yi turns to the macro backdrop:

> *Overall, China's economic growth is strong, stable and resilient. Recently, the downward pressure on the economy has mounted, and the growth of off-balance-sheet financing has slowed down significantly.*

He describes recent liquidity actions as defensive in nature, i.e. reactive to the fallout from the "deleveraging" program as opposed to preparing the ground for fresh stimulus:

> *The PBC reduced the requirement reserve ratio (RRR) four times, which freed RMB 3.65 trillion capital in total, and unleashed RMB 1.76 trillion of liquidity in the market via the MLF. All these measures were taken to provide stronger support for the real economy and ease the investment contraction as a result of economic cycle. Meanwhile,* ***regulatory policies and some other management requirements, such as the purge of local government debt, can also give rise to investment contraction. Through RRR cuts and the MLF, we can supply liquidity, offset cyclical investment contraction and ensure the stability of economic operation****.*

Yi then alludes to a top-down edict to cap the economy-wide credit-to-GDP ratio:

> *Currently, M2 grows at a rate of 8%, and aggregate financing around 10%, matching the growth rate of the real economy. The current macro leverage ratio stands at a rather stable level. The leverage ratio in 2007 and 2008 was around 150%, and then increased to around 250% in 2016, which means that all economic entities borrowed considerably.* ***This has drawn the attention of regulatory authorities and the authorities in charge of macro regulation and control****. In recent years, the central government has proposed to facilitate "deleveraging". Consequently, the leverage ratio has been standing at around 250% since last year and has remained stable for almost eight quarters without further rise.*

Yi does suggest the possibility of a shift out of bubble-deflating mode in response to "external shocks," although as of yet there is no indication that China has made this pivot:

> *The monetary policy should be flexibly adjusted according to changes in the economic situation, and counter-cyclical adjustments be especially strengthened. If the leverage ratio is rather high, or bubbles emerge in asset prices, the best strategy is "slow air-bleed" and "soft landing" so as to make smooth adjustments to the economy. When the market or economy is impacted by external shocks, we should take prompt measures to stabilize the financial market and, in particular, to bolster market confidence. This is a fairly good regulation and control strategy. In the next phase, the monetary policy is going to push forward with its support for the real economy.*

Next, Yi highlights the PBoC's support for credit insurance products as a palliative for the financing difficulties of private enterprises. (Last fall, to surprisingly little fanfare, PBoC announced it was funding a CNY 10bn capitalization of China Bond Insurance Company, who would underwrite bond insurance contracts along with the large banks who serves as underwrites of corporate debt issuance).

> *What we do is to provide bonds with insurance, so as to help private enterprises issue bonds smoothly. Then the successful bond issuance becomes a piece of good news. After knowing that bonds have been issued, commercial banks will understand that the enterprises have secured money and stop urging them to pay back loans. When the stock market receives the message of bond issuance, the share price of such enterprises will probably take a favorable turn. This is the reason why* ***we have decided to choose bond issuance as the sally port in easing the financing difficulty of private enterprises****.*

Governor Yi's comments provide a glimpse of the future of Chinese credit markets. As defaults rise to address the endemic moral hazard problem, market participants rush to the perceived safety of a Government guarantee, which the Government then has to increasingly extend to non-state actors to avoid a credit crunch. The government will decide which credits live and die until eventually the entire system becomes guarantee-dependent.

In Q&A, Yi confirmed that PBoC now stands behind the new bond insurance products:

> *With the PBC's support, insurance CBIC underwrites won't fail to repay upon crisis as what happened to AIG, so the insurance will be 100% repayable. However, the whole process is market-based and launched with principal underwriters. It means that this instrument created by the PBC acts as an ignitor introducing market players into the market. Once the market is restored after the introduction, the PBC will gradually step out. When there's no one else to issue bonds or underwrite insurance, only the PBC takes the responsibility.*

This highlights a distinguishing feature of the Chinese financial system: credit transmission problems are easily fixable. The Government can intermediate every credit in the system if it wants to. But as implicit guarantees become increasingly explicit, the question of what stands behind the Chinese government's "wrap" around some $40T in credit assets comes into sharper focus. The answer, of course, is the PBoC and its ability to issue liabilities without limit, or more colloquially, to "print money."

Which leads to Yi's exposition on the external constraints to monetary policy.

> *Lastly, I would like to talk about the relations between internal and external balances. As the "impossible trinity" cited in many literature shows, since China has been highly integrated with the global economy, we have to take global factors into consideration while designing domestic monetary policies and other policies.*

> *The Fed is now in an interest rate hike cycle. As it approaches the neutral rate, the uncertainty about a further rate hike seems to be greater than that in a few months ago, let alone compared with a year ago. However, as our economy faces certain downward pressure and requires for relatively loose monetary conditions***, it is a typical contradiction between the internal and external equilibrium. In this case, we shall focus on the internal equilibrium while considering the external one to strike a balance in between***, which in fact is the optimal balance point.*

To the PBoC's credit, they are consistently respectful of the "impossible trinity" and under no illusions that capital controls provide a costless solution to the problem of "external equilibrium." (In reality, they've been forced into instituting quotas on the market-wide availability of foreign exchange, a policy which would become highly disruptive to trade in a high-stress scenario).

<u>Conclusions</u>

- Chinese monetary policy remains quantity-oriented, and until further notice the quantities appear to be capped by a "stable debt ratio" edict from on high.

- Don't worry about policy transmission – they know how to prevent a "credit crunch."

- With the entire ~$40t credit market starting to roll up onto the sovereign balance sheet and external economic threats elevated, the RMB remains a key constraint on policy.

<u>The market's dream of Chinese stimulus with RMB stability will require threading a needle</u>.

There are three necessary conditions:

- A trade deal
- A weak Dollar
- A policy pivot to abandon deleveraging

A trade deal will require RMB stability and will also incentivize China to avoid reliance on heavy-handed capital account measures. The scope for stimulus will remain limited barring a substantial decline in the broad Dollar.

A no-deal scenario will immediately tighten the external constraint via heightened capital outflow pressure. China's choice then would be to hammer global markets with stimulus-cum-devaluation or retreat from them via draconian capital-account measures that will increasingly cut China off from global trade and finance.