

# In the light of growing economic and financial interdependence, we need to have a better understanding of how monetary policy works in China

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*With the Bank of England recently establishing swap lines with the People's Bank of China and financial linkages between Britain and China set to become more intense over time, it is important to have a good understanding of how Chinese authorities conduct monetary policy. A new report by OMFIF, outlined here by **John Plender** and **Gabriel Stein**, stresses the need for Britain to be prepared for the macroeconomic effects that a fully capital account liberalised China might have.*



A decade or so ago, few in the UK apart from China analysts were much exercised about the framework and conduct of Chinese monetary policy. Today, with China the No.2 economy after the US, the rest of the world cannot afford not to take note, especially since China is moving gradually towards capital account liberalisation. This is a central theme of a new report on China's monetary policy published by the Official Monetary and Financial Institutions Forum (OMFIF).

At present the interconnectedness of China with the rest of the world is chiefly felt through official capital flows and trade linkages. But as the spike in China's interbank interest rates in June this year demonstrated, turbulence in the Chinese financial system, together with the fear of a sharper economic slowdown than hitherto expected, can cause sharp fluctuations on global capital markets.

This financial impact primarily reflects worries about the potential spillover of slower economic growth onto China's trading partners. The commodity markets likewise feel the backwash since China is one of the world's biggest consumers of such materials as iron ore, copper and aluminum, as well as oil and food, with its share of world consumption frequently at 40-50%. The world needs to recognise that the slowing and rebalancing of the Chinese economy could have a profoundly deflationary impact on global markets in the short and medium term.

The events in June were a modest foretaste of what might happen in the longer run if China finally achieves its goal of full capital account liberalisation. That will have considerable macroeconomic effects around the world, as well as producing a dramatic impact on capital markets, not least in London where the volume of dealing in the renminbi is on the increase and the Bank of England has recently established swap lines with the People's Bank of China. Financial linkages between Britain and China are set to become more intense over time.

While financial liberalisation will help reduce a national savings rate that is currently around half of gross domestic product (GDP), China is nonetheless destined to remain a relatively high saver. When domestic capital is finally freed from all constraints, the outflow could propel stock markets higher all around the world. There is a serious risk that bubbles could ensue.

It is important to recognise that capital account liberalisation is frequently – it is tempting to say invariably – followed by financial and currency crises. Given China's sheer size, that will spill over into the international financial system. On a more optimistic note, it must be emphasised that China enjoys many advantages in managing the transition to a more market-oriented system that other countries have lacked.

In the light of this growing economic and financial interdependence, policy-makers, bankers, regulators, market practitioners, investors and others need to have a better understanding of how monetary policy works in China, how the central bank seeks to achieve its financial stability objective and how the liberalisation process will evolve as the

economy is rebalanced away from exports and investment towards consumption.

Our report is designed to provide an accessible route map for an understanding of these three strands, while also making recommendations for policy. It does so against a background of worryingly rapid credit creation in China, which raises the risk that tighter credit policy will be required to slow excessive lending via the informal sector. A looming debt sustainability issue has to be addressed. That has prompted fears that GDP growth may fall to well under 6% compared with the 7-8% currently being targeted.

The report endorses the government's plans to move to a more conventional monetary policy framework over time with reduced reliance on administrative controls, while urging that China's broad money measure (M2) should be expanded to include the wealth management products (WMP) of the shadow banking system. It calls for realistic early recognition of bad debts in the big banks' loans to zombie enterprises, with bad debts hived off into bad banks under state ownership, in line with the experience of the late 1990s.

We place special emphasis on the need for the authorities to improve communications. This is not only relevant for open market operations. A public dialogue is needed on capital account liberalisation to convey the message that potential losses on China's huge official foreign exchange reserves are a legacy of the export-led growth model. Publication of the mark to market value of the reserves should be an important part of expectations management as the authorities carefully sequence the integration of China's capital flows and markets with the rest of the world.

On full opening of the capital account there is a risk that large capital outflows may cause the renminbi to plunge, leading to an uncontrolled currency crisis. The report argues that the appropriate response would be to accommodate the outflow, while using the country's substantial hoard of foreign exchange for a major stabilising intervention in the renminbi market before leaving the currency to fluctuate on a free market basis. In addition, the report highlights those areas of the financial system that need to be made more robust to cope with the inevitable strains that will stem from sequential progress to full liberalisation.

The adjustments that China needs in order to secure the transition to a more market-oriented economy are unique in scale if not in kind. The challenge will be all the greater because the external environment is unhelpful. Global growth is being held back by tight fiscal policy in the UK, US and Europe while over-indebted countries deleverage. A retreat from quantitative easing in the US adds the risk of increased market volatility to the mix. Moreover, there are many obstacles that could cause the reforms to stall as a result of a 'winners and losers' problem. Vested interests in the administration and at the top of the state owned enterprises will seek to reverse a liberalisation process designed to bring about a reduction in the current substantial subsidy from households to a bloated and inefficient chunk of the corporate sector.

It is in the UK, as well as everyone else's, interest that this huge economic and financial experiment is brought to a successful conclusion. The biggest beneficiary will be the Chinese people who currently under-consume and have long suffered from negative real interest rates on their savings.

*The New Global Frontier: Understanding China's Monetary Policy* by John Plender and Gabriel Stein, OMFIF, September 2013 can be found [here](#).

*Note: This article gives the views of the author, and not the position of the British Politics and Policy blog, nor of the London School of Economics. Please read our [comments policy](#) before posting.*

## **About the Authors**

**John Plender** is a director of OMFIF and a columnist at the *Financial Times* where he has been a contributor since 1981. He was a non-executive director of UK real estate company Quintain for eight years from 2002 and chaired the company from 2007 to 2009. After completing his degree at Oxford University, Plender joined Deloitte and qualified as a chartered accountant. His books include 'That's The Way The Money Goes', 'The Square Mile', 'A Stake In The Future, and Going Off The Rails – Global Capital And The Crisis Of Legitimacy.'

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