

**RECENT DEVELOPMENT AND
IMPLICATIONS OF CHINA'S
MONETARY POLICY**

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Executive Summary

1. The Chinese government reiterated its commitment to its long-standing guiding principle of proactive fiscal and prudent monetary policy in July 2015 despite the growing downward pressure to its economy.
2. Nonetheless, since late 2011, the central bank has taken consecutive measures to gradually loosen its money supply. These include reducing the Required Reserve Ratio (RRR) and lowering benchmark deposit and lending rates six times each between December 2011 and June 2015.
3. The government has also implemented measures to liberalise the financial market, such as removing the upper and lower bounds for lending rates, as well as the lower bound for deposit rate.
4. Since 2014, when economic growth decelerated, the government has to strike a difficult balance between ensuring modest growth and promoting restructuring. Meanwhile, the central bank is required to perform the dual tasks of maintaining an accommodating monetary environment for growth and improving credit allocation among different sectors.
5. Consequently, in addition to using conventional instruments such as RRR and interest rates to loosen monetary policy, the central bank experimented with various innovative new tools, such as the Pledged Supplementary Lending (PSL), which aims to help improve the structure of credit allocation.
6. The RRR reduction and other loosening measures have increased money supply which has been accompanied by modest GDP growth and relative low inflation, an uncommon phenomenon.
7. Increased money supply has been associated with surging housing prices, which are not captured in the consumer price index and connected closely to mounting local government debt.

8. Indeed, local government financial platforms are responsible for mopping up a large portion of the newly created credit through the under-regulated shadow banking sector. Their investment in the property market has led to surging housing prices.
9. The root cause of the swelling local debt and surging housing price is the high and rising saving rate of households and state firms. However, to change saving preferences, improve property market development and solve local debt problems, the government has to develop coordinated policies.
10. In fiscal policies, for example, the government has to enhance the provision of public goods and social welfare, and implement taxation reforms to develop an efficient property market.
11. Further reforms in the financial sector are also essential to improve credit allocation. Although the central bank has developed numerous new measures to modify lending practices and more experiments are expected, it remains to be seen whether these new, more flexible and targeted tools are sufficient to achieve healthy growth and better credit allocation.