Dual-Track Interest Rates and the Conduct of Monetary Policy in China

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Summary

Unlike in the advanced market economies where monetary policy typically has "one target and one instrument," the monetary policy framework in China is regarded as having multiple targets and multiple instruments. Key to a good understanding of China's monetary policy framework is the "dual-track" interest-rate system: on the one hand, bank deposit and lending rates are regulated by the central bank (i.e., the imposition of a deposit-rate ceiling and a lending-rate floor); on the other hand, interest rates in money and bond markets are market-determined.

The objective of this paper is to provide a framework that allows us to have a better understanding of the conduct of monetary policy in China under the dual-track interest-rate system and a juxtaposition of both price-based and quantity-based policy instruments. By taking into account fund flows between the banking sector and the bond market, we model the transmission of monetary policy instruments to market interest rates, which, together with an indicative quantitative credit target in the banking system, ultimately serve as the lever by which monetary policy affects the real economy. We conduct a simple calibration of the theoretical model to compare the relative potency of various policy instruments. We then estimate two empirical models to test the predictions of the theoretical model.

The results from both theoretical and empirical analyses show that monetary policy instruments work reasonably well under the dual-track system, in the sense that their effects on the cost of credit are predictable both qualitatively and empirically. Market interest rates are most sensitive to changes in the benchmark deposit interest rates, significantly responsive to changes in the reserve requirements, but not particularly reactive to open market operations.

The results of this study help us understand why the PBC conducts monetary policy in China the way it does: a combination of price and quantitative instruments, with various degrees of potency in terms of their influence on the cost of credit. They also help us understand why the central bank needs to retain quantitative targets on credit when the observed real interest rate is below the equilibrium interest rate. Finally, this study argues that raising the deposit-rate ceiling toward the equilibrium rate would be the key in a well sequenced process of interest rate liberalization in China.