International monetary policy spillovers and responses

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Abstract

This paper briefly discusses the view of the People's Bank of China (PBC) on the spillover effects of the monetary policies of advanced economies and on the policy responses of emerging market economies. The paper also explains China's policy measures to combat these spillover effects, and calls for closer international policy coordination and cooperation.

Keywords: Monetary policy, international spillover, emerging market economies

JEL classification: E52, F30, O10, O16

1. International monetary policy spillovers and responses

Since the 2008 international financial crisis, the central banks of the world's main developed economies have maintained their interest rates at extremely low levels and carried out a series of unconventional measures such as quantitative easing (QE) and forward guidance. These unconventional monetary policies, such as the large scale asset purchases and forward guidance are aimed at expanding the scope of the monetary policy and exploring new mechanisms, in order to maintain economic and financial stability around the zero-rate bound. The observed effects show that the developed economies' QE has played an important role in stabilising their domestic situations and in promoting economic recovery. To some degree, it has also boosted the external demand of emerging market economies (EME). However, as EMEs and developed economies differ in terms of both where they are in the economic cycle and their policy influences, the QE measures have had some negative impacts on a number of EMEs, greatly adding to their difficulty in managing the macroeconomic situation and also entailing downside risks.

Recent research shows that the developed economies' QE impacted on EMEs in five ways. First, it lowered the EMEs' short-term policy rates. Second, it brought down the EMEs' long-term rates. Third, it has had an influence on global asset allocation, dramatically increasing the fluctuations in EME exchange rates and foreign reserves. Fourth, EMEs face mounting currency mismatches as they accumulate more local currency assets and more foreign currency liabilities. Fifth, cross-border capital flows have had impacts on EMEs' domestic capital markets.

2. China's measures in response to external risks

The QE of the developed economies has flooded the globe with liquidity. Under such circumstances, cross-border capital flows tend to be large, fast and easily reversible, posing challenges to EMEs' macroeconomic and financial management. While China's economic foundations are still sound, these large-scale capital inflows and outflows have had a number of adverse impacts. To cope with these external spillover effects, the PBC has implemented a series of measures.

First, the PBC has strengthened its overall liquidity management. It keeps a close eye on the influence of global conditions on capital flows and has improved its monitoring of cross-border capital flows. A combination of various monetary policy tools, such as quantitative tools and price tools, are now employed to better sterilise and manage the country's liquidity situation. With these tools, the PBC has maintained a proper level of liquidity and reasonable growth in credit and social financing. When capital inflows are reduced or reversed, the PBC applies measures such as open market operations (OMO), a reserve requirement ratio and innovative tools such as short-term liquidity operations (SLO), standing lending facilities (SLF) etc, to adjust its liability structure and provide liquidity to the banking system.

Second, the PBC has improved the exchange rate mechanism and increased the flexibility of the RMB exchange rate. In 2012, the floating band for the spot RMB exchange rate in the interbank market was expanded from 0.5% to 1%. The market now plays a more important role in determining the RMB exchange rate, which is becoming more flexible and contribute to the balance of international payments.

The PBC has also largely reduced interventions in the foreign exchange market, and the RMB is exhibiting "two-way fluctuations" to a greater extent. In 2013, the current account surplus to GDP ratio declined to 2.1%, showing that the RMB exchange rate is getting closer to its equilibrium level.

Third, the PBC continues to improve its macroprudential management framework. Based on the lessons from the financial crisis, the PBC carried out systemic research of macroprudential management in 2009 and accordingly conducted a number of experiments. In 2011, the PBC introduced the dynamic adjustment mechanism of differentiated reserve requirement, which relates credit expansion to macroprudential requirements, systemic importance, the soundness of financial institutions and the economic environment. With transparent rules, the measure is used to guide and encourage financial institutions to maintain sound operations. At the same time, the PBC continues to improve its monitoring and reviewing framework for financial stability purposes and carries out on-site inspections of the soundness of financial institutions. It has implemented prudential tools such as the loan-to-value ratio (LTV) to restrain banks' issuance of mortgage loans. It also draws on the latest international experience of macroprudential policies, with which it sets specific rules related to countercyclical capital buffers and systemically important banks.

3. Strengthening monetary policy cooperation and coordination

Against the backdrop of economic globalisation, economies increasingly depend on each other. When one jurisdiction implements monetary policy measures to fulfil its domestic macroeconomic objectives, it causes spillover effects on other economies and the effects could further spill back to the original jurisdiction. This requires the authorities to take into account both the objectives and responses of other economies when determining their own policies. Therefore, to strengthen policy cooperation is a reasonable and inevitable course of action.

The extra-accommodative monetary environment of developed economies has had evident effects on EMEs, and the tapering of the unconventional measures also exposes the EMEs to risks of capital reversals and outflows. Recently, when the US Federal Reserve reduced its asset purchases, some EMEs suffered large capital outflows in the short run. For now, the major developed economies should properly manage the rhythm of their tapering measures, and strengthen policy coordination with EMEs via platforms such as the G20 and international organisations. They should also take a gradual, transparent and predictable approach in their tapering measures to avoid turbulence in the global financial markets or even a new crisis.