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Monetary Policy and Liquidity Dynamics in China: Investigating the Reasons for the Ineffectiveness of Central Bank Open Market Operations in Alleviating Banking Funding Constraints

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Abstract: In August 2023, the People's Bank of China (PBOC) implemented a series of monetary policy measures, including interest rate cuts and expanded reverse repo operations, to address economic challenges. These actions were driven by factors such as a sluggish intrinsic economic recovery, weak financing demand in the real economy, and concerns over credit risks associated with major property developers. Ensuring the stability of commercial banks' profitability was also deemed crucial for overall financial system stability. However, despite these measures, interbank market rates displayed an atypical and sustained upward trend, tightening liquidity conditions. This phenomenon appears to be linked to government debt issuance. Looking ahead to September, the paper anticipates potential bank credit expansion, especially with relaxed mortgage lending policies in first-tier cities and accelerated special bond issuance. While short-term liquidity conditions may remain tight, an anticipated reserve requirement ratio cut is expected to restore liquidity and support debt refinancing needs. This study underscores the complex interplay of monetary policies and market dynamics in China's financial landscape.

1. Introduction

Following the earlier interest rate cut in the middle of the year, the People's Bank of China (PBOC) unexpectedly reduced interest rates once again on August 15th. On that day, the PBOC conducted a 401-billion-yuan Medium-Term Lending Facility (MLF) operation, with a winning bid rate of 2.50%, marking a 15-basis point (BP) decrease in MLF rates. Simultaneously, the 7-day reverse repo operation rate was lowered by 10 BP to 1.8%. Furthermore, the scale of monetary net injections began to expand continuously. On August 28th, the PBOC executed a 332 billion yuan 7-day reverse repo operation, resulting in a net injection of 298 billion yuan, reaching a six-month high. Notably, since August 15th, the daily average volume of reverse repo operations has consistently exceeded 200 billion yuan, as shown in Figure 1 and Figure 2.

Similar to previous rate cut scenarios, the current domestic economic recovery has slowed down, with financial data in July showing a seasonal decline. Confidence in the real estate market's

recovery has also been dampened, leading to heightened market expectations for further cuts in reserve requirements and interest rates from the PBOC. The timing of these two consecutive rate cuts in June and August was unexpected, underscoring the PBOC's determination to implement countercyclical adjustments and stabilize market expectations.

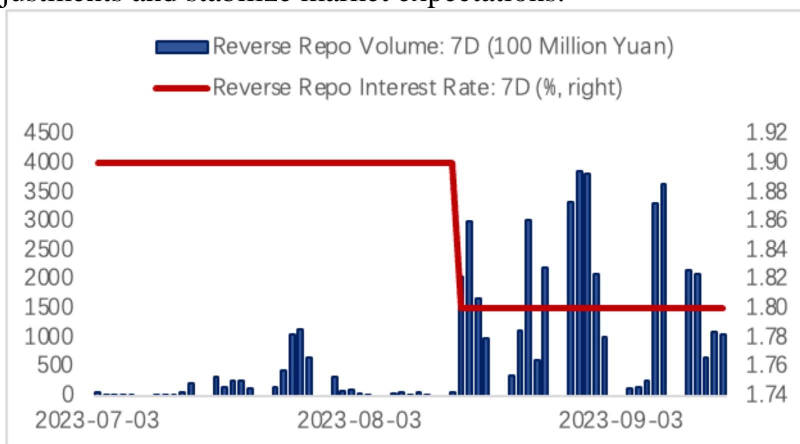

Figure 1: Central Bank reverse repos increased in mid-August.

Figure 2: The surge in net central bank money supply (100 million Yuan).

2. The Key Drivers of PBOC's Reverse Repo Operations

2.1. Weak Financing Demand and Waning Confidence in the Real Economy

The primary rationale behind the recent countercyclical operations conducted by the People's Bank of China (PBOC) can be attributed to the lackluster financing demand and declining confidence in the real economy [7]. Notably, July's economic data fell short of expectations, with a year-on-year decrease of -0.3% in the Consumer Price Index (CPI) and a -4.4% decrease in the Producer Price Index (PPI). This negative trajectory was mirrored in financial indicators, including a year-on-year increase of only 528.2 billion yuan in new social financing, which marked a significant decline from the previous year. Furthermore, new Renminbi loans amounted to 3,459 billion yuan, reflecting a year-on-year decrease of 3,498 billion yuan. Broad money supply (M2) and narrow money supply (M1) increased by 10.7% and 2.3%, respectively, with the M2-M1 gap expanding by 0.2 percentage points compared to June. These developments signaled a deterioration in both the quantity and structure of social financing, causing a notable credit shortfall and a lack of enthusiasm for mid- to long-term corporate loans, thereby exacerbating the weakness in economic

recovery momentum.

Several factors contributed to the deceleration of key economic indicators. Firstly, adverse weather conditions, characterized by high temperatures and heavy rainfall, hindered outdoor construction activities, impacting infrastructure investment. Secondly, the persistently sluggish real estate market not only affected real estate investments but also led to a rapid decline in the growth rate of residential consumption, including building materials and home furnishings. Lastly, the combination of weak domestic and external demand, coupled with marginal declines in industrial enterprise profits, led to a reduction in manufacturing expansion intentions.

2.2. Credit Risks in Leading Property Developers and Market Concerns

The implementation of interest rate cuts was also influenced by the exposure of leading property developers to credit risks. Presently, approximately 80 A-share and Hong Kong-listed property firms have disclosed their performance forecasts for the first half of 2023, with over 60% of these firms' anticipating losses. The cumulative total of expected losses ranges from 10 billion yuan to 550 billion yuan, with prominent real estate developer, Country Garden, projecting a staggering net loss between 45 billion yuan and 55 billion yuan in the first half of the year. Additionally, multiple bonds issued by Country Garden were suspended from trading, signaling liquidity pressures. This situation has initiated debt restructuring proceedings.

The cumulative area of commodity housing sales in China from January to July 2023 decreased by 14.9% year-on-year, exacerbating the ongoing downturn. The demand for residential property remains subdued, constraining market performance and causing diminished market confidence. To address these challenges, further policy actions are warranted. The August Loan Prime Rate (LPR) was set at 3.45% for one-year maturities, down 10 basis points from the previous rate, while the LPR for maturities longer than five years remained unchanged at 4.20%. This decision to keep the five-year LPR stable may serve the dual purpose of preventing undue pressure on commercial bank profits and laying the groundwork for future government debt initiatives. It should be noted that it may also be a precursor to future adjustments in existing housing loan rates [8].

3. PBOC's Ongoing Liquidity Injection and Persistent Banking Sector Tightness

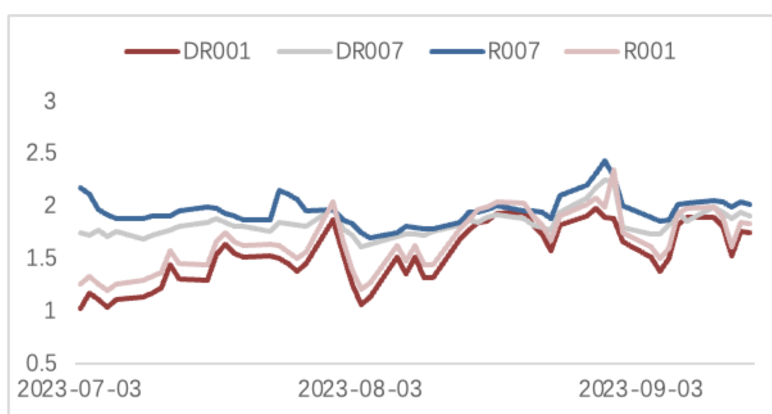

Figure 3: Weighted average interbank repo rate remains high (%).

Since August 15th, according to Figure 3, despite the significant expansion of reverse repo operations by the PBOC, liquidity conditions have not significantly eased; instead, they have exhibited tightness. In the banking sector, indicators such as R001, R007, DR001, and DR007 have experienced multiple days of rising rates, with instances of rate inversions [5]. Interbank market conditions have shown continuous convergence, with R001 and R007 even surpassing the 2% mark

at certain points. DR001 and DR007 have also consistently approached 2%, with DR001 rapidly rising in mid-August to reach 1.94% on August 18th, surpassing the 1.92% rate of DR007 on the same day, resulting in a brief inversion. Additionally, the supply of funds has markedly decreased, as evident from the significantly reduced net lending in the form of pledged repurchase agreements by state-owned banks.

4. Liquidity Tightness and the Dominance of Government Bonds as a Primary Funding Outlet

Since the beginning of the year, the pace of issuance for local government bonds has been relatively sluggish, with financing in the first seven months accounting for less than 70% of the annual allocated quota. By the end of July, the cumulative issuance of new local government bonds stood at approximately 2.8 trillion yuan, which is below the 70% threshold when compared to the same period's four-year average.

In line with policy directives, this year aims to complete the issuance of new special bonds by the end of September and utilize the funds raised through these bonds for project construction by the end of October. In response to the accelerated requirements for local government bond issuance, the pace of issuance has notably intensified since August, particularly in the latter half of the month, resulting in a significant expansion in the volume of local government bond issuances. In August, the scale of local government bond financing is expected to reach up to 800 billion yuan, reaching historical highs.

4.1. The Upcoming Peak in Government Bond Issuance Leading to Liquidity Tightening

As banks are major players in allocating funds to interest rate bonds, the accelerated issuance of government bonds not only directly absorbs bank funds but also necessitates banks to proactively reserve a portion of liquidity to accommodate future local government bond supplies. This has contributed to a certain degree of tightening in interbank liquidity conditions [4].

4.2. Implementation of Comprehensive Debt Restructuring Requiring Monetary Support

In 2022, China's government debt ratio reached 122%, surpassing the international cautionary threshold of 120%, with an interest expenditure rate of 6.3% that significantly exceeded the nominal GDP growth rate. This situation implies that the financing costs for government sectors in China substantially outweigh the investment return rates for the overall economy. Local governments heavily rely on the accommodative monetary policies of the central bank to manage their mounting debt burdens [1].

The July Political Bureau meeting emphasized the need to effectively prevent and resolve local government debt risks and implement a comprehensive debt restructuring plan. This heightened market attention on regions with high debt levels. Currently, local governments are facing substantial pressure to repay their principal and interest. If debt restructuring plans materialize, it is expected to alleviate fiscal pressures at the local level, mitigate local government debt risks, and reduce the cost of new financing. In the case of urban development bonds, areas with significant hidden debt burdens are likely to benefit more from this round of debt resolution. The liquidity tightness observed in late August may be related to debt restructuring efforts.

4.3. Potential Restart of Special Refinancing Bonds as a Crucial Tool for Debt Resolution

According to reports from Caixin Weekly, China plans to allow local governments to issue 1.5 trillion yuan in special refinancing bonds to help provinces and regions with relatively high debt

repayment pressures, including Tianjin, Guizhou, Yunnan, Shaanxi, and Chongqing, to repay their debts [3]. The People's Bank of China (PBOC) may establish an emergency liquidity financial instrument (Special Purpose Vehicle, SPV) with the participation of major banks, offering low-interest, long-term liquidity support to local government urban development platforms.

Starting in 2015, China conducted three rounds of implicit debt swaps, with the first two involving debt replacement and the last utilizing special refinancing bonds. Between 2015 and 2018, a total of 12.2 trillion yuan in replacement debt was issued. By converting substantial high-cost debts into government bonds with longer tenures and lower interest rates, bond issuers transitioned from local government financing platforms to local governments, thereby reducing default risks associated with debt. The second round of local government debt swaps, initiated in 2019, had an issuance scale of approximately 157.9 billion yuan. Although not substantial in size, it helped alleviate liquidity pressures for certain regions. The third round of debt swaps occurred during the COVID-19 pandemic in 2020, with Jiangsu Province leading the way by issuing special refinancing bonds specifically for servicing existing government debts, ushering in a new phase of debt resolution.

5. Conclusions

In summary, this study has delved into the intricacies of China's monetary policy and liquidity dynamics [6]. Despite the People's Bank of China's efforts to address economic challenges, interbank market rates continued to rise, leading to tightened liquidity. The link between this phenomenon and government debt issuance is evident.

Looking forward, we anticipate potential credit expansion and liquidity improvement. However, the complex interplay of monetary policies and market dynamics underscores the need for ongoing vigilance and adaptability [2].

As China's financial landscape evolves, policymakers must remain responsive to ensure a delicate balance between stimulating growth and maintaining stability, fostering resilience in the financial system.

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