

China's Economy and Monetary Policy

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1. The Chinese economy: current trends and challenges

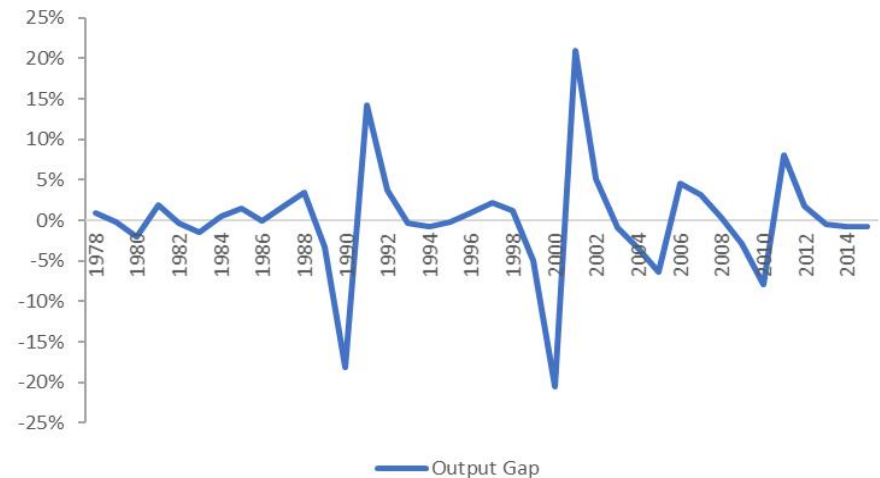
China's actual growth is still close to its growth potential

- Output gap was close to zero in recent years
- Actual real GDP growth has been in line with potential growth since 2012
- Excess capacity is largely a structural issue

➤ Some sectors have excess supply (e.g., steel) while others have shortages in supply (e.g. healthcare)

➤ At the aggregate level, China does not have a significant output gap.

China: Output Gap, 1978-2015



Note: output gap was the difference between actual and potential output. Potential output was obtained through applying HP filter to logged annual

Sources: NBS, PBC staff calculations

China's slowdown is mainly driven by lower potential growth



Sources: NBS, and PBC staff calculations.

Why is potential growth declining?

- Main factors contributing to China's 30 years of rapid growth
 - Demographic dividend (L): ample and low-cost labor supply
 - High savings rate (K): massive investment
 - Land and housing (Land): land as collaterals to support credit expansion and corporate funding
 - Total factor productivity (TFP): technological innovations and institutional improvements
 - High tolerance to the absence of Public Goods (PG): growth at the cost of deteriorating environment and waste of resources
- Structural changes are happening to all these factors...

2. Managing aggregate demand: China's macroeconomic policy mix

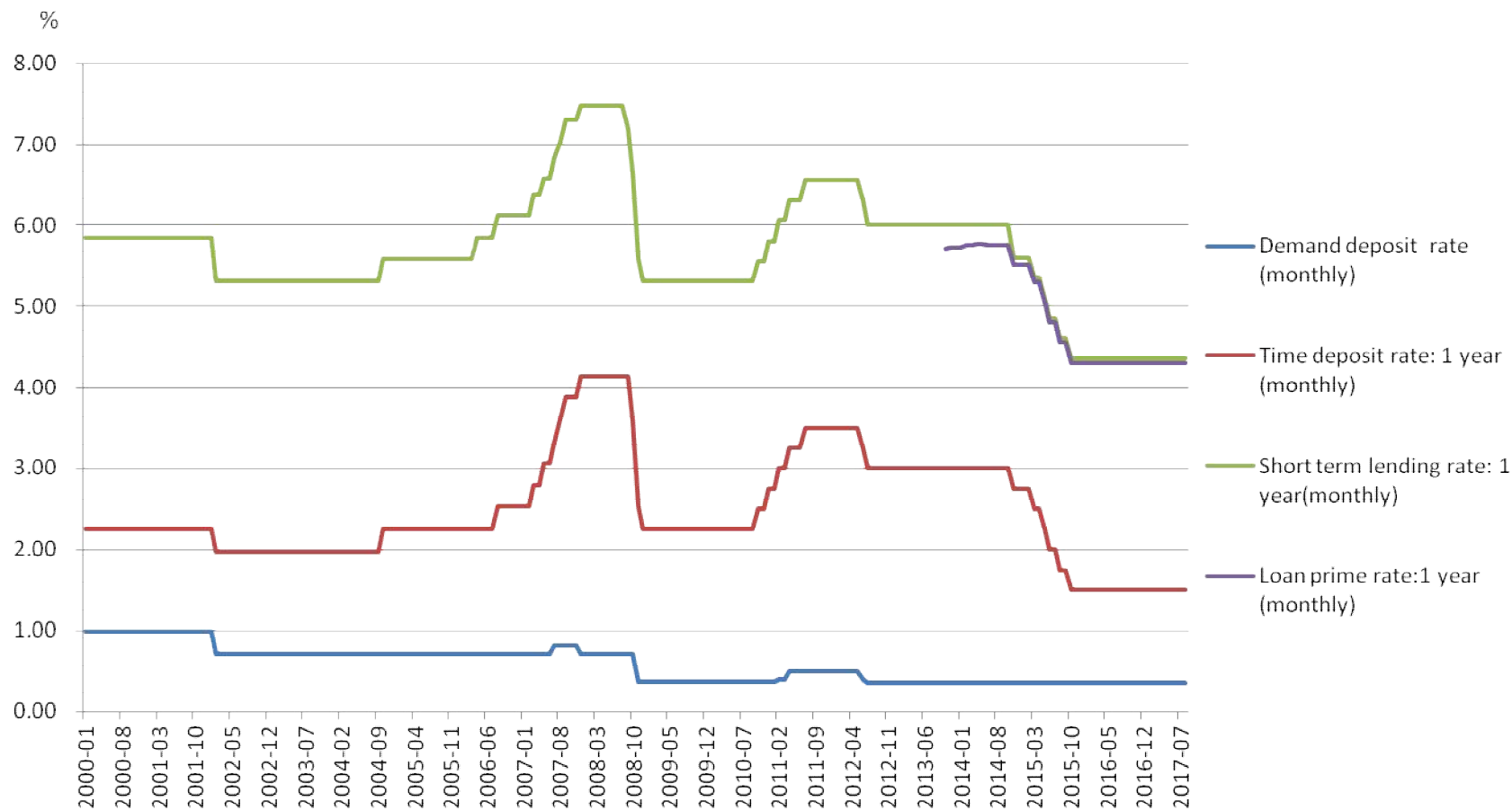
Managing aggregate demand

- Macroeconomic policy measures (fiscal and monetary) can boost aggregate demand in a short time period, but their impact cannot be sustained
- When lower growth is driven by potential output rather than widening output gap, overly-stimulative macro policies will lead to severe imbalances
 - aggravate excess supply problem
 - further increase leverage and overall indebtedness
- The role of macroeconomic policies is to promote a stable macroeconomic environment that is conducive to structural reforms

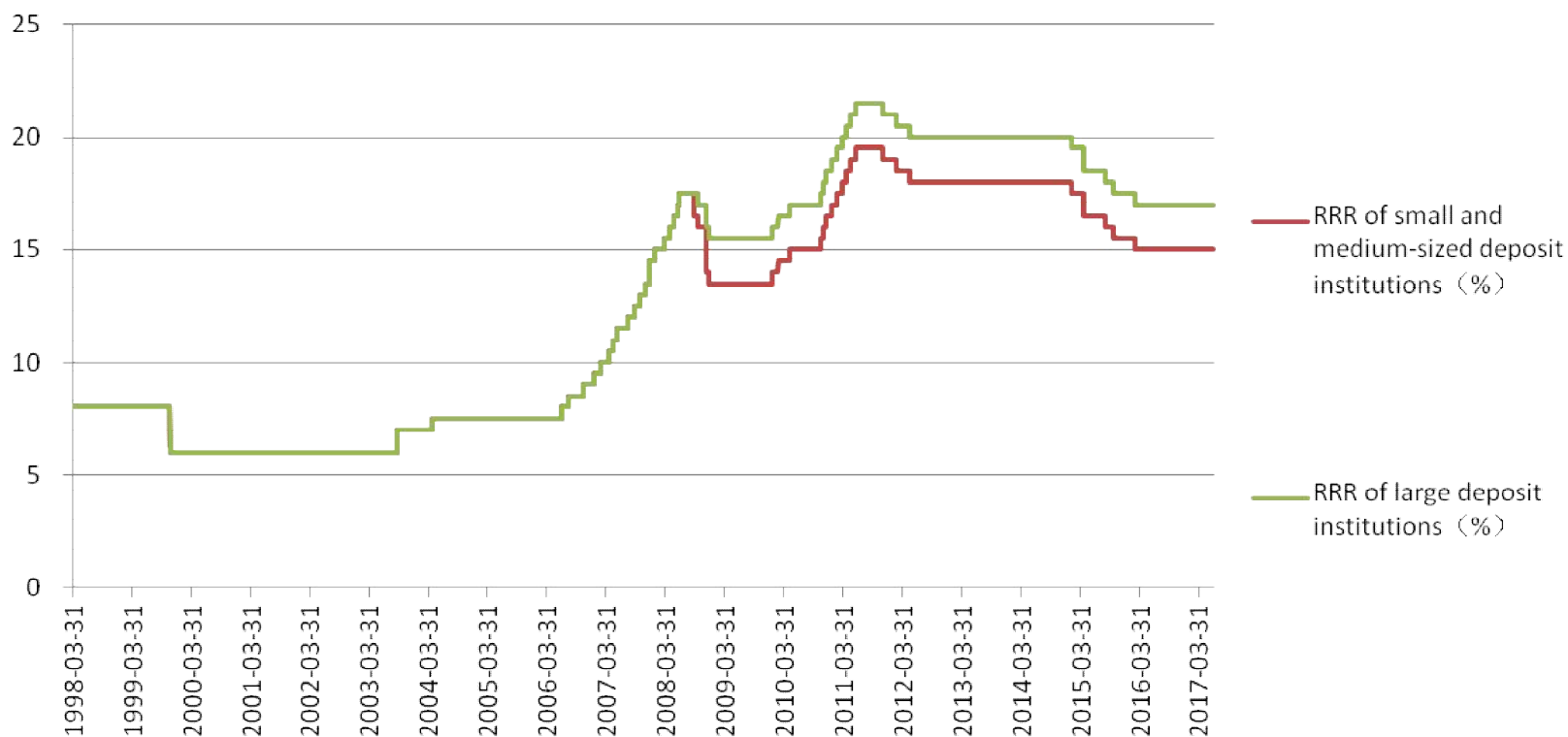
China currently maintains a prudent and neutral monetary policy stance

- China's monetary policy operations
 - Lowered interest rates in 2014-15 to keep real interest rates stable, against the backdrop of declining CPI inflation
 - Lowered RRR in 2015-16 to fill the liquidity gap as a result of capital outflows
 - PPI inflation has turned positive again in September 2016, after being in the negative zone for almost 5 years
- Monetary policy stance should be neither too tight, in consideration of downward pressures on output and prices, nor too loose, in prevention of risks associated with high leverage
- Improve macro-prudential policy framework. The core of macro-prudential policy is leverage management
 - 2016, "upgraded" to macro-prudential assessment (MPA)
 - 2017, impose capital requirement on off-balance-sheet assets in MPA

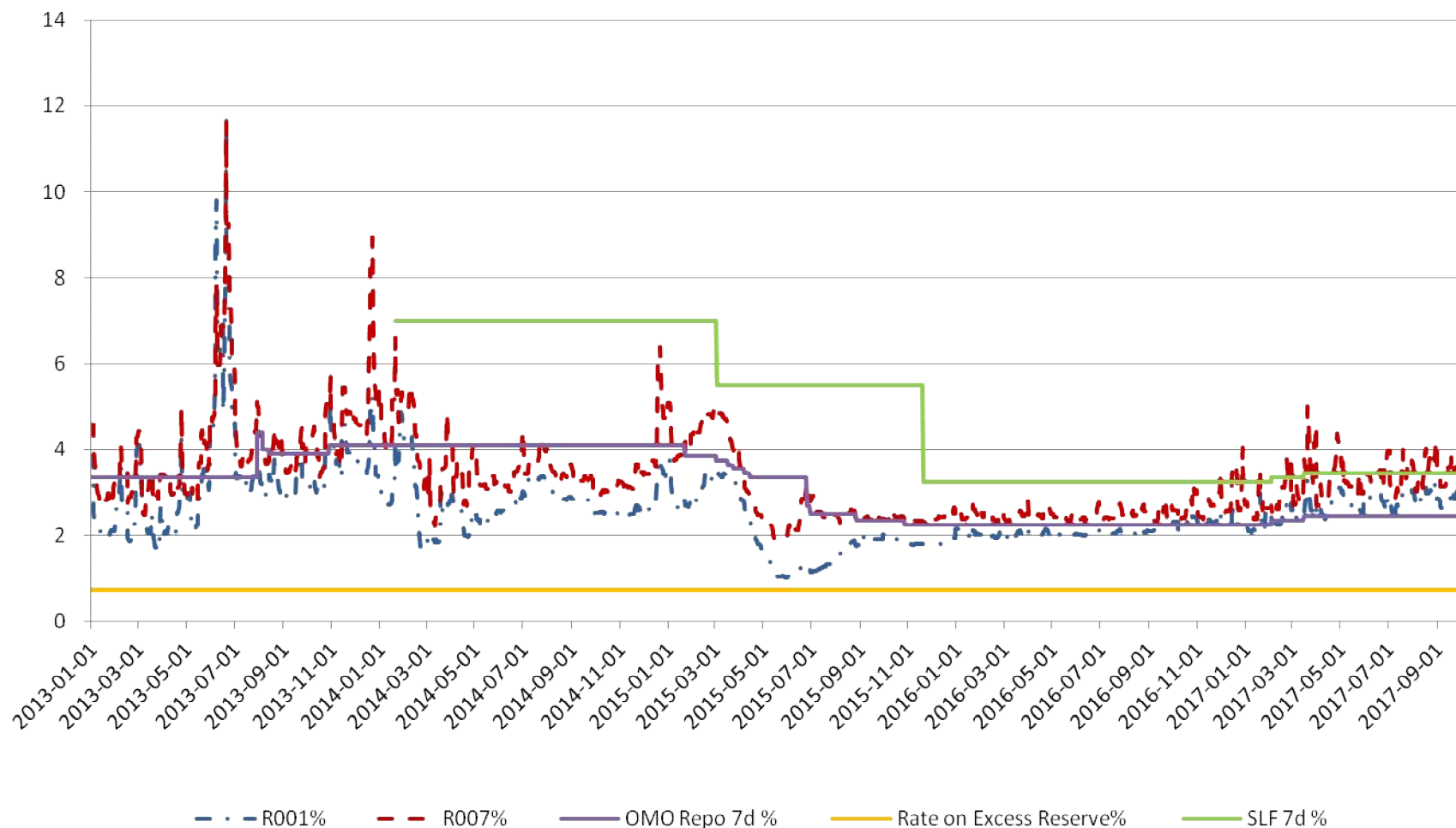
Interest Rates



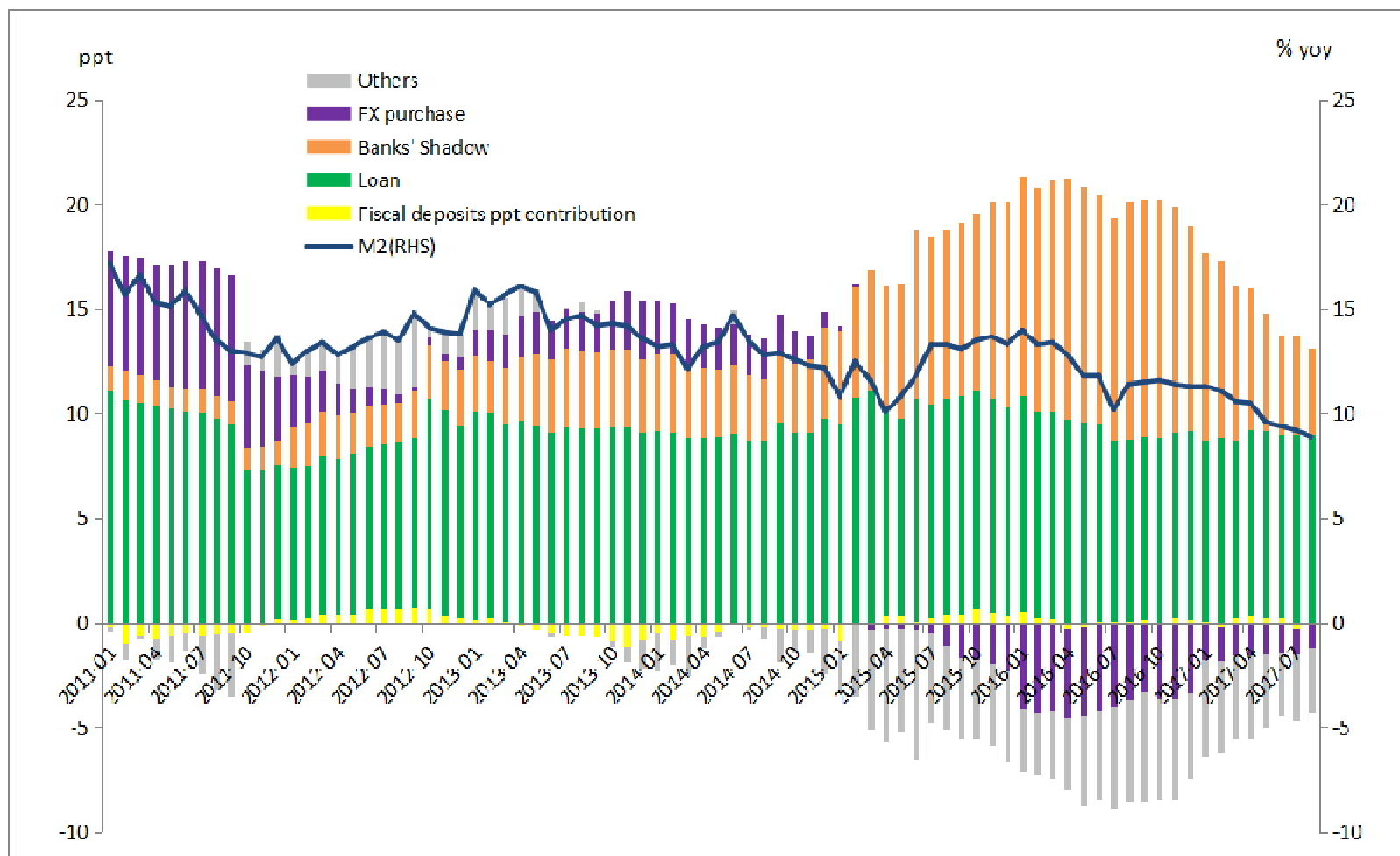
Reserve Requirement Ratio



Short Term Policy Rates and Money Market Rates



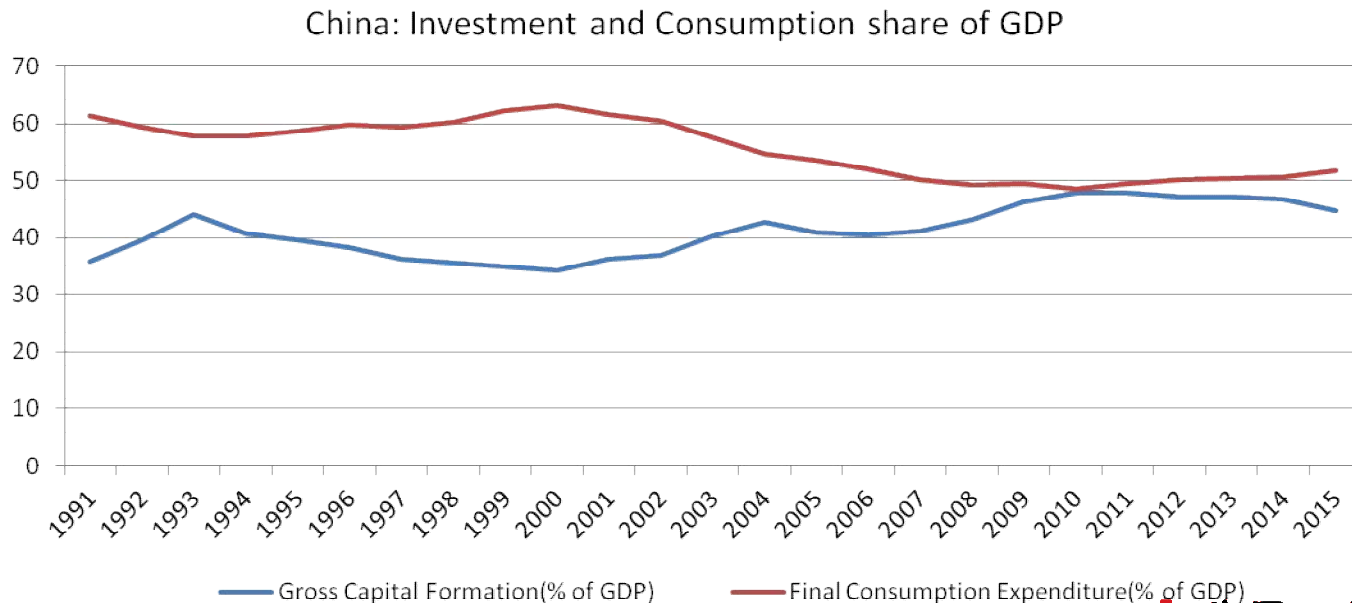
Strengthen the regulation on banking system



3. Reforms to renew China's growth engine

China has the potential to maintain growth at medium-to-high speed and of higher quality

- Urbanization and economic transition carries huge potential for China's future growth
 - Urbanization rate is at 57.35% in 2016. There is still room for 10-15 pts increase in urbanization rate
 - The quality of growth can be improved through further increasing the share of consumption
 - Private investment (61%) has already surpassed government investment (39%). Continued investment in infrastructure as well as more investment in new economic sectors will also help achieve quality growth



Structural reforms are key to China's future growth prospects

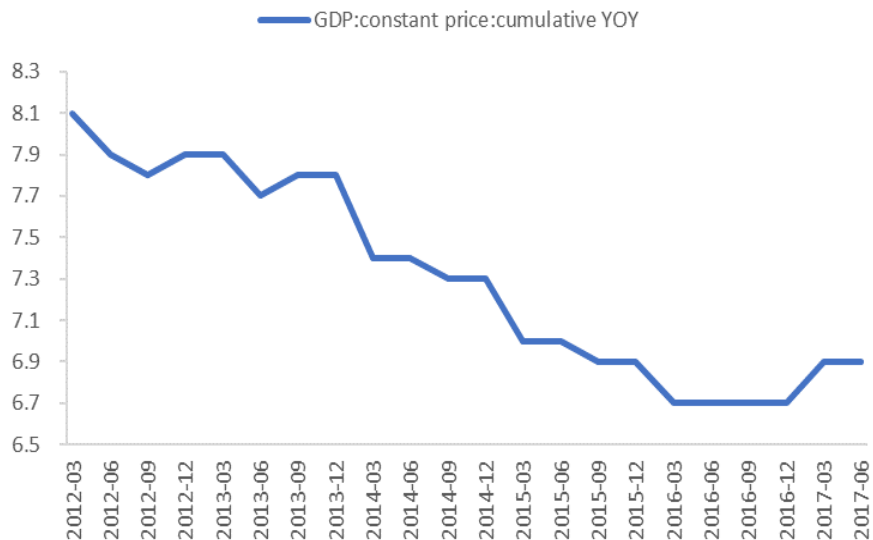
- China's further growth will come from renewed efforts in advancing with structural reforms
- Areas for further reforms:

Labor Market	Public Goods
Capital Market	SOEs
Land	Prices
Technology	Openness

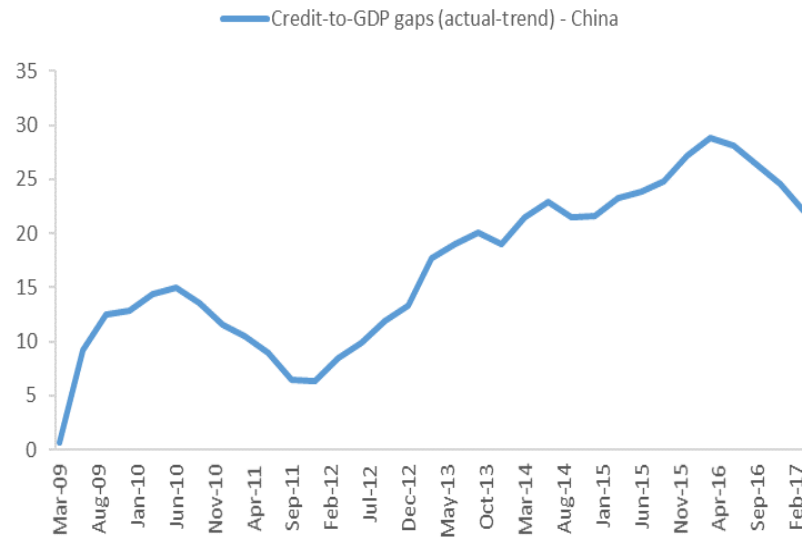
Positive Changes in 2017

- The growth of economy has picked up
 - The GDP growth is 6.9% in the first half year and is expected to be 7% in the second half year
 - The driving force of economic growth is mainly comes from the rapid growth of consumption in the households
- The leverage ratio has been stable
 - The growth rate of M2 is less than 9%
 - The overall leverage rate is beginning to decline
- More attention would be paid to deepen the reform and maintain financial stability.
 - Focus on four issues: shadow banking; asset management industry; Fin-tech and financial holding companies

China: GDP growth , 2012-2017H



China: Credit-to-GDP gaps , 2009-2017S1



Conclusions

- China's slowdown is a natural result of its development stage, driven by structural factors
- Boosting demand through fiscal and monetary stimulus would have large side effects, leading the economy to an unsustainable path
- China still has large growth potential through further urbanization and economic transition, and the urbanization process of China is still in rapid development
- Structural reforms and further opening up are the foundations for China's future growth and development. More attention would be paid to deepen the reform, deleverage and maintain financial stability in the future
- The momentum of economic growth has rebounded since this year

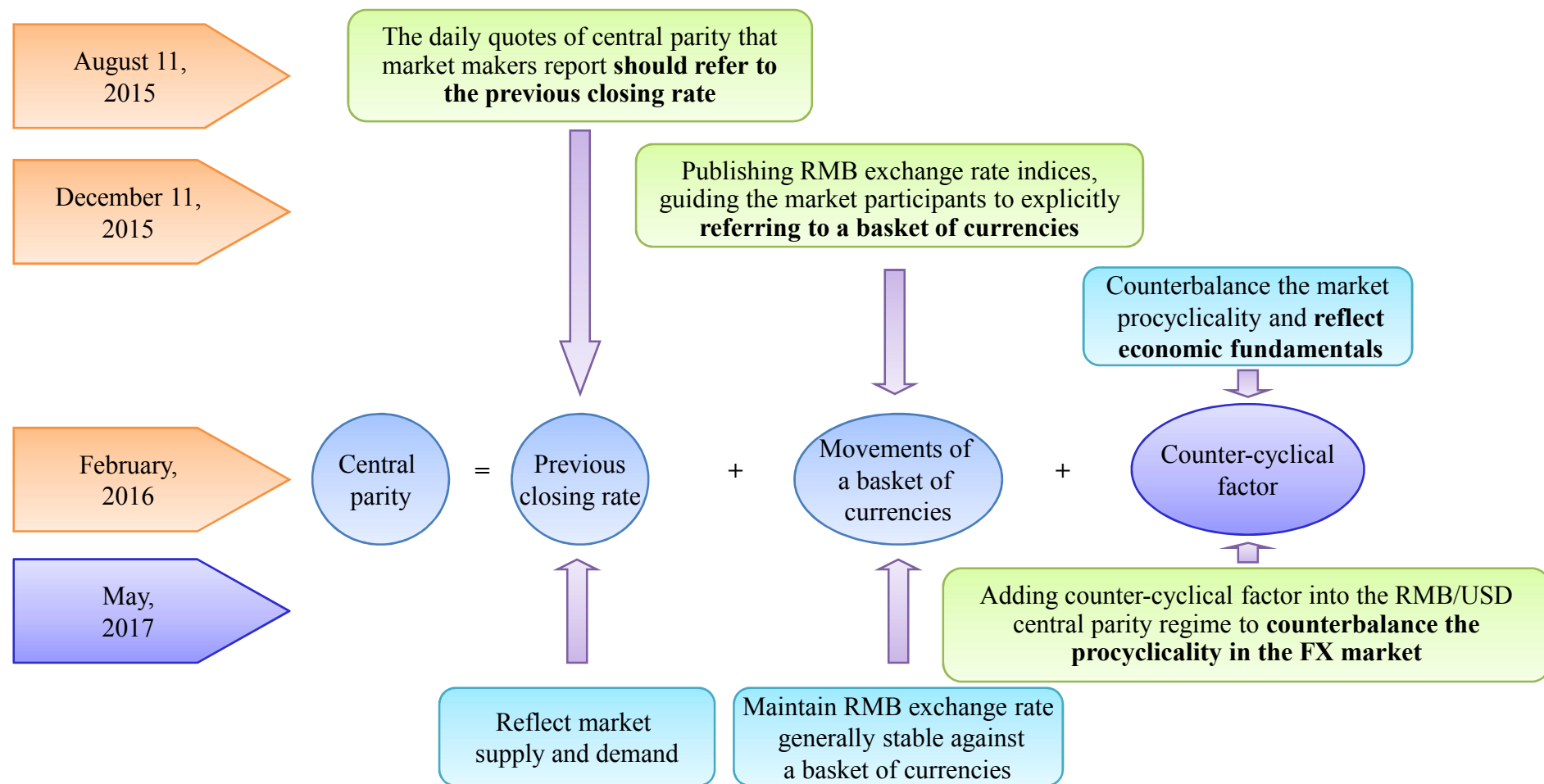
4. Respond to U.S policy normalization

Combination of policy instruments

Within “Scalene Impossible Trinity”, capital flow is more important, central bank should maintain macroeconomic equilibrium through working on the 3 pillars

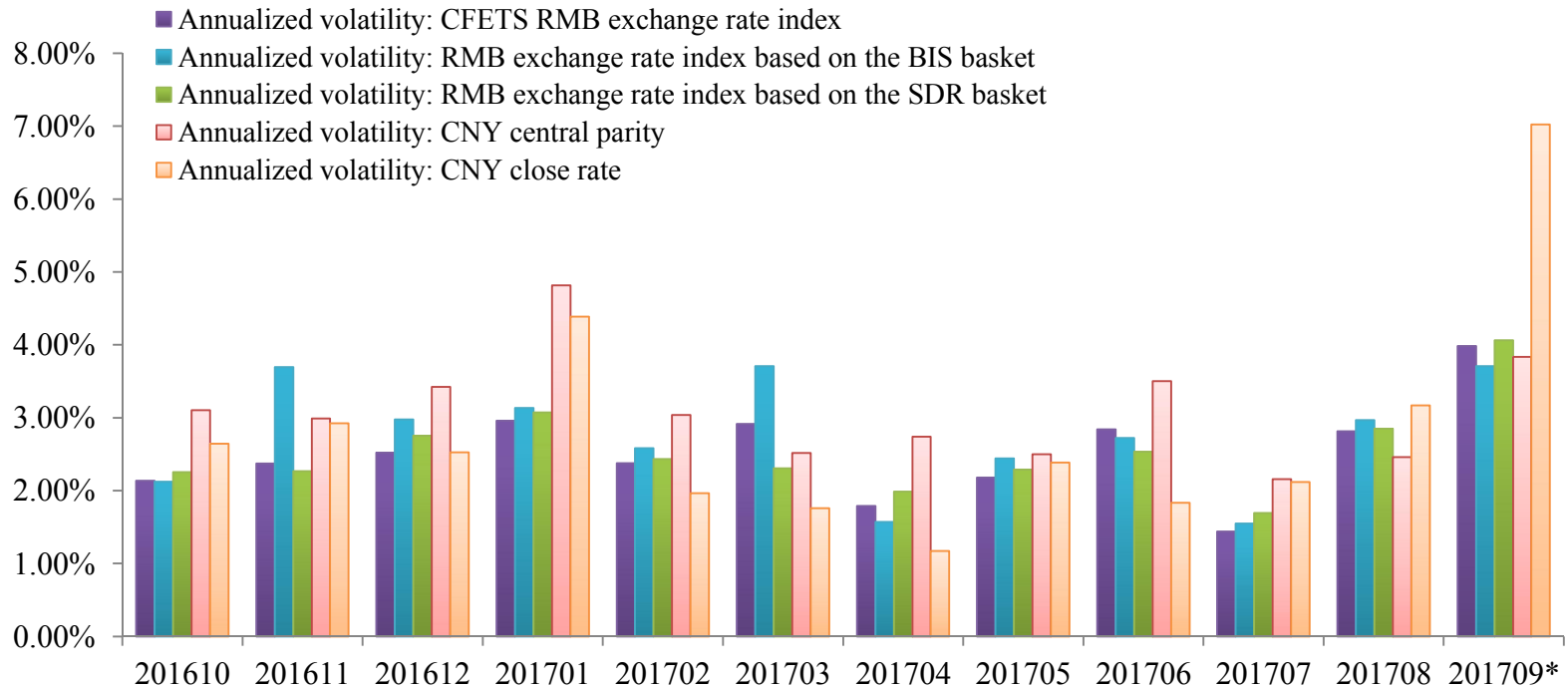
- Increasing exchange rate flexibility
- Improving macro-prudential policy framework regarding cross-border capital flow
- Strengthening international monetary policy coordination

Improving Market-based RMB Exchange Rate Regime



- Since the second half of 2015, China has further enhanced the RMB exchange rate formation mechanism, which is based on market supply and demand and with reference to a basket of currencies.

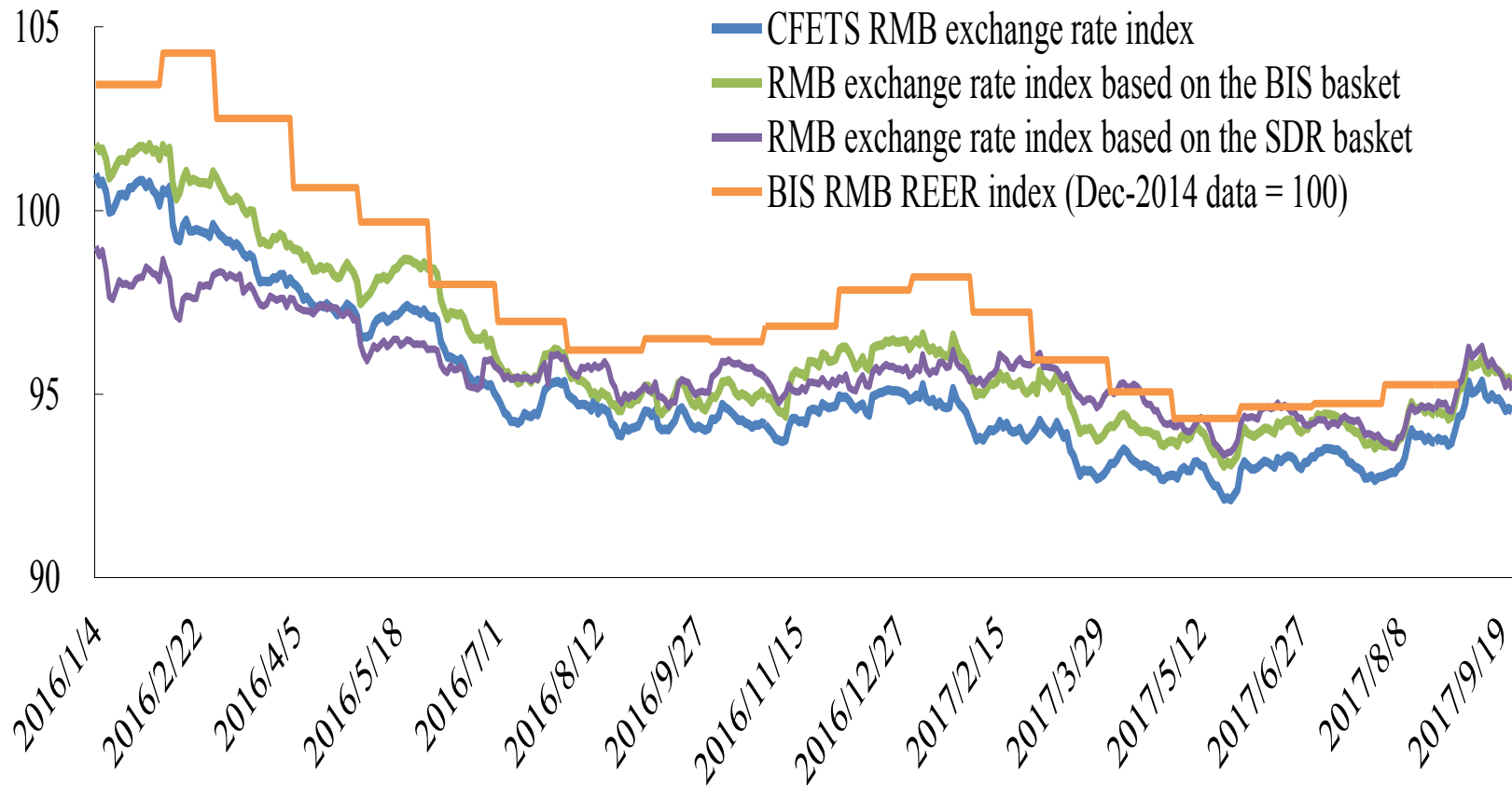
RMB exchange rate volatility: against USD vs. against a Basket of Currencies



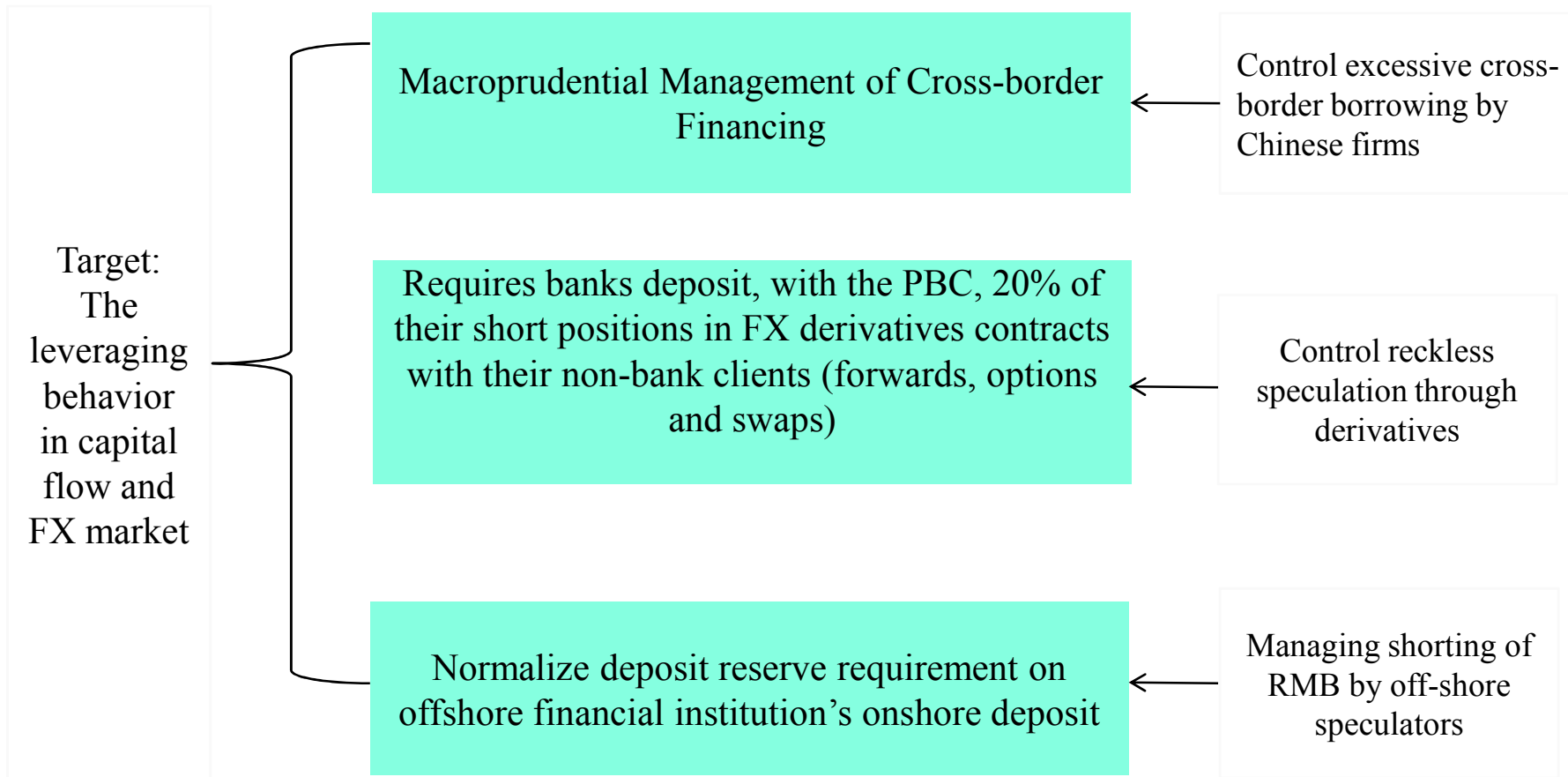
- In most of the period since October 2016, the volatility of RMB/USD exchange rate has been higher than that of RMB exchange rate indices.

*: data up to September 22th

RMB Exchange Rate against a Basket of Currencies



Macroprudential Management of Cross-border Capital Flow: General Framework



Strengthening International Monetary Policy Coordination

- ✓ With economic and financial globalization further deepening, the positive welfare effect of monetary policy coordination becomes stronger.
- ✓ Current coordination is embodied in that when monetary authority of certain economy is contemplating its monetary policy, it not only considers domestic conditions, but also considers external environment.
- ✓ International Monetary Policy Coordination has been also improved through financial market channel.



Thank you