Central Bank Monitoring

IV/2023

Czech National Bank ——— Central Bank Monitoring ——— IV/2023

CZECH NATIONAL BANK

www.cnb.cz

In this issue

Inflation continues to fall in most of the countries under review, yet still exceeds the central banks' inflation targets. At the same time, their interest rates are probably close to the peak of the current monetary cycle, while most of them, including the Fed and the ECB, did not change their rates in the last quarter. However, the Riksbank and the Norwegian NB have raised their rates further, while the Hungarian MNB and the Polish NBP are gradually lowering them. The ECB has moved to the next phase of the digital euro project. Starting next year, the Riksbank will increase the frequency of monetary policy meetings to eight per year and respond to the new law on the central bank. The mandates of the central banks in New Zealand and Australia have changed. The Bank of Japan has further increased the flexibility of its yield curve control.

Spotlight focuses on China's monetary policy, describing its objectives and instruments – which differ in many ways from the monetary policy in advanced countries – and discusses the latest developments and current challenges. In our *Selected Speech*, Swiss SNB Governor Thomas Jordan discusses the role of monetary policy uncertainty in the context of current economic developments.

This publication aims to familiarise experts with recent monetary policy developments, monetary policy strategy, and communication in selected central banks.

Current and past issues are free to download from the *Monetary policy* section of the CNB website: https://www.cnb.cz/en/monetary-policy/monitoring/, where you can also download a list of all thematic articles and speeches.

This publication is produced by the Monetary Policy and Fiscal Analyses Division of the Czech National Bank's Monetary Department, and is freely distributable. Authors: Vojtěch Molnár (editor), Natálie Dvořáková, Ivana Kubicová and Josef Simpartl.

The cut-off date for this issue is 14 December 2023.

Contents

I. LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS 4

I.1 Key central banks in the Euro-Atlantic area 4

I.2 Selected inflation-targeting non-EU countries 5

I.3 Selected central banks of inflation-targeting EU countries 6

II. NEWS OVER THE LAST THREE MONTHS 7

III. SPOTLIGHT: MONETARY POLICY OF THE CHINESE CENTRAL BANK 10

IV. SELECTED SPEECH: THOMAS JORDAN: POLICY-MAKING UNDER UNCERTAINTY – THE IMPORTANCE OF MAINTAINING A MEDIUM-TERM ORIENTATION 15

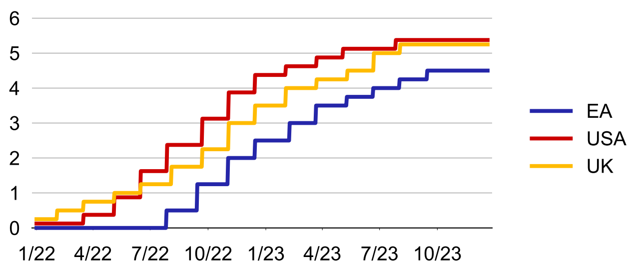
I. LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS

I.1 KEY CENTRAL BANKS IN THE EURO-ATLANTIC AREA

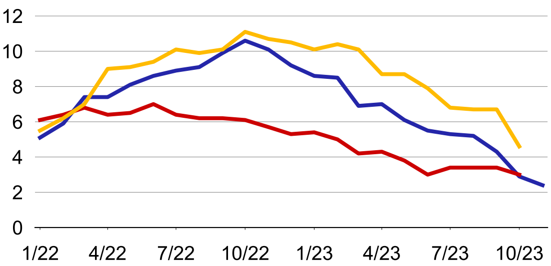
	euro area (ECB)	USA (Fed)	United Kingdom (BoE)
inflation target	2% (HICP)	2% (PCE)[1]	2% (CPI)
latest inflation	**2.4%** (11/2023, flash)	**3.0%** (10/2023)[1]	**4.6%** (10/2023)
current basic rate	**4.50%**	**5.25–5.50%**[2]	**5.25%**
MP decision publication (rate changes)	26 October (0.00) 14 December (0.00)	20 September (0.00) 1 November (0.00) 13 December (0.00)	21 September (0.00) 2 November (0.00) 14 December (0.00)
expected MP decisions	25 January 7 March	30–31 January	1 February

Note: [1] as measured by index PCE (Personal Consumption Expenditures); [2] chart shows centre of band.

Key interest rates



Inflation



The **ECB** left its interest rates unchanged at 4.5%. Although inflation has fallen in recent months, it is likely to rise temporarily. According to the new forecast, inflation is expected to fall further next year (by slightly more than expected in September) to 2.7% and then to 2.1% in 2025. Core inflation has moderated further. However, domestic price pressures remain elevated, primarily on account of strong growth in unit labour costs. Tighter financing conditions are dampening demand, helping to curb inflation. Economic growth will remain subdued in the near term before the economy recovers on the back of rising real incomes. The ECB expects GDP to grow by 0.8% next year and by 1.5% the year after that. According to the ECB's current assessment, interest rates have reached levels which, given enough time, will help inflation return to target values. However, the ECB will continue to make decisions based on incoming data, in particular the inflation outlook, core inflation dynamics and the strength of monetary policy transmission. The ECB decided to start reducing the size of the PEPP portfolio in the second half of next year by an average of EUR 7.5 billion per month and intends to terminate reinvestment under this programme at the end of 2024.

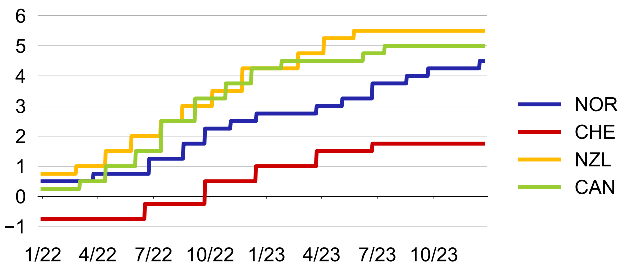
At its last three meetings, the **Fed** left the range for its key interest rate at 5.25%–5.50% and is continuing its quantitative tightening. According to the current median forecasts of FOMC members, a sharper rate cut than implied by the September forecast can be expected next year, i.e. currently a decrease of 75 bp to 4.6% at the end of 2024. Eight members expect fewer than three decreases of 25 bp next year, while five expect more decreases. Inflation has slowed over the last year, although it remains high. Most FOMC members currently see the inflation risk as balanced. The latest indicators point to a slowdown in economic activity growth from its strong pace in Q3, and a moderation in job growth. According to the FOMC forecast, real GDP will grow by 1.4% next year, while core inflation and PCE inflation will both be 2.4% next year.

The **BoE** has left its key interest rate unchanged at 5.25% three times. Six MPC members voted to maintain the key rate at 5.25% in December – three members wanted to raise the rate by 25 bp to 5.5%. At its September meeting, the BoE increased the pace of reducing asset holdings under the Asset Purchase Facility to GBP 100 billion per year. This covers the period from October 2023 to September 2024, while in the previous 12 months the BoE reduced its government bonds by GBP 80 billion. Inflation fell rapidly to 4.6% in October and will remain at similar levels around the turn of the year. In the short term, inflation will be somewhat lower than the November forecast, partly reflecting the recent fall in energy prices. GDP was flat in Q3, while the latest data indicate this will also be the case in Q4. Monetary policy will need to be sufficiently restrictive for a sufficiently long time to ensure that inflation returns sustainably to the 2% target over the medium term. Further monetary policy tightening would be required if there was evidence of more persistent inflation pressures.

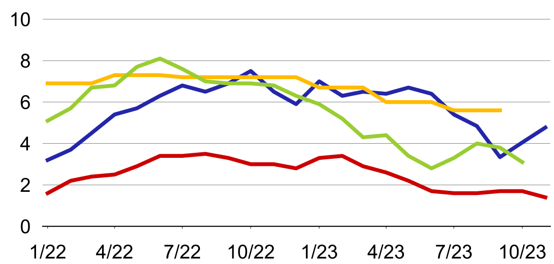
I.2 SELECTED INFLATION-TARGETING NON-EU COUNTRIES

	Norway (NB)	**Switzerland** (SNB)	**New Zealand** (RBNZ)	**Canada** (BoC)
inflation target	2% (CPI)	0-2% (CPI)	2% (CPI)	2% (CPI)
latest inflation	**4.8%** (11/2023)	**1.4%** (11/2023)	**5.6%** (Q3 2023)	**3.1%** (10/2023)
current basic rate	**4.50%**	**1.75%**	**5.50%**	**5.00%**
MP decision publication (rate changes)	21 September (+0.25) 2 November (0.00) 14 December (+0.25)	21 September (0.00) 14 December (0.00)	4 October (0.00) 29 November (0.00)	25 October (0.00) 6 December (0.00)
expected MP decisions	25 January	21 March	28 February	24 January 6 March

Key interest rates



Inflation



In line with its previous communication, **NB** raised interest rates by 25 bp at its September meeting and once again at its December meeting. According to Governor Ida Wolden Bache, the economy is cooling yet inflation remains too high. The current increase in the key rate thus reduces the risk of inflation remaining high for a long time. The key rate will probably be held at its current level of 4.5% until the autumn of next year. NB was addressing the balance between the risk of excessive monetary policy tightening and the risk of too little tightening. On the one hand, it sees a cooling of the economy and also that the full effects of past interest rate increases are only starting to be felt in the economy. On the other hand, inflation is high and is more difficult to reduce due to the depreciation of the krone. There is uncertainty about the future evolution of the Norwegian economy, and NB has outlined the following developments. If inflation remains elevated or the Norwegian krone turns out to be weaker than expected, NB stands ready to raise the interest rate again. If the Norwegian economy slows more markedly or if inflation falls faster, the interest rate may be lowered earlier than currently expected.

After increasing it in June, the **SNB** left its key interest rate unchanged at 1.75% in September and December. Inflation pressures decreased slightly in the last quarter, but according to the SNB, uncertainty remains high. To ensure appropriate monetary conditions, the central bank remains ready to actively enter the foreign exchange market. The current inflation forecast is below 2% for both next year and the following one. GDP growth was modest in Q3 and total production capacity utilisation was only slightly above average. Economic growth is likely to be weak over the coming quarters, dampened by subdued external demand and tighter financing conditions. According to the SNB, GDP will probably grow by 1% this year and the economy will grow by 0.5%–1.0% next year. A more pronounced economic slowdown abroad is the main risk to this forecast.

The **RBNZ** left its key interest rate unchanged at 5.5% in both October and November, and plans to keep it at restrictive levels for longer to ensure that inflation returns to the 1%–3% target band. High interest rates are limiting spending in the economy. Inflation is falling but remains too high, with the MPC remaining alert to continued inflation pressures, which persist given the still-insufficient supply compared to relatively strong demand. If inflation pressures turn out to be stronger than expected, the key interest rate would probably have to rise further. Economic activity continues to moderate, especially in interest rate-sensitive segments.

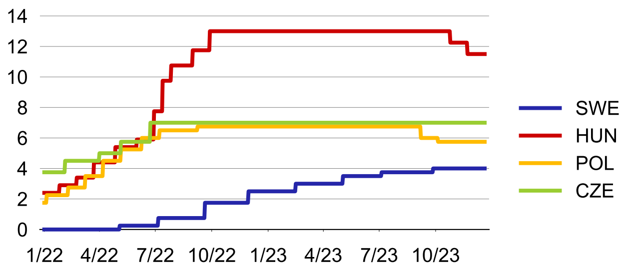
The **BoC** left the interest rate unchanged at 5% and continued its quantitative tightening. The economic downturn is reducing inflation pressures over a widening range of goods and services prices and this, combined with a fall in petrol prices, resulted in inflation at 3.1% in October. Core inflation remained between 3.5% and 4%. Real GDP declined in Q3. The increased interest rates are clearly constraining spending, with consumption growth close to zero over the past two quarters, and business investment essentially stagnant over the past year. The labour market is continuing to ease, but wages are still rising by 4%–5%. The Governing Council remains concerned about the risks to the inflation outlook, and stands ready to increase the interest rate further if needed. It also wants to see a continued and robust fall in core inflation.

I.3 SELECTED CENTRAL BANKS OF INFLATION-TARGETING EU COUNTRIES

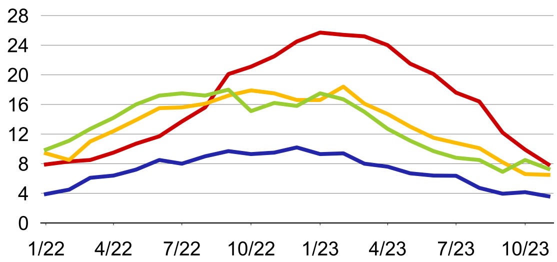
	Sweden (Riksbank)	**Hungary** (MNB)	**Poland** (NBP)	**Czech Republic** (ČNB)
inflation target	2% (CPIF)[1]	3% (CPI)	2.5% (CPI)	2% (CPI)
latest inflation	**3.6%** (11/2023)[1]	**7.9%** (11/2023)	**6.5%** (11/2023 flash)	**7.3%** (11/2023)
current basic rate	**4.00%**	**11.50%**	**5.75%**	**7.00%**
MP decision publication (rate changes)	21 September (+0.25) 23 November (0.00)	26 September (0.00)[2] 24 October (-0.75) 21 November (-0.75)	4 October (-0.25) 8 November (0.00) 6 December (0.00)	27 September (0.00) 2 November (0.00)
expected MP decisions	1 February	19 December 30 January 27 February	9 January 7 February 6 March	21 December 8 February

Note: [1] CPIF (consumer price index including a fixed interest rate); [2] at the September meeting, the MNB left its formally main interest rate unchanged, but lowered some of the other rates used – see *News*.

Key interest rates



Inflation



The **Riksbank** further raised its key interest rate by 25 bp in September and then left it unchanged at 4% in November. According to the Riksbank, the key rate is likely to remain at around 4% for the next two years. Inflation pressures have clearly eased and inflation has fallen, but it remains too high and there is a persistent risk that it will not fall towards the target sufficiently rapidly. The Executive Board stands ready to raise the interest rate further if the inflation outlook deteriorates. The central bank expects inflation to return to the target over the course of 2024. GDP will contract by 0.2% next year, returning to almost 2% growth in 2025. A decision could be taken to increase the volume of government bond sales at the January monetary policy meeting.

The **MNB** left its key interest rate unchanged in September, but lowered some of the other rates used and took steps to simplify its monetary policy toolkit (see *News*). The MNB lowered its key interest rate by 75 bp in both October and November, to 11.5%. The O/N deposit rate currently stands at 10.5% and the O/N collateralised borrowing rate at 12.5%. Although Hungarian inflation is now falling from its peak, it is still the highest among the countries under review. The MNB expects inflation of 4%–6% next year, and that it will not reach the tolerance band around the target until the start of 2025. The MNB expects GDP to grow by 3%–4% in the years ahead.

After lowering its key interest rate by 25 bp in October, the **NBP** did not lower the rate further, leaving it unchanged at 5.75%. Against the backdrop of weakened global economic conditions, economic activity in Poland remains subdued, rising by 0.5% in Q3 after a previous contraction. Incoming data point to low demand and cost pressures in the Polish economy, which will support the continuation of the gradual fall in domestic inflation amid weakened economic prospects and falling inflation pressures abroad. This fell to 6.5% in November according to a preliminary estimate. The NBP considers that the fall in inflation is being fostered by the appreciation of the zloty, which is in line with the fundamentals of the Polish economy.

The **CNB** left the 2W repo rate unchanged at its September and November meetings. At the November meeting, two Bank Board members voted to lower rates by 25 bp. The strong cost-push inflation pressures stemming from the external environment and demand pressures stemming from the domestic economy are fading in the Czech economy. The forecast is that inflation will fall significantly and close to the inflation target at the start of next year, reaching an average of 2.6% in 2024. According to the CNB forecast, domestic GDP will decline by 0.4% this year, returning to growth of around 1.2% next year. The baseline scenario of the forecast implies a gradual decline in interest rates from Q4 2023 onwards. According to communication by the Bank Board, the interest rate cuts will initially be moderate and gradual. The interest rate path is thus likely to be higher in the quarters ahead than in the baseline scenario of the forecast.

II. NEWS OVER THE LAST THREE MONTHS

The ECB continues with the digital euro project

In October, the European Central Bank decided to launch the preparatory phase for a digital euro. This step follows a two-year research phase in which the ECB examined the design and distribution of a digital euro, the results of which were presented in a summary publication. A digital euro should be widely available, free of charge for regular use, and usable for all digital payments in the euro area. Payments should be settled immediately and also available offline. There is an emphasis on high levels of protection for privacy and personal data. In general, a digital euro should be very similar to cash in most of its characteristics, thus representing its electronic equivalent (cash and a digital euro should work in parallel, increasing user choice, not replacing the former with the latter). ECB representatives expect a digital euro to increase the resilience, competitiveness and innovation of the payment system in the euro area.

In the preparatory phase, the ECB will address, among other things, the digital euro infrastructure, the testing of its functioning and its rules. After two years, the Governing Council will assess whether to continue preparations for the project. However, the current move to the next phase of the project does not represent a decision on the future adoption of a digital currency. The decision on the eventual adoption of a digital euro will depend both on the evaluation of the project's further progress and on the implementation of legislative changes that would have to precede such a decision (the European Commission launched the related legislative process this June).

The International Monetary Fund has released a handbook on CBDCs

In November, the IMF published a virtual handbook on central bank digital currencies (CBDCs), intended to be a handbook for central banks and finance ministries. The aim is to gradually accumulate knowledge and experience on this topic, which has been addressed by a number of central banks in recent years. Five chapters of the handbook are currently available, addressing the approach to CBDC research and development and issues relating to the impact of a digital currency on monetary policy transmission, capital flows and financial inclusion. The IMF plans to gradually publish additional chapters and update the existing ones on an ongoing basis.

The BoE has clarified the terms of reference for its review...

In September, the Bank of England published more details about the terms of reference for the ongoing review of its forecasting processes led by Ben Bernanke. The focus of the review should be forward-looking: it is not an analysis of previous monetary policy decisions (although the review may take into account past experience, as well as that of other central banks). In general, the revision should address an appropriate approach to forecasting and the preparation of materials for monetary policy decision-making, including the related communication in times of high uncertainty. It should focus, among other things, on the importance of forecasting in the decision-making and communication of the MPC (including the roles of the experts and the MPC in forecast creation), on the concept of forecast conditionality, including the interest rate path on which the forecast is based, and on the approach to taking into account significant shocks and changes on the supply and demand sides of the economy.

... and has become the target of criticism by the House of Lords

The Economic Affairs Committee of the House of Lords, the upper house of the Parliament of the United Kingdom, has released a report assessing the functioning of the BoE and its monetary policy. The report was prepared on the occasion of the 25th anniversary of the central bank's independence and in the context of the significant economic volatility over recent years. This committee of the House of Lords expresses strong support for the independence of the central bank yet is critical of the BoE's functioning in a number of aspects. Among other things, the report recommends a clearer definition of responsibilities and communication between monetary and fiscal policy, including the role of quantitative easing. The committee's opinion also includes a warning about the excessive expansion of the central bank's mandate (for example, including climate change or support for the competitiveness of the British financial sector), which may have a negative impact on the fulfilment of its main objectives of price and financial stability (while the setting of the mandate is the responsibility of the Treasury, i.e. the Ministry of Finance, not the central bank). According to the report, the central bank should strive for greater diversity of opinions, and attention should be paid to the management of the bank and the selection of members of the MPC's monetary policy body (the committee considers it was groupthink and a lack of diversity of opinions that contributed to the BoE's delayed response to the inflationary wave in recent years). The BoE's accountability to Parliament should also be increased, while still preserving the central bank's independence. The committee also welcomes the ongoing review of the BoE's forecasting processes.

The Hungarian central bank is simplifying its monetary policy toolkit

The MNB last raised its key interest rate in September 2022 and then held it at 13% until this October. However, over the past year, it has used a number of other tools to regulate its monetary policy. In particular, the overnight quick deposit tender, which stood at 18% at its introduction last year, played a significant role in withdrawing liquidity before the MNB started gradually reducing it in May this year, merging it with the base rate of 13% in September. At the same time, in September the bank issued a statement on the simplification of its monetary policy toolkit. In it, the MNB declared, among other things, that the base rate would once again take over the role of the main monetary policy instrument. The required and voluntary reserves of banks will now be remunerated at the base rate (with the exception of the part of the required reserves not subject to remuneration), as will long-term deposit facilities. The MNB has also returned to a symmetrical interest rate corridor, with the O/N deposit rate being 1 pp below the base rate and the O/N collateralised borrowing rate 1 pp above the base rate (this rate was as high as 25% last year). In line with the return to a symmetrical corridor, the MNB cut all three rates simultaneously in October and November, each time by 0.75 pp.

The Riksbank is changing how many meetings it will have...

From 2024, the Swedish central bank will switch to a frequency of eight monetary policy meetings per year from the current five. Four times a year, the Riksbank will publish a Monetary Policy Report with a new forecast after a meeting, while the remaining meetings will be based on assessments of new information, which will be summarised in a shorter document (until now, the bank published a Monetary Policy Report with a forecast after each meeting). All meetings will continue to be preceded by a one-week media quarantine and followed by a press conference and then the publication of minutes – these will now be published approximately five business days after the meeting instead of the current ten days.

... and will respond to the requirements arising from the new Sveriges Riksbank Act

In accordance with the new law, the Riksbank is changing the procedure for filling positions in its highest body, the Executive Board, with a new open competition for the positions. For the first time, a successor to a current member of the Executive Board, Martin Flodén, whose second mandate will end in May next year, will be selected in this way, while according to the law, members of the Executive Board can now have a maximum of two mandates in office. The General Council of the Riksbank (a parliament-appointed body that oversees the central bank without interfering in its decision-making), which has appointed the Riksbank's management until now, will be in charge of evaluating the selection process.

Under the same law, the Riksbank must ask the Swedish parliament for a capital injection if its equity falls below SEK 20 billion (while the target value of its equity should be SEK 60 billion). Due to the central bank's large loss in 2022, the Riksbank is currently operating with negative equity, and Governor Thedéen has therefore said in parliament that the bank will need a capital replenishment – just under SEK 80 billion according to current estimates. The official application will be submitted by the Riksbank next year based on the financial results for 2023.

The Australian government and central bank have issued a joint statement on monetary policy implementation

In response to the recent review of the monetary policy of Australia's RBA, the bank issued a joint statement with the government detailing its monetary policy regime. The statement redefines the dual mandate of price stability and full employment, while the economic prosperity and well-being of the Australian nation – the third separate monetary policy objective to date – will now constitute an overall general objective that the RBA can achieve by ensuring price stability and full employment. The target inflation band of 2%–3% remains unchanged, but the bank will aim for inflation in the middle of this band. The full employment target has been redefined as the maximum employment rate consistent with low and stable inflation. In line with the recommendations from the revision, these steps should thus describe the monetary policy regime more accurately. The RBA should also communicate more clearly its approach to unconventional monetary policy instruments (it should communicate openly about their benefits, costs and risks, and clarify its decision-making process for situations where it might consider the use of such instruments in advance). Following the planned establishment of the new Monetary Policy Board, the RBA will also publish an unattributed record of votes, while the materials for monetary policy meetings will also be published five years after the event.

Support for employment ceases to be part of the RBNZ mandate

New Zealand's Treasury announced its updated '*Remit for monetary policy committee*' in December, a document setting out the basic elements and objectives of the RBNZ monetary policy regime. The new remit ends the central bank's dual mandate (introduced in 2018), with the objective of promoting maximum sustainable employment being removed from the document compared to the previous version. The formulation of the price stability target was maintained in the same form. The target range for inflation will remain 1%–3% in an effort to keep inflation close to the central 2% level and the RBNZ should strive to meet the target in the medium term, i.e. it should not respond excessively to short-term price shocks. In pursuing its primary objective, it should take into account financial stability and avoid excessive volatility of GDP, employment, interest rates and the exchange rate.

This step is in line with the central bank's recommendation to the Treasury, which the RBNZ provided this year as part of its opinion on a regular five-year update of the *MPC remit*. The bank preferred to depart from the dual mandate and set a clear hierarchy of objectives with price stability as the primary objective. However, this recommendation was not reflected in the July update of the document (for more information on the whole process, see the June and September issues of Central Bank Monitoring). However, with the change of government after the October elections, the attitude of the Treasury also changed, and in the first weeks after its formation, the new government modified the mandate of the RBNZ.

New Zealand expands available monthly price sub-indices

New Zealand is the only OECD country that does not calculate consumer price inflation for each month, but only quarterly. Since November, however, the country's statistical office has been publishing monthly sub-indices showing the development of prices of alcohol and tobacco, fuel, airline tickets and accommodation. These data will augment the already available monthly data on food prices and rents. Together, this means that monthly data with a weight of approximately 44% of the overall consumer price index will be available, giving the local central bank a more detailed insight into price developments in individual sectors of the economy every month. However, the official inflation indicator (and the central bank's target) remains inflation measured through the consumer price index, only available quarterly.

The Bank of Japan further increases yield curve control flexibility

In July, the BoJ started considering the upper limit of the tolerated band for ten-year government bond yields of 0.5% as a benchmark, with the understanding that it would not tolerate yields above 1% (having faced upward pressures on yields in recent quarters and yields exceeding the 0.5% reference level in the months following the July decision). At its October meeting, the BoJ again revised its approach to yield curve control, deciding to take the 1% yield on 10-year government bonds as a benchmark. While the Japanese central bank still formally targets a 10-year yield of 0%, the decision represents another step toward greater flexibility of (and potentially a possible exit from) the instrument.

The SNB reduces remuneration of reserves

Since December, the Swiss central bank has stopped remunerating reserves held to meet reserve requirements. In addition, the SNB has lowered the threshold factor up to which institutions subject to the reserve requirement are remunerated at the monetary policy rate on their other deposits with the central bank. Deposits above this limit will be remunerated at a rate 0.5 pp lower (through *tiering*). According to the SNB's press release, these adjustments will ensure that monetary policy transmission remains effective (the monetary policy stance itself remains unchanged) and will reduce interest costs for the central bank.

III. SPOTLIGHT: MONETARY POLICY OF THE CHINESE CENTRAL BANK

China's monetary policy is a complex system in which the central bank pursues a number of objectives. The stability of the Chinese renminbi exchange rate plays an important role, especially in the context of the current global economic challenges. China, within the planned economy of which the central bank is part, is actively seeking to strike a balance between supporting the domestic economy and addressing potential problems arising from international capital flows. The dance between liberalisation and maintaining control thus defines China's monetary policy. This article assesses its evolution and provides comparisons with advanced market economies.[1]

China is the second-largest economy in the world. The influence of the Chinese economy was particularly pronounced during, for example, the COVID-19 pandemic. The disruption of global supply chains during the pandemic stemmed mainly from limited exports from China, resulting in negative supply and production effects in many countries. The functioning of Chinese monetary policy is thus also relevant to other economies due to the size of the Chinese economy.[2]

The PBC and monetary policy objectives

PBC functions are set out in the 2003 Law of the People's Republic of China on the People's Bank of China and include, inter alia, monetary policy, currency management, financial-market regulation, financial stability, currency stability, etc. The primary objective is "to safeguard currency stability[3] and promote economic growth". The Chinese Communist Party Committee Secretary, nominated by the Chairman of the State Council, has a key influence on the management and direction of the PBC, and not the governor. However, Mr. Pan Gongsheng currently holds both of these posts.

The Monetary Policy Commission (MPC) was set up in 2000 and has the task of discussing and proposing: (i) changes in the monetary stance, (ii) monetary policy objectives, (iii) the use of monetary instruments, and (iv) macroeconomic policy coordination measures. Jones and Bowman (2019) describe that the MPC organisational structure adheres to international standards, although its powers are relatively limited – it is merely an advisory body for monetary policy creation. The composition of the MPC is determined by the State Council and currently comprises 14 members. The MPC meets on a quarterly basis, and the minutes of its meetings and recommendations of decisions are submitted to the State Council for approval. Unlike most central banks of advanced economies, therefore, China's MPC is not an independent executive body. MPC meetings are based on the Monetary Policy Report, which summarises the development of the Chinese economy in the previous quarter and suggests further monetary policy steps. It also includes a qualitative description of expected future developments. However, no quantitative forecast can be found in the Report, unlike in the case of the central banks of advanced economies.

Main monetary policy instruments

Compared to advanced economies, China uses a broader set of monetary policy instruments to achieve its objectives. The monetary policies of advanced economies usually put the emphasis primarily on price instruments, first and foremost on interest rates. However, the Chinese economy (characterised by state ownership of banks and firms) uses an instrument system that combines both price[4] and volume market instruments, and non-market instruments:

- *Rates for open market operations (OMO)*: OMOs are carried out on a regular basis with the aim of correcting liquidity in the banking market. They include operations with PBC treasury bills (repo, reverse repo), and their yield can be considered a monetary policy rate. The key OMO rate is the 7-day reverse repo rate, which affects short-term interest rates like the DR007 repo rate on the interbank market.
    - *Interest rate corridor:* The PBC keeps short-term interest rates within a defined range using an interest rate corridor, where the standing loan facility (SLF) rate serves as the upper bound and the interest rate on excess reserves as the lower bound.
    - *Additional lending facilities* – in particular the medium-term lending facility (MLF): the MLF rate is the one-year central bank interest rate which, together with the 7-day reverse repo rate, forms the overall monetary policy interest rate system. It gives a price for the medium-term funds for which the banking

---

[1]China's monetary policy and its evolution during the first decade of the century was also discussed in the April 2011 issue of Global Economic Outlook.

[2]In the monetary policy context, China's growing influence on the global economy was examined, for example, in a recent study by Chen et al. (2023). The paper shows that China's monetary-policy shock has had significant spillover effects on macroeconomic and financial variables in twenty-six countries of the Belt and Road Initiative (BRI), or New Silk Road – China's initiative, which includes, for example, infrastructure projects to develop connectivity between these countries and China.

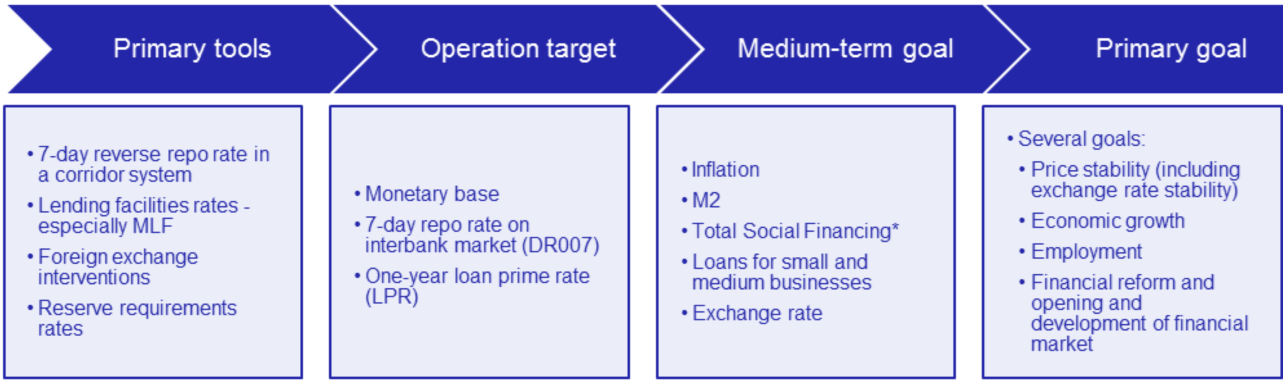
[3] Currency stability comprises two dimensions: internal (domestic inflation stability) and external (a stable exchange rate).

[4] The interest-rate system is described in more detail in an article by then Governor Yi (2021).

system borrows from the central bank. Since 2019, the PBC has introduced a structured approach to MLF operations, which it conducts on a monthly basis. In 2018, the PBC implemented the TMLF (Targeted MLF) programme, available for three years, to support lending to micro and small enterprises. The relevant rate was 15 basis points lower than the MLF rate.

- *Foreign exchange interventions*: China also uses foreign exchange market interventions through which it affects the exchange rate. The role of the exchange rate in monetary policy is described in more detail below.
- *Window guidance*: a non-market instrument, mainly typical of Chinese and Japanese monetary policy. This consists of 'guidance' (in the form of directives) to financial institutions to grant and allocate credit in line with official (government) objectives. Jones and Bowman (2019) state that the PBC maintains a strong influence on both the amount of credit provided by the banking system and the sectors that can receive credit financing. However, this instrument is not mentioned in the latest Monetary Policy Reports and is used only occasionally.
- *Reserve requirements (RR)*: by changing the RR rate, the PBC is able to influence interbank liquidity and the availability of funds, and thus seeks to influence lending activity. The PBC applies a multi-layered RR rate system in which it takes into account factors such as bank size, the composition of individual bank loans and financial stability.

The monetary policy framework of the PBC



Prepared based on Jones and Bowman (2019), Das and Song (2023).

* Total Social Financing (TSF) comprises bank loans, non-bank forms of credit intermediation (e.g. trust and entrusted loans) and capital market issues.

Transmission mechanism

When describing the Chinese monetary policy transmission mechanism, it is worth mentioning some factors that complicate this analysis. First, the Chinese monetary framework is complex and not fully transparent in several aspects, including some monetary policy instruments. Second, the institutional environment for macroeconomic policy-making, where the State Council acts as the final decision-making body, leads to a high degree of coordination between monetary and fiscal policy (Das and Song, 2023). The interconnection of monetary policy with banking supervision and financial stability and agreements with banks (in many cases state-owned) is also of considerable importance. For example, supervision has the decisive power to determine who will be granted credit, who, on the contrary, can declare bankruptcy, etc. The main unifying element of these policies is ensuring overall stability.

Despite this, Das and Song (2023) state that monetary policy is increasingly transmitted via interest rates, which now have a greater influence on corporate and household decisions than monetary aggregates. This tendency is confirmed by Jones and Bowman (2019), who state that the transmission of short-term repo rate shocks to asset prices and real economic activity is stronger than those of monetary aggregates. However, China differs significantly from advanced economies in terms of the transmission of the effect of monetary policy instruments on inflation. For example, the PBC does not have independent instruments and does not have a clear nominal anchor, as is customary in the monetary policies of advanced economies and, according to the article, the effect of interest rates on inflation is limited.

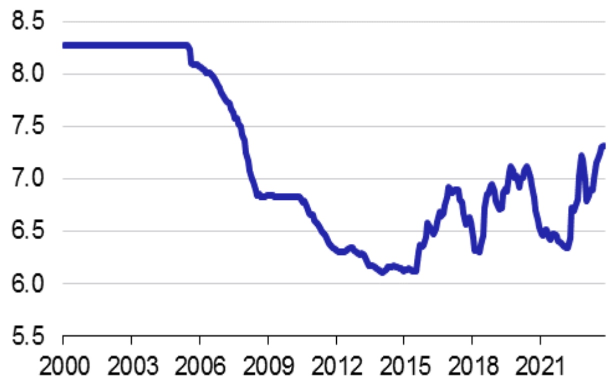
The exchange rate as an instrument of China's monetary and export policies[5]

Since July 2005, a regime of a managed floating renminbi (RMB or CNY, pronounced 'rɛnmɪnbi') exchange rate has been officially introduced, but in reality, it has long been a crawling peg against the US dollar. This system allowed the Chinese

[5] As far as the stability of the renminbi exchange rate is concerned, supervision of foreign exchange transactions is ensured by the State Administration of Foreign Exchange (SAFE), a body subordinate to the PBC. Thus, for example, the SAFE grants permits for the export or import of capital.

currency to appreciate slowly until July 2015, except for the two-year period following the start of the global financial crisis, when the exchange rate was kept stable. China intervened intensively in the foreign exchange market between 2005 and 2014 to ease currency appreciation, with foreign exchange reserves rising from USD 733 billion in July 2005 to a peak of USD 3.99 trillion in June 2014. Market sentiment reversed in 2014 towards a feeling that the renminbi is overvalued, exerting pressure on capital outflows. In order to limit the depreciation of the exchange rate against the US dollar, in the summer of 2014 the foreign exchange interventions changed to sales of reserves, which ensured that the exchange rate was stable yet capital outflow pressures remained strong. In effective terms, however, the renminbi appreciated by 14% between the end of 2013 and July 2015. Exports and overall economic growth thus slowed in this period (Das, 2019).

Chart 1: USD/RMB exchange rate (2000–2023)



Source: FRED.

In August 2015, a change in the central parity mechanism (around which some fluctuation is allowed) between the renminbi and the US dollar was announced. Prior to this change, the PBC was essentially arbitrarily determining the parity, and the difference between the hypothetical market rate and the official rate was reflected in changes in the foreign exchange reserves. Following the change, the PBC started to take into account the previous day's market rate when setting parity, so the effect of market forces on the exchange rate increased. In this context, the central parity rate suddenly shifted downwards. The Chinese government presented this depreciation as a move towards greater renminbi flexibility but,[6] but at the same time, a weaker currency may have supported declining exports due to weak foreign demand.[7] Capital outflows were also accelerated in this period (Das, 2019).

In this context, it is also possible to mention the composition of international reserves, which the PBC does not disclose in detail, even though some aspects are evident. In September 2023, China held around 10% of the total US external debt, ranking it second among holders after Japan. There is an effort to diversify, as currently illustrated by a steady rise in gold reserves for the 12th consecutive month. This strategy is in line with a trend through which a number of other central banks are increasing their gold reserves to increase asset diversification, hedge against geopolitical risks, and reduce their dependence on the US dollar.

Monetary policy during the COVID-19 pandemic

In response to the pandemic, the PBC has taken several measures to directly support the real economy. These included, for example, the provision of special loans from the central bank amounting to RMB 300 billion. The PBC has also provided loans with lower interest rates of RMB 1.8 trillion to support micro and small enterprises (MSEs) as well as rural development. These monetary policy instruments directly supported the sectors of the economy hit by the pandemic. Two other instruments have also been introduced: one allowing a postponement of the repayment of inclusive loans for MSEs, and the other was a support plan for inclusive loans for MSEs. The aim was not only to provide immediate financial assistance, but also to improve the effectiveness of structural monetary policy instruments contributing to more targeted support for micro, small and medium-sized enterprises.

Current state of the economy and the monetary policy stance

The performance of the Chinese economy was rather lacklustre after the post-COVID reopening, but in Q3 the year-on-year GDP growth accelerated to 4.9%, exceeding analysts' expectations. The impact of government stimulus measures had a particularly positive effect. Chinese exports have declined in recent months owing to subdued external demand, while imports have increased. The Chinese economy has fallen into deflation, with annual consumer price inflation of -0.2% in October and falling further to -0.5% in November.[8] In recent years, China has also been struggling with a crisis in the property market.[9] In 2020, the government intervened due to the rapid indebtedness of developers, setting strict limits on three key debt indicators. This has led to the slowdown or suspension of many projects and, in some cases, to the

[6] Ahmed (2021) argues that greater renminbi flexibility after 2015 is motivated by efforts to increase the global importance of the currency. At the same time, he considers it may also be that the easing of the renminbi's link to the US dollar was accelerated by the ongoing trade war between the USA and China in an effort to protect itself against the impacts of tariffs.

[7] See Global Economic Outlook August 2015.

[8] For more details on recent developments in the Chinese economy, see Global Economic Outlook November 2023.

[9] According to an estimate by Rogoff and Yang (2023), the share (including the indirect effect) of the property and infrastructure construction sector in the Chinese economy has exceeded 30% of GDP in recent years.

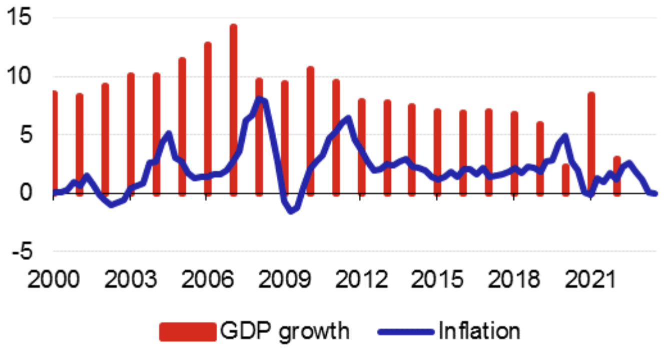
bankruptcy of developers. The property crisis has had an impact on the quality of banks' loan portfolios and on the finances of provincial governments and municipalities. In addition, youth unemployment is increasing (reaching 21.3% in June 2023).

Given the current state of the economy, the PBC has eased monetary policy in recent months. It has already lowered the RR twice this year. The weighted average of the RR for financial institutions is now 7.4%. In recent months, the PBC has provided the banking system with sizeable liquidity injections via a one-year MLF. In November, the net funds amounted to RMB 600 billion, the largest medium-term liquidity injection since 2016. At the same time, it left the MLF rate unchanged at 2.50%. For OMO operations, the 7-day reverse repo rate is now 1.80%. In this context, the renminbi is showing a depreciation trend this year, partly because of a wider interest rate differential – rates remain elevated in the USA and in other major economies. However, the experience of 2014 and 2015 raises concerns that a sharp currency depreciation could cause massive capital outflows. The PBC therefore wishes to maintain the stability of its currency and is taking concrete measures in this context. Even though the central parity of the renminbi-dollar exchange rate is set every day on the basis of market forces, the bank has the option of adding a countercyclical factor. In this way, the bank can set the central parity rate a little stronger every day. It also seeks to support the renminbi by reducing liquidity outside mainland China,[10] which makes it more difficult for speculators to lend the renminbi for sale. According to Wang et al. (2023), the PBC has thus regained control over the value of the renminbi, albeit to the detriment of market-setting of the exchange rate and internationalisation of its currency. Moreover, the interventions are acting in the opposite direction to the easing of other monetary policy instruments.

Chart 2: DR007 interbank repo rate

Source: Bloomberg.

Chart 3: GDP and inflation



Note: Year-on-year real GDP growth, annual data.
Year-on-year headline inflation, quarterly data.
Source: World Bank and FRED.

Challenges and outlook

From a long-term perspective, China faces serious challenges at home, such as population ageing, the rural-urban divide, excessive public infrastructure construction, an underdeveloped financial system, a lack of innovation, and dependence on fossil energy sources. In addition, China's external geopolitical relations with a number of important partners have deteriorated, leading to increasing trade and investment barriers on both sides. According to Yoshina and Miyamota (2019), the gradual ageing of the population and the declining share of the working population are resulting in a declining effectiveness of monetary and fiscal policy.

As regards the potential paths of Chinese monetary policy, the development of the digital currency (CBDC) is at a very advanced stage. The PBC is a leader among central banks in terms of digital currency application and scope of use. Unlike Western economies, China is seeking to replace cash with the digital renminbi rather than simply supplementing it. The motivation for the creation of a CBDC is also different from other economies: the issue of greater control of the population is controversial (at least from an external point of view), and the effort to increase the global importance of the Chinese currency also represents a certain motivation for the introduction of the digital renminbi. Until now, the digital currency has been used mainly for domestic retail payments, and its share in total currency in circulation remains negligible, but the scale of its use continues to grow. The next stage of its development includes integration into wholesale banking transactions and cross-border payments.

[10] In an effort to internationalise the renminbi, in the absence of a fully liberalised capital account, China has introduced an offshore RMB market, creating a situation of "one currency, two markets" (onshore CNY and offshore CNH in places such as Singapore and Hong Kong). According to Wang et al. (2023) it now finds itself in a dilemma: while the monetary authorities can regain control over the exchange rate in the onshore market (tighten control of the exchange rate in the onshore market or liquidity in the offshore market), they should be aware that such measures can bring complications in the process of exchange rate marketisation and currency internationalisation.

Gradual liberalisation?

With some implementation elements (e.g. the key interest rate corridor), China's monetary policy is increasingly converging with those of advanced economies as it continues to move from a volume-based monetary policy system to a price-based system (Jones and Bowman, 2019). Das and Song (2023) indicate that the liberalisation of interest rates was essentially completed by the removal of the deposit rate cap in 2015. While the financial system remains largely banknote-oriented, the government is pursuing measures to develop financial markets, including opening the Chinese bond market. According to Schipke et al. (2019), this implies that capital markets will play a relatively larger role in the allocation of savings and investment in the future.

On the other hand, Kawai and Liu (2015) argue that monetary policy autonomy has decreased, constrained by the declining effectiveness of capital controls and the rigid exchange rate regime. Jones and Bowman (2019) further point out that the government's occasional use of window guidance still influences the flow of credit in China. The authors also summarise that, although monetary policy in China has evolved significantly over the years, it still differs from advanced economies. Given China's political regime, institutional set-up and economic development measures, the likelihood of further convergence in the monetary policy regime does not seem high.

Conclusion

China's monetary policy is characterised by a number of objectives, as well as by a relatively wide set of instruments, including non-market instruments. China has no clear nominal anchor and the effect of interest rates on inflation is only limited. An important role is played by the renminbi exchange rate, which the PBC has significantly influenced over a long period through its interventions (although since 2015 market forces have had a greater influence on the exchange rate than in previous years). Moreover, the central bank does not have full control over monetary policy; decisions are subject to approval by the State Council.

The Chinese economy is currently facing many challenges, including the ongoing property market crisis, deteriorating global demand and rising unemployment, which affect overall economic activity. In the longer term, unfavourable demographic developments, among other things, pose a difficult challenge to China's economy and monetary policy.

Despite the gradual monetary policy easing, the differences between China's monetary policy and its counterparts from advanced economies remain sizeable. Moreover, given the political regime and concrete steps taken by the Chinese authorities, a further convergence of the monetary policy regime is unlikely. This points to the specificity and individual nature of the path China is taking in its efforts to maintain stability and successful economic development.

Literature

Ahmed, R. (2021). Monetary policy spillovers under intermediate exchange rate regimes. Journal of International Money and Finance, 112, 102342. (LINK)

Chen, Y., Liu, D., & Zhuang, Z. (2023). The spillover effects of China's monetary policy shock: Evidence from BaR countries. Emerging Markets Review, 55, 100952. (LINK)

Das, M. S. (2019). China's evolving exchange rate regime. International Monetary Fund. (LINK)

Das, S., & Song, W. (2023). Monetary policy transmission and policy coordination in China. China Economic Review, 82, 102032. (LINK)

Jones, B., & Bowman, J. (2019). China's evolving monetary policy framework in international context. Reserve Bank of Australia. (LINK)

Kawai, M., & Liu, L. G. (2015). Trilemma challenges for the People's Republic of China. Asian development review, 32(1), 49-89. (LINK)

Schipke, A., Rodlauer, M., & Zhang, L. (2019). China's Bond Market: Characteristics, Prospects, and Reforms (p. 3–31). The Future of China's Bond Market. International Monetary Fund. (LINK)

Yi, G. (2021). China's Interest Rate System and Market-based Interest Rate Reform. Journal of Financial Research, Issue 9. (LINK)

Yoshino, N., & Miyamoto, H. (2019). How does population aging affect the effectiveness of monetary and fiscal policies? (No. 1064). ADBI Working Paper Series. (LINK)

Wang, P., Ho, T., Liu, X., & Wu, S. (2023). China's Trilemma: Exchange Rate Marketization, RMB Internationalization, and Exchange Rate Pricing Power. Borsa Istanbul Review. (LINK)

IV. SELECTED SPEECH: Thomas Jordan: Policy-making under uncertainty – the importance of maintaining a medium-term orientation

In his November speech at a joint conference by the SNB, the Fed and the BIS on global risk, uncertainty and volatility, Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank (SNB), discusses uncertainty and its impact on decision-making and considerations on monetary policy.

In the introduction to his speech, Thomas Jordan names the uncertainties in the current economic environment. There is, for instance, substantial uncertainty regarding the impact of accumulated monetary tightening on future inflation. There is also high uncertainty about how the current geopolitical tensions will affect the global economy. These examples illustrate just two of many different sources of uncertainty. At the same time, Thomas Jordan recalls the SNB's risk management approach to monetary policy. This approach is characterised by three principles: pragmatism, consistency and determination. A pragmatic risk management approach means choosing policies that deliver good outcomes in many scenarios, rather than seeking policies that are optimal in one particular scenario only but deliver poor outcomes in most others. At the same time, monetary policy has to be consistent – policy decisions must always be geared towards the objective of price stability. Finally, determination is important in preventing uncertainty from giving rise to inherent indecision. A risk management approach to policy-making sometimes requires decisive action.

The economic backdrop has changed

With inflation rates lower and interest rates higher than they were a year ago, it has become considerably more difficult to balance the risk of tightening too much against the risk of tightening too little. Many central banks have therefore also slowed or paused tightening, while signalling that they remain focused on returning inflation to their respective targets.

When central banks approach monetary policy turning points, the way forward is particularly uncertain. Providing forward guidance in such situations carries high risks, according to Thomas Jordan. A central bank that gives strong forward guidance has to be fairly certain about the future path of monetary policy. Suppose the economy moves in a direction that calls for a monetary policy that is not in line with the forward guidance provided. This can put the central bank in a dilemma. Either it deviates from its guidance, which can lead to a communication problem and even a loss of credibility. Or it sticks to its guidance and runs the risk of pursuing an inappropriate monetary policy. That is why central banks have moved away from providing strong forward guidance at present.

Instead, many central banks are emphasising that their decisions are data-dependent. The SNB, too, is highlighting the importance of incoming data. Nevertheless, Thomas Jordan asks what exactly do central banks mean when they say their decisions are data-dependent? After all, central banks always take a close look at the data. The fact is that given the high uncertainty regarding the economic outlook, there is no clearly mapped out path for monetary policy in the near future. Therefore, central banks are using incoming data to reassess the desirable path for monetary policy from meeting to meeting.

Data-dependent but with a clear medium-term orientation

However, Thomas Jordan emphasises that proceeding in a data-dependent, meeting-by-meeting manner also entails certain challenges. The first challenge is not to fall into the temptation of reacting to every data surprise with a substantial change in monetary policy. Such behaviour would result in an erratic monetary policy. As monetary policy affects the economy only with a certain lag, frequent changes of direction would be counterproductive. Thus, while being data-dependent, central banks must maintain a medium-term orientation. Their models, which incorporate medium-term relationships between economic variables, can help them achieve this goal. Rather than reacting directly to incoming data, central banks first let their models process the incoming data. By factoring in different assumptions, the models provide decision-makers with scenarios for setting monetary policy. But models only reflect reality to a limited extent. Therefore, outside information – such as discussions with company managers and anecdotal evidence – support central banks in checking the plausibility of the model results. Finally, central banks have to use judgement in deciding whether a new scenario has become more likely, and whether a change in monetary policy is warranted.

A second challenge is how to communicate the currently high uncertainty about the monetary policy outlook while still providing some guidance to households and companies. Thomas Jordan states that central banks have to acknowledge that there is uncertainty surrounding the monetary policy outlook. At the same time, they can give households, companies and market participants a compass by clearly communicating their reaction function. This includes information on how they deal with trade-offs. What are their priorities when there are upside risks to inflation, but downside risks to economic activity? The SNB has clearly communicated that its focus remains firmly on ensuring price stability, and that it will not hesitate to tighten monetary policy further if necessary in order to keep inflation below 2% on a sustainable basis. Although this may not give markets certainty about future monetary policy, it does provide some guidance. Households and companies can continue to plan for stable prices in Switzerland in the future.

Issued by:
CZECH NATIONAL BANK
Na Příkopě 28
115 03 Prague 1
Czech Republic

Contact:
COMMUNICATIONS DIVISION
GENERAL SECRETARIAT
Tel.: 224 413 112
www.cnb.cz