

Policy Transmission Mechanism and Effects Analysis of China's Standing Lending Facility

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Abstract

In June 2013, on the basis of conventional monetary policy tools, People's Bank of China added unconventional monetary policy tool of standing lending facility as a complementary tool to bank liquidity management. The tool formed the upper limit of interest rate corridor to guide short-term market interest rate. This paper gives a brief introduction to standing lending facility, and focuses on the policy transmission mechanism and regulation effects of this innovative monetary policy tool.

Keywords

Standing lending facility; Liquidity; Interest rate corridor; Unconventional monetary policy.

1. RESEARCH BACKGROUND

At the beginning of 2013, Federal Reserve's quantitative easing policy expectation increased and the downward pressure on domestic economy got stronger, China has gradually faced the problem of insufficient liquidity and rising market interest rate. At the same time, as the original large surplus of China's balance of payments was gradually narrowed due to cross-border funds fluctuations and central bank's liquidity delivery by foreign exchange purchase was hampered, domestic liquidity was even more tighter. In the middle of 2013, China's commercial banks faced a "money shortage", and the inter-bank overnight lending rate rose sharply. However, China's money supply still maintained a relatively high growth rate. This showed that the liquidity shortage in China at that time was a structural problem, instead of the problem of insufficient money supply. Traditional monetary policy tools has strong irritation on market and are likely to cause large fluctuations of market expectations and interest rates. In addition, they have the characteristics of serious time lag and weak targeting. As a result, traditional monetary policy almost failed at that time.

Therefore, People's Bank of China initiated standing lending facility in June 2013 and officially disclosed this unconventional monetary policy in November of the same year. The standing lending facility is applied to solve the temporary liquidity fluctuations of banking system and meet the large and long-term liquidity requirements of financial institutions so as to stable short-term interest rate fluctuations. At present, the standing lending facility has become a regular supplement to the conventional monetary policy tools, and its policy effectiveness has become a concern of domestic scholars and policy makers.

2. LITERATURE REVIEW

At present, the implementation time for standing lending facility is relatively short. Related studies are quite few. They can be divided into three aspects. The first is the overview of the nature and characteristics of standing lending facility and international comparisons. The

second is the study of mechanism. The third is the study of role and effects, which are also the purpose of this paper. Guofeng Sun and Chunchun Cai (2015) believed that standing lending facility plays an important role in China's liquidity management. When the market interest rate is higher than the reasonable level, the central bank can release liquidity to the market through the tool of standing lending facility so that the interest rate falls rapidly to a rational level. Guogang Wang (2014) believed that the standing lending facility can reasonably guide interest rates of different maturities and form a diversified interest rate corridor mechanism in addition to adjusting supply of money and credit. Xianling Jiang (2016) studied the effectiveness of standing lending facility based on SVAR model and found that it played the role of the upper limit of interest rate corridor. In view of the increase of operational data for standing lending facility in recent years, research and analysis may lead to different conclusions from previous literature. This paper provides a brief analysis of the effectiveness of standing lending facility in 2013-2017.

3. TANDING LENDING FACILITY REVIEW

"Standing lending facility" is not originated in China. Central banks in most countries in the world have this kind of monetary policy tool, such as Fed's discount window, European Central Bank's marginal loan facility, Bank of England's operational standing facility, Bank of Japan's supplementary loan facility, Bank of Canada's standing liquidity facility, Singapore Monetary Authority's standing loan facility, and Russian Central Bank's guaranteed loans, Reserve Bank of India's marginal standing facility, Bank of Korea's liquidity adjustments loans, central bank of Malaysia's mortgages and so on. China's standing lending facility is developed according to reality, and has the same characteristics and also unique features as other monetary policy tools. It is a supplementary channel for the central bank to regulate liquidity supply in addition to "three magic weapons". Compared with short-term liquidity regulation, it mainly satisfies large and long-term liquidity requirements of financial institutions; And compared with open market operation, it is a direct financing method that financial institutions voluntarily apply to the central bank for a certain amount of money based on their liquidity and use qualified assets for mortgage; Compared with re-discount, the interest rates of standing lending facility are and are a kind of punitive rate. The main operational targets are commercial banks and policy banks and the main operating time is 1 to 3 months.

3.1. Features

The central bank has no initiative. The sponsors of the standing lending facility are financial institutions. These financial institutions apply to central bank according to economic environment and the liquidity conditions of themselves. The central bank can only passively accept their requirements.

The tool is Targeted. Standing lending facility is a one-to-one transaction between central banks and financial institutions, rather than the central bank's handling of funds throughout the market.

The tool has wide range of applications. The standing lending facility is mainly secured by the promoter's own assets. There are no other mandatory conditions and is basically applicable to all financial institutions. At the same time, the interest rates of standing lending facility are not preferential rates, so the financial institutions that applied for it will not be considered to have financial problems like the financial institutions that apply for re-discount. Therefore, the standing lending facility has a wider scope of application.

3.2. Application Status

The Central Bank began to use the standing lending facility from 2013. By January 2018, the operations can be divided into the following phases: June 2013—February 2014, February

2015—March 2015, December 2015—October 2016, and November 2016—January 2018. The balance of standing lending facility in these periods changed constantly, and the scale was relatively large except for the relatively small scale from December 2015 to October 2016. In February 2015, the Central Bank announced the nationwide promotion of the standing lending facility of commercial bank branches to further develop this unconventional monetary policy, while also providing short-term liquidity support to eligible small and medium-sized financial institutions.

4. POLICY TRANSMISSION MECHANISM

The policy transmission mechanism of standing lending facility is the same as that of conventional monetary policy. It first affects the intermediary targets of monetary policy and then acts on the ultimate goal of the economy. The intermediary target of standing lending facility is interest rate. The central bank comprehensively determines the interest rates of standing lending facility according to the adjustment of monetary policy and the intentional market interest rate level, so that the standing lending facility rate can play the role of short-term interest rate corridor ceiling and guide the short-term market interest rate to get downward so as to control the fluctuation of short-term market interest rates within a certain range. Then, the interest rate corridor functions through two paths: credit and asset price, thus achieving ultimate economic goal. The ultimate goal of standing lending facility includes steady development of economy, prevention of deflation, stabilization of employment situation and financial stability, which are basically consistent with conventional monetary policy objectives, but with different emphases.

4.1. Credit Transmission Mechanism

Through “one-to-one” transactions with financial institutions, the Central Bank injects liquidity into these institutions and improves the availability of corporate credit funds, thereby stimulating investments of credit-backed enterprises and increasing the overall level of gross output. The total mechanism can be summarized as: the application of standing lending facility – the role playing of short-term interest rate corridor ceiling – the reduction of short-term market interest rates – the increase of loanable funds – the increase in investment – the increase of output. Apart from increasing the total output of the society, the central bank's use of standing lending facility is also intended to increase the availability of credit funds for small and micro enterprises and “three rural” enterprises, balance the flow of money in various fields of the market, and achieve structural adjustment of the economy.

4.2. Asset Price Transmission Mechanism

According to Tobin q theory, the decline of market interest rate will lead funds to capital market, so that the price of stocks and other financial assets rise accordingly. That is, the application of standing lending facility – the role playing of the short-term interest rate corridor ceiling – the short-term market interest rate reduction – the increase in q – the increase in investment – the increase of output. According to the theory of wealth effect, when prices of financial assets rise, the total amount of wealth rises, and then the expenditure of consumers will increase, which eventually affects national income. That is, the application of standing lending facility – the role playing of the short-term interest rate corridor ceiling – the short-term market interest rate reduction – the rise in financial asset prices – the increase in wealth – the increase in consumption – the increase in national income.

5. REGULATION EFFECTS

After the “money shortage” phenomenon occurred in June 2013, the People's Bank of China launched a standing lending facility to facilitate the temporary liquidity shortage in the banking

system. From June to September 2013, the monthly balance of standing lending facility of People's Bank of China was 416 billion yuan, 396 billion yuan, 410 billion yuan, and 386 billion yuan respectively. In 2013, the accumulated standing lending facility volume was 236 billion yuan. In addition, standing lending facility has been carried out during Spring Festival, when liquidity demand was strong. During that time, this unconventional monetary policy tool played an important role in meeting the temporary liquidity needs of financial institutions.

Specifically, the initial purpose of the introduction of standing lending facility was to meet the liquidity needs of commercial banks. The intermediary target is the short-term market interest rate. In view of this, this paper measures the regulation effects of standing lending facility from the two aspects – the liquidity of banking system and the short-term market interest rate. The liquidity of banking system is expressed by the loan-to-deposit ratio of Chinese-funded national banks. The higher the loan-to-deposit ratio is, the lower the liquidity is. Meanwhile, this paper distinguishes between large banks and small and medium-sized banks. The short-term market interest rate is calculated by the inter-bank 7-day period rate. The changes of the ratios and rates from 2013 to 2017 are shown in Figure 1 and Figure 2, respectively:

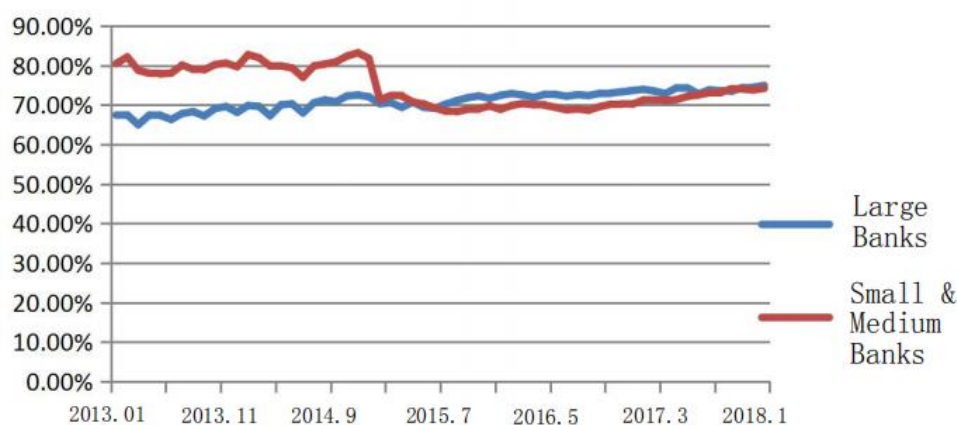


Figure 1. Loan-to-Deposit Ratio of China National Bank from 2013 to 2017

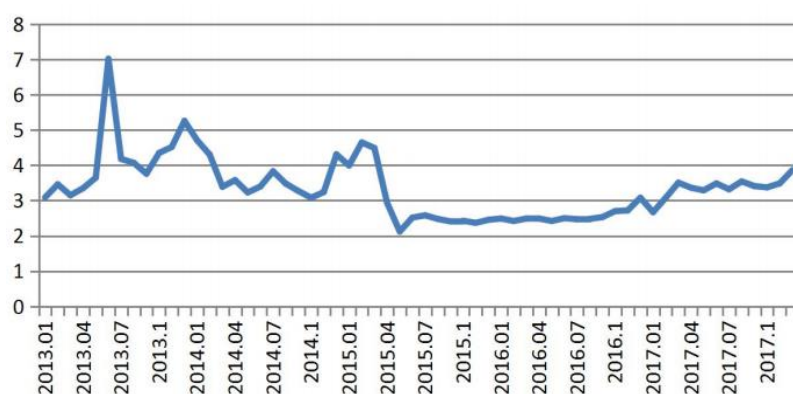


Figure 2. Inter-Bank 7-Day Period Rate of China National Bank from 2013 to 2017

As can be seen from Figure 1, there has been insufficient liquidity in China's banking system from 2013 to 2015, especially for Chinese-funded small and medium-sized banks with The loan-to-deposit ratio fluctuating around 80%. However, it is worth noticing that after using the standing lending facility several times in the latter half of 2013, the liquidity situation improved in December 2013. Moreover, since 2015, the problem of insufficient liquidity in the banking system has obviously improved, especially for small and medium-sized banks. But as for large banks, the improvement of liquidity problems is not obvious. This shows that standing lending

facility can to a certain extent meet the liquidity needs of banks, especially small and medium-sized banks, and in general can adjust the liquidity structure of the banking system.

As can be seen from Figure 2, the short-term market interest rates surged in June 2013, exceeding the level of 7%. The central bank then began piloting the use of standing lending facility at this point in time, while stipulating that 7-day repo rate could not exceed 7%. Since then, the inter-bank 7-day pledged repo rates remained below 6%, indicating that the unconventional monetary policy tool has played a good role in the interest rate corridor ceiling. At the same time, it can be seen from the figure that the range of fluctuations of short-term market interest rate has shown a significant downward trend, which has greatly reduced the volatility of the money market. It indicates that the standing lending facility has the fine-tuning effects which conventional monetary policies do not have. Thus, standing lending facility is a complementary tool to conventional monetary policy.

6. SUMMARY

This paper focuses on the policy transmission mechanism and the regulation effects of standing lending facility. In terms of policy transmission mechanism, it is similar to the transmission mechanism of conventional monetary policy. It first affects the intermediary target interest rate, and then influences the ultimate goal of the economy through the two paths – credit and asset price. In terms of regulation effects, the loan-to-deposit ratio and the inter-bank 7-day pledged repo rate respectively indicate the liquidity of the banking system and the short-term market interest rate. According to collected data, standing lending facility plays a certain role in the liquidity regulation of financial institutions, the guidance of market interest rates and the ironing of abnormal fluctuations in the money market. However, China's standing lending facility has not been produced and implemented for a long time, and is still in the stage of development and exploration. This tool still needs to be further cultivated and improved in terms of policy positioning and effects. Meanwhile, if the use of standing lending facility is too frequent, it may increase the moral hazard of financial institutions. Therefore, standing lending facility should be used as a tool to supplement liquidity, and the number of its applications should not be too frequent in order to avoid banks' dependence on them. At the same time, the standing lending facility lowers the requirements for funds, collateral and credit for transactions, which helps to support the development of emerging small and medium-sized start-ups. In addition, the central bank should combine the use of standing lending facility with conventional monetary policies to maximize the effectiveness of monetary policy.

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