

China's Monetary Policy Communication: Money Markets not only Listen, They also Understand

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Summary

Central bank communication is becoming a key aspect of monetary policy as a consequence of financial liberalization and the introduction of market instruments to conduct monetary policy. The objective of this paper is to assess whether China's money markets "listen" to the PBoC's messages and, possibly, whether they "understand" them.

Following the existing literature, we interpret "listening" as the central bank's ability to "move" the markets when making a certain verbal or written statement. The usual way to measure this phenomenon is to assess empirically whether the volatility of interbank rates changes right after a speech from the PBoC's governing body or the publication of a written statement by its MPC. We also consider the effects of PBoC words on trade volume in the repo market since this may represent an indirect conduit to volatility, which has been all but neglected in the communication literature. Examining five years of daily repo rates for the one-day maturity, the most liquid since the mid 2000s, we find statistically significant changes in the volatility (measured by the logarithm of the range) and trading volume of money market rates after PBoC communication is released. This provides evidence for the hypothesis that money markets listen to the PBoC through both direct and indirect channels.

Whether money markets understand the PBoC is a much more demanding question and requires a different empirical strategy. In fact, we need to differentiate across PBoC messages in terms of their monetary policy stance, and see whether money markets react to these in the right direction. Using high-frequency data, we find strong evidence of a good understanding of PBoC statements, as evidenced by money market repo rates increasing immediately after a hawkish statement from the PBoC and the other way round (reduction in rates following dovish statements).