

Predicting China's Monetary Policy with Forecast Combinations

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Summary

China's monetary policy is unconventional and constantly evolving as a result of its rapid economic development. This paper proposes to use forecast combinations to predict the People's Bank of China's monetary policy stance with a large set of 73 macroeconomic and financial predictors covering various aspects of China's economy. The multiple instruments utilised by the People's Bank of China are aggregated into a Monetary Policy Index (MPI). The intention is to capture the overall monetary policy stance of the People's Bank of China into a single variable that can be forecasted. This MPI also includes the 7-day reverse repurchase rate as one of the instruments as the benchmark deposit and lending rates have become dormant since 2015.

Forecast combination assigns weights to predictors according to their forecasting performance to produce a consensus forecast. The out-of-sample forecast results demonstrate that optimal forecast combinations are superior in predicting the MPI over other models such as the Taylor rule and simple autoregressive models featuring a lag of the MPI. The results are also statistically significant. Furthermore, the results point to corporate goods price index and the US nominal effective exchange rate as the most important predictors. The former is an indicator of wholesale price relevant to China's manufacturing sector, while the latter is related to the strength of the US dollar and highlights the importance of international trade for China.