# The Implementation of Monetary Policy in China: The Interbank Market and Bank Lending

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## Summary

It is generally felt that the short-term interbank lending rate is not a good measure of the stance of monetary policy in China, in contrast to the cases in US and Euro area. Indeed, empirical evidence suggests that the interest rate channel of monetary policy transmission is weak or non-existent in China. Explanations put forward in the literature have typically focused on how structural impediments in financial markets have weakened the link between interbank rates and the cost and availability of bank loans. However, the literature has been silenced about the link between policy implementation and interbank rates. To implement the monetary policy, the People's Bank of China (PBoC) intervenes in both the wholesale money market by Open Market Operations (OMOs), adjusting the Required Reserve Ratio (RRR), and in the retail deposit and lending market by changing the ceiling for deposit rates and the floor for retail lending rates and bank loan targets. Therefore, a reverse transmission of policy from the retail interest rates to the wholesale money market occurs.

This paper studies both links to understand the bank lending channel of monetary policy transmission in China. We present a model of bank behavior in China, which is an extension of the model of Porter and Xu (2009a), which, in turn, is an extension of Freixas and Rochet (2008). The model illustrates how the interbank lending rate and the quantity and price of retail lending are determined when banks compete, when deposit and lending rates are regulated and when there is credit guidance.

The model suggests that the effect of policy instruments on the interbank money market and bank loans depends on how the regulated interest rates deviate from their equilibrium levels, defined as the rates we would observe in the absence of regulation. In the current case of China, the PBoC's intervention in the deposit and lending market impairs the transmission of OMOs and changes in RRR to bank credit growth through the interbank money market, therefore sometimes rendering window guidance of credit growth necessary for the PBoC's implementation of monetary policy. It further implies that such intervention prevents interbank lending rates from signalling the monetary policy and transmitting the policy to retail bank lending. Moreover, the uncertainty about the equilibrium deposit and lending rates complicates the conduct of monetary policy. Liberalizing the regulated rates eliminates this uncertainty and would facilitate the setting of policy.