An Analysis of the Endogenous Contradictions between China's Monetary Policy and Banking Supervision

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Keywords: foreign exchange write-off, monetary policy, currency issuance basis; banking supervision

Abstract: On March 23, 2018, US President Trump formally signed a memorandum of understanding on trade with China at the White House to launch a trade war with China. On May 20, 18, China and the United States issued a joint statement on the economic and trade consultation, indicating that they had reached an agreement to jointly negotiate measures to reduce the trade deficit between China and the United States. China is carrying out L-shaped economic reform and the process of economic de-leverage. Foreign exchange write-off is very important to the stability of China's financial environment. In order to cope with the substantial reduction of basic currency, China has adopted a variety of monetary policies, such as MLF, to increase the strength of the issuance of basic currency. The core purpose of these monetary policies is to maintain the stability of the total amount of money. However, the current monetary policy in China needs to be put into the circulation of real economy through banks. This puts forward higher requirements for risk management and control of banks in China. This paper analyses the inherent contradictions between China's monetary policy and banking supervision and puts forward countermeasures.

1. Introduction

China is actively deleveraging, and the independence of currency is particularly critical at this moment. In China's currency issuance system, the largest item of RMB collateral is still foreign exchange reserve. Foreign exchange reserve is not only to meet daily recurrent expenditure, but also plays a cornerstone role in the stability of monetary policy.

China is implementing L-type economic reforms in the process of economic de-leveraging. The problem of foreign exchange account write-off is crucial to the stability of China's financial environment. In order to cope with the massive reduction of the base currency, China has adopted a variety of monetary policies, such as MLF, to increase the issuance of the base currency. The core purpose of these monetary policies is to maintain the stability of the monetary aggregate. However, the monetary policy currently adopted by China needs to be transferred to the real economy through the bank, which puts higher requirements on the risk management and control of China's banks. This paper analyzes the endogenous contradiction between China's monetary policy and banking supervision and puts forward countermeasures.

2. The macro environment overview

The rapid development of China's economy has driven the rise of property prices, and there are also many backs of foreign activities. Due to the US subprime mortgage crisis in 2008, the US dollar adopted a zero-interest rate policy, which formed a difference in interest rates between China and the United States. The Chinese economy has maintained rapid development for 30 years. These two factors have made China the darling of international hot money. Despite the foreign exchange policy of capital control implemented in China, there are still many foreign capitals, and they have entered China by adopting false trade situations such as “copper financing“ and “re-export trade“. In recent years, China has reached the world's leading level in various industries, and the industry's rate of return has gradually decreased. This is a normal phenomenon in economic development, but the return to normal development speed has led to the withdrawal of hot money.

  DOI: 10.25236/icemeet.2019.395

In the past few years, the problem we have been facing is that the foreign exchange reserves have been decreasing, making the assets behind the RMB less. At the same time, with the rapid development of China's economy, the debt problem is getting more and more serious, and more and more currencies are needed. The same foreign exchange reserves, and even less and less foreign exchange reserves have to release more and more renminbi. There are two paths that can be realized theoretically: First, we can increase the currency multiplier, that is, by lowering the rate. To increase the liquidity of money, but this has a ceiling and a potential risk, which is contrary to China’s policy of de-leveraging. Another way is to let the renminbi depreciate against the US dollar, so that we can release more renminbi on the basis of limited foreign exchange reserves, diluting the increasingly serious debt problem. However, the central bank's asset side, the so-called foreign exchange is the currency issued by other central banks. That is the debt of other central banks. In other words, the basis for the issuance of RMB in China is subject to the size of the balance sheet of other central banks.

The independence of monetary policy is crucial for any country, especially a large economy like ours, because monetary policy should be adapted to the development of the regional economy. When the economy develops at a high speed, due to the high marginal rate of return of capital, people tend to use the form of borrowing for production and investment, and the flow rate of broad money rises. A large amount of investment will further stimulate the development of the economy, and the accumulation of capital will easily form an “industry bubble“. Such phenomena will often be shattered when external constraints reach the upper limit. Such external constraints are usually capped by industry or national capital. When the economy goes down, the price of assets or commodities falls, and the flow rate of broad money declines. Enterprises with debts tend to sell their own goods or assets to pay off debts because of the difficulty of cash flow, which in turn causes further decline in asset prices, and the real liabilities of enterprises themselves become more. The above phenomenon is a manifestation of "Fisher spiral deflation" and a common form of economic crisis.

In order to avoid frequent occurrence of the above phenomenon, we have formed a modern central bank monetary system, expecting to raise interest rates when the economy is going up, implementing a deflationary monetary policy, and controlling the pace of development. When the economy is in recession, the expansion of monetary policy will stimulate the recovery of economic development and reduce the possibility of Fisher's spiral deflation. Although academically, the adjustment of interest rates does not completely eliminate the economic cycle. However, if the opposite monetary policy is implemented for various external reasons, it will inevitably have an impact on the economy.

As the world's second largest economy, China's domestic demand and productivity are very large. It is very important to maintain a monetary policy that suits its own economic cycle. This is also the reason why, in the past four years, despite many difficulties, our central bank authorities have always tried to maintain the reason why the monetary aggregate and China's exchange rate are relatively sTable.

3. The monetary policy adopted by China

The essence of contemporary legal currency is the claim for an asset. The legal currency is essentially the central bank’s liabilities, our assets. In many countries, the signature of the central bank governor is printed in the currency, and its historical meaning is the signature of the person in charge of the arrears. When A and B used the French currency to trade, A paid the legal currency to B. In essence, A gave his claim to a certain part of the central bank's assets.

Therefore, when central banks issue or recycle base currencies, they need to have equal assets to match them. This is why the foreign exchange account write-off will affect the independence of monetary policy. The renminbi is the debt of the central bank, and what can be realized behind the renminbi is the assets of the central bank. How much value does the RMB in our hands have? It depends on what assets are in the central bank's assets. In the past 10 years, about 80% of the central bank's balance sheet is foreign exchange reserves.

If the currency in circulation corresponds to the central bank's balance sheet, then the monetary system is very simple and clear. However, it is worth noting that the total amount of money in circulation is not equal to the total assets of the central bank, which involves the issue of credit derivation of money. Banks have always played a vital role in the contemporary monetary system. The following is a short example of the concept of currency derivation:

Suppose that in an environment where initial currency is issued, the central bank put 100 legal dollars into the only bank in the system. At this time, A hopes to purchase a certain commodity from B at a price of one hundred yuan. Therefore, A borrowed 100 yuan from the bank and paid it to B. After receiving the money, B deposited it in the bank. Since then, C hopes to purchase certain types of goods from Ding, repeating the above behavior. At this time, A and C each owe 100 yuan to the bank, while B and D each think they can withdraw 100 yuan from the bank. But at this time, the only money the bank can actually pay is the 100 yuan originally issued by the central bank.

In the above simple model, if the deposit reserve ratio is 0, then the broad currency that can be derived from the base currency of 100 yuan is almost infinite. Of course, this is accompanied by a very high risk. If the broad money multiplier is 100, then each person withdrawing 1 yuan from the bank will exceed the upper limit of their ability to pay. And when we set a certain deposit reserve ratio, the maximum amount of broad money that can be derived has a clear limit. This is also why Chinese financial regulators have recently paid attention to the reasons such as Alipay and WeChat payment. Their business has similar functions as banks to absorb savings, but lacks effective control and supervision, and has the possibility of generating broad money far beyond its ability.

After understanding the above issues, it is self-evident to review the foreign exchange reserves. Foreign exchange reserves are the largest part of China's central bank's balance sheet, once exceeding 80% of the balance sheet. Although China's broad money multiplier has been relatively sTable and relatively low relative to the United States in the past. But as can be seen from the figure below, since 2014, China's broad money multiplier is gradually rising.

The main reason is not the sharp growth of China's broad money, but because of the sharp outflow of China's foreign exchange reserves since 2014, the central bank's balance sheet has decreased, and its corresponding base currency has also decreased correspondingly, while the broad money aggregate has remained sTable. In the face of the problem of a large amount of foreign exchange reserves, the central bank authorities of China took the initiative and adopted the 811-exchange reform and subsequent multi-currency issuance methods to stabilize China's total money supply and its growth rate during 2014-2017. The stability of the total amount of money is of great significance for stabilizing China's financial environment and for the steady development of China's economy. Among them, the most important monetary policy is the MLF policy.

In September 2014, the People's Bank of China created the Medium-term Lending Facility. MLF is a monetary policy tool for the central bank to provide medium-term base currency. It is targeted at commercial banks and policy banks that meet macro-prudential management requirements and can be developed through tendering. The method of issuance is pledge, and high-quality bonds such as treasury bonds, central bank bills, policy financial bonds, and high-grade credit bonds are required to be qualified pledges.

4. The contradiction between banking supervision and monetary policy

Whether in theoretical analysis or in actual operation, there are indeed obvious differences and even conflicts between monetary policy and financial supervision. Monetary policy acts on economic growth (focusing on quantitative aspects) from the perspective of regulating the supply of money, while financial regulation acts on economic growth (focusing on qualitative aspects) from the perspective of ensuring the normal operation of funds. From the perspective of their respective goals, the primary goal of the central bank's monetary policy is to maintain the stability of the currency's currency and promote economic growth. The financial supervision is based on the principle of prudential supervision, avoiding problems in financial institutions and liquidity. The crisis brings systemic risks to the entire financial system. This also determines that monetary policy should focus on the overall macroeconomic situation, affect financial institutions through various monetary policy instruments, and bring the economy closer to an ideal state, and it mainly uses monetary policy tools such as interest rates to achieve Indirect regulation of economic entities; while financial regulation focuses on the financial system and financial markets, directly affecting the financial risk prevention and resolution of microfinance entities. It mainly relies on mandatory laws and regulations to stipulate the standards that microfinance entities must meet. And requirements to regulate and constrain the behavior of financial institutions. From the perspective of their respective roles, the monetary policy changes in the opposite direction to the economic cycle, that is, the expansionary monetary policy is adopted in the economic downturn, and the tightening monetary policy is adopted when the economic development is too fast; while the financial supervision and the economic cycle generally show positive To change, that is, in the economic boom, the business is in good condition, the financial institutions are running well, the positions are loose, and the financial supervision is relatively loose. When the economy is in recession, the business conditions deteriorate, the non-performing loan ratio of financial institutions rises, and financial risks increase. Financial supervision tends to be strict.

MLF is essentially a base currency delivery. Whether the base currency can be effectively invested in the real economy to derive the corresponding broad money depends on the bank's ability to launch and risk management. In 2018, China Banking Regulatory Commission repeatedly instructed banks to support the private economy. However, the business unit of the bank is biased towards conservative investment in the economic downturn. This has led to a large amount of funds hoarding in banks and cannot be effectively circulated in the real economy. The essence of this problem is an imbalance of the power and responsibility structure. China's monetary policy requires banks to assume the responsibility of the currency circulation channel, but the loan risk needs to be borne by the bank itself. In the bank, every business person who manages is responsible for the investment in each project. At the same time, China's financial regulatory authorities also have strict bad debt control policies for banks. This has led to internal contradictions between monetary policy and bank supervision.

5. Conclusion

In summary, China's economy is in the process of L-shaped economic transformation and de-leveraging to optimize the economic structure. The prerequisite for achieving a soft landing is to maintain the stability of asset prices and financial structures. In this process, it is crucial to deal with the issue of foreign exchange account write-offs. Therefore, China has adopted a variety of monetary policies such as MLF. The main channel of the MLF is the bank, which requires the bank to effectively channel the base currency into the real economy. However, in the case of economic downturn, the banking industry is also facing financial supervision of all parties, and it is responsible for the risk of investing in its own projects. The bank bears the responsibility of the monetary policy channel and faces the risk of bad debts. Its essence is an endogenous contradiction brought about by the imbalance of the power and responsibility structure.

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