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The transition to market-based monetary policy: What can China learn from the European experience?

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Abstract

We discuss the prospects for Chinese money market development and transition to market-based monetary policy operations based on a comparative historical analysis of the present Chinese situation and the development in 11 European countries from 1979 up to the launch of the European Economic and Monetary Union (EMU). Central banks in the latter group of countries typically had an incentive to encourage the formation of efficient benchmark segments in the domestic money markets for the conduct of open market operations as traditional quantity-oriented instruments became increasingly ineffective. China is displaying many of the same symptoms as the European countries in the 1970s and 1980s, including poor monetary transmission due to excess liquidity and conflicts of interest due to unclear priority among multiple policy goals. We conclude that in a number of aspects, current Chinese monetary policy operations are counter-productive to efforts to develop an efficient money market that can serve as arena for an effective market-based monetary policy, and provide policy recommendations.
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1. Introduction

The practical implementation, as well as the targets and the underlying objectives of monetary policy underwent significant changes in most industrial countries during a period from the late 1970s until the late 1990s. These changes were paralleled by a transformation of financial

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markets – including money markets as the main 'forum' for the implementation of monetary policy – consisting essentially of broad-based deregulation of credit systems on the one hand, and a rapid growth of alternatives to central-bank money as sources of financing on the other. The parallel processes of financial market development and reorientation of monetary policy are intertwined[1] and mutually reinforcing, and have their roots in domestic historical and political-economy factors as well as in increased international financial integration (Forssbæck & Oxelheim, 2003).

The weakness of the financial system is often argued to be an Achilles heel of the Chinese economy, and China is committed under its World Trade Organization (WTO) accession agreement to further opening up its financial system. This implies the removal of a large number of administrative restrictions, controls and regulations. Required reforms include opening up the capital account, liberalizing interest rates, and allowing foreign banks full access to the domestic market. There is a large (and growing) literature on the fragility of the Chinese banking sector, Chinese capital flows and capital flight, China's exchange rate regime, etc. However, the co-dependence between financial market development and increased effectiveness of monetary policy in the face of increased international integration – through a reorientation of the targets as well as the arsenal of instruments used by the central bank – is a less explored area of study. Because the money market is a key link between a country's financial system and its real economy, and the primary arena for the conduct of monetary policy, a poorly functioning money market is presently a key problem in China, as the development toward a market economy in other sectors and commitments under the WTO accession agreement have taken the need for reforms of beyond the point of no return. We argue in this paper that remnants of a traditional 'dirigiste', direct-control approach presently thwarts the effectiveness of monetary policy, and that with a more open financial system these problems are likely to persist, or even accelerate.

We further argue that in several key respects – e.g. initial financial repression, increased capital mobility, poor transmission, and multiple targets – relevant to this line of inquiry, the present situation in China is comparable to that of several European countries in the 1980s. Although potentially an economic giant, the size of the Chinese economy and its dependence on external markets during the 1990s and early 2000s make it more comparable with small and open, rather than with larger, developed economies.

The paper thus builds on research on money market development and monetary policy reform in a sample of small or medium-sized, open European countries[2] and extracts lessons for China from the experiences of these countries. Apart from their dependence on external markets, the choice of benchmark countries is also motivated by the fact that the money markets for these countries' currencies were virtually non-existent at the beginning of the 1980s, but then went though phases of emergence, growth, sophistication and international integration over a period of approximately 20 years. The process is thus in some sense 'completed', rather than still ongoing, as in most other Asian countries (except Japan, which, however, is a special case for other reasons), or in alternative possible benchmark countries. The countries also represent the full

[1] Existing cross-country comparisons of monetary policy operating procedures – e.g., Kneeshaw and Van den Bergh (1989), Batten, Blackwell, Kim, Nocera, and Ozeki (1990), Bernanke and Mishkin (1992), Kasman (1992), Goodhart and Viñals (1994), Hooyman (1994), Bisignano (1996), Borio (1997), BIS (2001), Kopcke (2002), Forssbæck and Oxelheim (2006) – consistently indicate that changes in central banks' operative frameworks are causes as well as effects of changes in the functioning and structure of the financial system.

[2] The benchmark countries are the following European countries: Austria, Belgium, Denmark, Finland, Greece, Ireland, the Netherlands Norway, Portugal, Sweden and Switzerland.

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