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CF40 Policy Brief

If the PBOC Began to Increase Bond Purchases in the Open Market Operations

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Abstract: *Recently, the market has engaged in extensive discussions on the government statement that "the People's Bank of China (PBOC) should gradually increase Treasury bond transactions in the open market operations". Some believe that this may indicate that the PBOC is preparing to enter the phase of quantitative easing, while more aggressive views suggest that this signals the onset of " modern money theory" (MMT) in China.*

The brief believes that buying and selling Treasury bonds in the open market operations by the PBOC is in essence a very conservative policy choice. The two main methods of balance sheet expansion previously adopted by the PBOC—forex purchase and structural monetary policy tools—are more aggressive than direct Treasury bond transactions. As long as the PBOC continues to face policy pressure from maintaining internal and external balance, its capacity for balance sheet expansion is limited, regardless of the method of expansion. We should thus view the method of bond purchases more rationally, instead of interpreting it as a shift towards a more aggressive monetary policy approach, nor should we directly link changes in the monetary operation mode to quantitative easing and the monetization of fiscal deficits.

I. Purchasing Treasury Bonds is a Very Conservative Monetary Policy Operation

Before the 2008 financial crisis, purchasing Treasury bonds in the open market was a conventional move of major central banks, primarily aimed at regulating the size of reserves in the interbank market through the purchase and sale of short-term government bonds, thereby maintaining short-term interest rates at the target policy rate.

Taking the Federal Reserve as an example, open market operations, mainly through buying and selling securities in the open market, are a key tool of the Fed to implement monetary policy. Before the global financial crisis, the Fed regulated the supply of reserves through open market operations, aiming to control short-term interest rates around the target policy rate.

In essence, bond purchases by the central bank are the conversion between two types of "super" safe assets—reserves and Treasury bonds. In other words, the central bank's buying and selling of Treasury bonds is a very conservative policy action, as the central bank does not assume any risk while doing so. This is why throughout history, major central banks have adopted this method — since it is sufficiently conservative and safe.

After the financial crisis of 2008, central banks in developed economies, such as the Federal Reserve and the European Central Bank, began to sharply expand the scale of bond purchases in the open market. The context at the time was that these countries' central banks had adopted a zero interest rate policy, leaving traditional monetary policy little room to maneuver. Under such circumstances, these central banks began to purchase long-term Treasury bonds at a large scale, but the objective was no longer to regulate short-term liquidity or to increase the supply of base money, but rather to reduce long-term interest rates through such operations. Although quantitative easing has now become a conventional monetary policy in developed countries, at that time, it was considered an unconventional and rather aggressive monetary policy choice.

It should be noted that a basic prerequisite for large-scale bond purchases under quantitative easing policy is that the central bank has already adopted a zero interest rate policy, and at this point, lowering long-term interest rates can only be achieved through the purchase of Treasury bonds. If the only purpose of purchasing Treasury bonds is to lower long-term interest rates, then the simplest and most direct method is to reduce the short-term policy rate when it has not fallen to zero. There is absolutely no need to lower long-term interest rates by purchasing Treasury bonds.

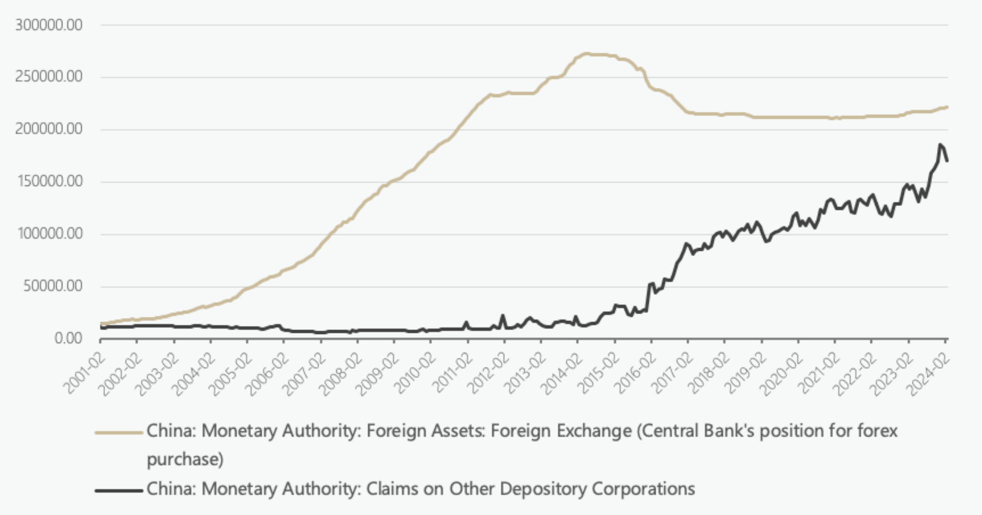
II. China's Way of Injecting Base Money is More "Aggressive"

Compared to Treasury bond purchases, the primary method adopted by the People's Bank of China (PBOC) to increase base money supply is somewhat more aggressive. Over the past twenty years, China mainly employed two ways to inject base money. From 2001 to 2014, the PBOC supplied more base money by purchasing foreign exchange and meanwhile regulated the pace of base money issuance through the issuance of central bank bills and adjusting the required reserve ratio. During this period, China's foreign exchange reserves rose from around 200 billion US dollars in 2001 to nearly 4 trillion US dollars in 2014. In essence, this was a move of massive asset purchases.

After 2015, the method of base money injection by the PBOC shifted to various "structural monetary policy tools" to increase liquidity. Compared to bond purchases, the method of injecting base money through various structural monetary policy tools enables the PBOC to directly guide the commercial banking system to increase lending (sometimes in specific sectors). Therefore, the PBOC is in effect employing a more aggressive method to inject base money, which, from the perspective of monetary policy transmission, is more aggressive than QE.

In recent years, the PBOC has set up a series of structural monetary policy tools as the major channels for base money supply. By the end of 2023, the balance of 17 structural monetary policy tools was about 7.5 trillion yuan,

Figure 1: Changes in the asset structure of PBOC (100 million yuan)



accounting for 16% of the central bank's total assets, demonstrating a high efficiency of balance sheet expansion. The PBOC's method indeed has drawn skepticism and is widely regarded as having "quasi-fiscal" features.

In fact, as early as 2016, Zhou Xiaochuan, then Governor of the PBOC, explained in detail during a speech at the IMF why the PBOC needs to set multiple objectives and assume part of the fiscal role:

When the old banking system of a transition economy is overwhelmed and fiscal capability is weak, a small transition economy can "sell" banks to protect the health of financial institutions, and it is relatively easy to find foreign banks willing to purchase, a model more commonly seen in transition countries of Central and Eastern Europe. However, China's banking system is large and hierarchical, and it is difficult for foreign banks to have the capacity and willingness to fully intervene. Hence, China had to rely on its own strength to rescue banks and carry out reforms. But at that time, fiscal resources were not sufficient, with fiscal revenue as a percentage of GDP only reaching around 10% in the 1990s, and there were also a lot of historical burdens left from the planned economy, so the central bank had to find ways to rescue financial institutions and maintain financial stability. In this process, the PBOC stripped away policy-based non-performing assets, injected liquidity into troubled banks, and encouraged major banks to go public, shift to mixed ownership, reform their governance, and enhance *international competitiveness, thereby maintaining financial stability on a macro level and navigating through the Asian financial crisis. At the same time, the PBOC focused on the micro-institutional development of regulatory systems, legal regulations, accounting and auditing standards, loan classification, financial reporting, etc., laying the foundation for the sustainable and healthy development of the banking sector and financial stability.*

In other words, in many cases, the PBOC in effect plays a “fill-in” role for fiscal policy, which should not be simplistically understood as the central bank “overstepping” to undertake fiscal tasks. From this perspective, the method of balance sheet expansion by the PBOC is much more aggressive than direct Treasury bond purchases, as the latter move does not imply assuming the functions of fiscal policy. In summary, the two methods of base money injection used by the PBOC in the past—forex purchase and structural monetary policy tools—are more aggressive policy measures than Treasury bond purchases.

III. Increasing Treasury Bond Purchases May not Necessarily Be a More Effective Way to Expand the Central Bank Balance Sheet.

There are at least two possible scenarios in which the central bank increases its treasury bond purchases.

The first scenario is where the central bank aims to change the current way of base money supply. As mentioned earlier, compared to the existing methods of balance sheet expansion, buying and selling Treasury bonds in the open market is a relatively common and more conservative monetary policy measure. Therefore, even if the PBOC chooses to increase liquidity by holding more government bonds in the future, it is not a conceptual breakthrough but rather replacing a somewhat aggressive measure with a more conservative one.

Moreover, such a move could limit the government’s ability to promote the expansion of broad credit. Currently, fiscal policy can facilitate credit expansion through the issuance of government bonds, while the PBOC mainly achieves this through refinancing and various structural monetary policy tools. These two policies are essentially independent and reflect the positioning of the central bank and the treasury as the "two purses" under the central leadership. If the PBOC no longer expands its balance sheet through various structural monetary policy tools but primarily through the purchase of treasury bonds to create base money, then the two purses effectively become one, thereby weakening the government's ability to expand credit.

The second scenario is the central bank increasing its purchases of treasury bonds for quantitative easing. However, the prerequisite for quantitative easing is that the policy rate has reached zero, necessitating the purchase of large amounts of treasury bonds to lower long-term interest rates. China's two most important policy rates, the 7-day reverse repo rate and the 1-year MLF (medium-term lending facility) rate, are 1.8% and 2.5%, respectively, which are still far from zero. Therefore, China does not meet the conditions for implementing a quantitative easing policy.

Meanwhile, as long as the PBOC continues to face policy pressure from maintaining internal and external balance, its capacity for balance sheet expansion is limited, regardless of the method of expansion. According to balance sheet data disclosed by the PBOC, the base money supply increased by 3.1 trillion yuan and 2.8 trillion yuan in 2022 and 2023, respectively, indicating that the PBOC has been quite aggressive in injecting base money over the past two years without apparent efficiency constraints. A significant part of the pressure faced by the PBOC stems from the policy goal of maintaining internal and external balance. Until this pressure is relieved to a large extent, the actual policy room for balance sheet expansion, regardless of the method used, will be quite restricted. Given the monetary policy space, opting for a more conservative method of expansion over a more aggressive one may ultimately weaken, rather than strengthen, the effectiveness of the central bank's monetary policy.

In summary, whether or not the PBOC will increase bond purchases, and whenever it may do so, buying treasury bonds in the open market is in effect a conventional monetary policy operation. We should view this operation more rationally, instead of interpreting it as a shift towards a more aggressive monetary policy approach, nor should we directly link changes in the monetary operation mode to quantitative easing and the monetization of fiscal deficits.

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