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Highlights: Potential change of China's monetary policy framework

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China's equity market extended its loss last week as the sentiment was weighed down further by tax news. Several listed companies have recently disclosed in filings with stock exchanges that they have received government notices requiring them to pay additional taxes ranging from tens of millions to several hundred million yuan. They have also warned investors that this may impact the companies' earnings, further weighing down market sentiment.

To address external doubts and concerns, the State Administration of Taxation of China clarified that it has not organized any nationwide, industry-specific, or centralized tax inspections, nor are there plans to conduct retroactive inspections covering 20 or 30 years. Nevertheless, this clarification failed to calm the market, especially after photos surfaced showing the establishment of The Police-Tax Joint Operations Center at the local level.

PBoC Governor Pan Gongsheng shed light on the future framework of China's monetary policy, outlining five main points: optimizing intermediate variables in monetary policy regulation, further improving market-based interest rate regulation mechanisms, gradually incorporating secondary market government bond transactions into the monetary policy toolkit, enhancing a targeted and moderate structural monetary policy tool system, and increasing monetary policy transparency. The discussion about PBoC's purchase of bonds in the secondary market has dominated headlines, sparking speculation about quantitative easing (QE). However, we believe the media has likely overemphasized this aspect.

Instead, we believe the most important hint from Governor Pan is the potential change in the main policy rate.

The 1-year Medium Lending Facility (MLF) has become China's key policy rate since 2019 after China discontinued benchmark lending rates and introduced the Loan Prime Rate (LPR), which became the key reference rate for bank loans.

However, the MLF has its own problems. As mentioned by the PBoC in its monetary policy report, there is no obvious link between the MLF rate and key short-term interest rates such as the 7-day Open Market Operation (OMO) rate.

Recently, this problem has been amplified as the MLF is increasingly misaligned with market-traded rates. For example, the 1-year Negotiable Certificate of Deposit (NCD) yield is much lower than the 1-year MLF rate, which has limited bank demand for the MLF. The net withdrawal of liquidity from the MLF was not the result of changing central bank policy but weaker demand from banks, which risks sending the wrong signal to the market. This issue also occurred with the Pledged Supplementary Lending (PSL). Given that the 5-year policy bank bond yield is lower than PSL borrowing costs, demand for PSL has declined dramatically, leading to a reduction in PSL outstanding.

The recent misalignment between PBoC policy rates, such as the MLF rate and PSL rate, and market rates has led to a shrinkage of the central bank balance sheet, complicating China's deflation fight and weakening central bank policy communication effectiveness.

These recent challenges pave the way for the PBoC to reoptimize its policy rate. In the future, consideration could be given to clarifying a specific short-term operating interest rate as the main policy rate. With the support of the interest rate corridor, market benchmark rates are guided to operate around the policy rate. These rates are then transmitted through the banking system to influence loan rates.

Since 2015, China has gradually established an interest rate corridor mechanism, with the upper limit defined by the 7-day Standing Lending Facility (SLF) rate and the lower limit defined by the excess reserve rate. PBoC Governor Pan suggested that it may also be necessary to appropriately narrow the width of the interest rate corridor, hinting that China may increase the interest rate paid on excess reserves.

In addition, China may also redefine its M1 calculation after the M1 growth fell to the record low in May. According to Governor Pan personal demand deposits and some highly liquid financial products with direct payment functions should be considered for inclusion in M1 statistics to better reflect the true state of the money supply from the perspective of monetary functions.

With China's move towards studying the possible change of monetary policy framework, China's macro policy is expected to be primarily driven by fiscal policy, with monetary policy playing a supportive role. Compared to interest rate cuts, reserve requirement ratio (RRR) reductions are likely to be used more frequently to complement fiscal policy.

Hong Kong's labour market softened further, in light of the weak domestic demand. Unemployment rates in most of the sectors edged up lately, while overall unemployment rate had been kept at a relatively low level of 3.0% in three-month ending May 2024. Meanwhile, underemployment rate rose by 0.1 percentage point to 1.2%. Specifically, unemployment rates in "retail, accommodation and food services" and "import/export trade and wholesale" sectors rose the most against recent low, up by 0.9 and 0.8 percentage points respectively. Further softening of labour market is likely to pile more weight on domestic demand and the unemployment rate may have more room to climb later this year.

High frequency market data suggested that the recent rebound in housing prices was short lived and all its gain had been completely erased, as sentiment turned south again amid tightened mortgage policies, competitive pricing strategy for newly launched projects and elevated mortgage rate.

Local commercial banks had quietly tightened mortgage policies, including reducing cash rebate, increasing scrutinization of mortgage applications and raising mortgage rate on specific type of residential units, over concerns for asset quality deterioration during the property market down cycle. On the other hand, developers have accelerated the launch of new projects, with some offering additional incentives on top of existing concessions, which was seen as a vote of non-confidence.

As a result, we have revised downward the full year forecast for housing prices. We now expect the price index to fall by 3-6%. That said, the increased housing demand from talent inflows and rally in rental index should still render some support to the overall sentiment.

Key events	
Facts	**OCBC Opinions**
▪ PBoC Governor Pan Gongsheng shed light on the future framework of China's monetary policy, outlining five main points: optimizing intermediate variables in monetary policy regulation, further improving market-based interest rate regulation mechanisms, gradually incorporating secondary market government bond transactions into the monetary policy toolkit, enhancing a targeted and moderate structural monetary policy tool system, and increasing monetary policy transparency.	▪ The discussion about PBoC's purchase of bonds in the secondary market has dominated headlines, sparking speculation about quantitative easing (QE). However, we believe the media has likely overemphasized this aspect. ▪ As China's financial markets rapidly develop, the scale and depth of the bond market have progressively increased, making it increasingly feasible for the central bank to inject base money by buying and selling government bonds in the secondary market. The inclusion of government bond transactions in the monetary policy toolkit does not imply a move towards QE but rather positions it as a channel for injecting base money and a tool for liquidity management. ▪ Instead, we believe the most important hint from Governor Pan is the potential change in the main policy rate. Currently, most investors consider the 1-year Medium-term Lending Facility (MLF) rate as China's key policy rate, although China has a variety of policy interest rates and the relationships between different monetary policy tools are quite complex. ▪ The MLF has become China's key policy rate since 2019 after China discontinued benchmark lending rates and introduced the Loan Prime Rate (LPR), which became the key reference rate for bank loans. As the LPR is a function of the MLF rate, the MLF became the de facto benchmark rate. ▪ However, the MLF has its own problems. As mentioned by the PBoC in its monetary policy report, there is no obvious link between the MLF rate and key short-term interest rates such as the 7-day Open Market Operation (OMO) rate. ▪ Recently, this problem has been amplified as the MLF is increasingly misaligned with market-traded rates. For example, the 1-year Negotiable Certificate of Deposit (NCD) yield is much lower than the 1-year MLF rate, which has limited bank demand for the MLF. The net withdrawal of liquidity from the MLF was not the result of changing central bank policy but weaker demand from banks, which risks sending the wrong signal to the market. This issue also occurred with the Pledged Supplementary Lending (PSL). Given that the 5-year policy bank bond yield is lower than PSL borrowing costs, demand for PSL has declined dramatically, leading to a reduction in PSL outstanding. ▪ The recent misalignment between PBoC policy rates, such as the MLF rate and PSL rate, and market rates has led to a shrinkage of the central bank balance sheet, complicating China's deflation fight and weakening central bank policy communication effectiveness. ▪ These recent challenges pave the way for the PBoC to reoptimize its policy rate. In the future, consideration could be given to clarifying a specific short-term operating interest rate as the main policy rate. At present, the 7-day reverse repo rate has largely assumed this function. The key challenge for China in switching to a short-term interest rate is higher volatility, which may increase the hurdle for policy communication. As such, China will continue to rely on the interest rate corridor to support the development of the main policy rates. ▪ With the support of the interest rate corridor, market benchmark rates are guided to operate around the policy rate. These rates are then transmitted through the banking system to influence loan rates. ▪ Since 2015, China has gradually established an interest rate corridor

	mechanism, with the upper limit defined by the 7-day Standing Lending Facility (SLF) rate and the lower limit defined by the excess reserve rate. PBoC Governor Pan suggested that it may also be necessary to appropriately narrow the width of the interest rate corridor, hinting that China may increase the interest rate paid on excess reserves. ▪ In addition, China's M1 statistical definition was established 30 years ago. With the rapid development of financial services, financial markets, and innovations like mobile payments, the categories of financial products that meet the definitions of monetary supply, particularly M1, have significantly evolved. It is essential to consider dynamically updating the statistical definition of monetary supply. Personal demand deposits and some highly liquid financial products with direct payment functions should be considered for inclusion in M1 statistics to better reflect the true state of the money supply from the perspective of monetary functions.

Key Economic News	
Facts	**OCBC Opinions**
▪ Hong Kong's labour market softened further, in light of the weak domestic demand. Unemployment rates in most of the sectors edged up lately, while overall unemployment rate had been kept at a relatively low level of 3.0% in three-month ending May 2024. Meanwhile, underemployment rate rose by 0.1 percentage point to 1.2%.	▪ Specifically, unemployment rates in "retail, accommodation and food services" and "import/export trade and wholesale" sectors rose the most against recent low, up by 0.9 and 0.8 percentage points respectively. Further softening of labour market is likely to pile more weight on domestic demand and the unemployment rate may have more room to climb later this year. ▪ Amid the ongoing top talents and labour importation schemes, rebound in labour force largely sustained notwithstanding some short-term fluctuations. Compared with the recent low in mid-2022, the labour force grew by 67,900 to 3,813,100 in March-May 2024. In parallel, total employed person increased considerably by 145,500 to 3,696,900 against the recent low, hence keeping the labour market still at the tight side.
▪ Hong Kong: High frequency market data suggested that the recent rebound in housing prices was short lived and all its gain had been completely erased, as sentiment turned south again amid tightened mortgage policies, competitive pricing strategy for newly launched projects and elevated mortgage rate.	▪ Local commercial banks had quietly tightened mortgage policies, including reducing cash rebate, increasing scrutinization of mortgage applications and raising mortgage rate on specific type of residential units, over concerns for asset quality deterioration during the property market down cycle. On the other hand, developers have accelerated the launch of new projects, with some offering additional incentives on top of existing concessions, which was seen as a vote of non-confidence. ▪ As a result, we have revised downward the full year forecast for housing prices. We now expect the price index to fall by 3-6%. That said, the increased housing demand from talent inflows and rally in rental index should still render some support to the overall sentiment.

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