The post-crisis period has seen a considerable shift in the composition and drivers of international bank lending and international bond issuance, the two main components of global liquidity. The sensitivity of both types of flows to the US monetary policy rose substantially in the immediate aftermath of the Global Financial Crisis (GFC), peaked around the time of the 2013 Fed “taper tantrum”, and then partially reverted towards pre-crisis levels. Conversely, the responsiveness of international bank lending to global risk conditions declined considerably post-crisis and became similar to that of international debt securities. The increased sensitivity of international bank flows to US monetary policy has been driven mainly by post-crisis changes in the behaviour of national lending banking systems, especially those that ex ante had less well capitalized banks. By contrast, the post-crisis fall in the sensitivity of international bank lending to global risk was mainly due to a compositional effect, driven by increases in the lending market shares of better-capitalized national banking systems.

International bond issuance was relatively robust during the post-crisis period. As a consequence, the composition of global liquidity has shifted away from cross-border bank loans and towards international bonds in what has been dubbed “the second wave of global liquidity”. Meanwhile, events such as the “taper tantrum” in 2013, when the Federal Reserve signalled it would start tapering its bond buying program, were marked by especially sharp changes in some capital flows to emerging markets.

In this paper, the authors drill down into observed changes, test for their proximate reasons, and distinguish between persistent versus transitory drivers. To achieve these ends, the authors draw on multiple databases on global liquidity component flows from both borrower country and creditor country perspectives, distinguishing between instrument types (international debt securities versus international bank loans), and between borrowing sectors (bank versus non-bank).

The first key result is that international capital flow sensitivities to global factors have changed considerably since the GFC. Advanced economy monetary policy, proxied by US monetary policy, became a more potent driver of both cross-border loan and international bond flows. The estimated policy impacts peaked in 2013 and then partially retracted toward pre-crisis levels while remaining elevated. Meanwhile, the sensitivity of cross-border bank loan flows to global risk conditions declined considerably post-crisis and became similar to the respective risk sensitivity observed for international bond flows. In fact, international bank loan and bond flows became more similar in terms of their responsiveness to global factors after the GFC. Overall, aggregate global liquidity flows (the sum of international bank loan and bond flows) have become more sensitive to US monetary policy and less sensitive to global risk.

The second set of results shows that post-crisis shifts in sensitivities of international bank loan and bond flows to global factors, observed from the borrower perspective, arise from a combination of changes in the country composition of lending banking systems and from changes in the behaviour of the creditors involved in international financial flows. Working across multiple databases, the authors show an increase in the responsiveness of flows from
individual lending banking systems to US monetary policy. The authors also find evidence of a compositional shift toward national lending banking systems with lower sensitivity to global risk conditions.

The authors find that the features of financial intermediaries that previously have been shown to stabilize domestic bank lending response to liquidity risk, like bank capital ratios and deposit funding, also support expansion of international market share relative to weaker peer country systems and help explain changing behaviours. National banking systems that were better capitalized before the GFC experienced smaller post-crisis rises in sensitivity to US monetary policy and larger increases in international lending shares. Higher ex-ante shares of deposits in total funding and of locally booked claims in total foreign claims were also associated with larger increases in international lending market shares.

Using data on international bank flows and international debt securities issuance from the bank and non-bank debtor perspective, the results indicate that an increase in global risk conditions (measured by the VIX) has a negative and strongly statistically significant effect on all flows. The US federal funds rate has a sharply negative impact on cross-border bank lending. Its estimated impact on international debt securities is also negative, albeit only marginally statistically significant. Local factors are also statistically significant drivers. Borrowing countries with higher GDP growth rates and with better sovereign credit ratings tend to attract more cross-border loans.

The results confirm that the relationship between the main global factors and international capital flows has changed profoundly since the GFC. Sensitivities of all flow types to US monetary policy increased sharply between the GFC and the taper tantrum. This is true for all flow types and for all borrowing sectors. The impact of US monetary policy on cross-border loans, which was already negative and statistically significant during the pre-crisis period, rose even further in the immediate aftermath of the GFC. More concretely, while prior to the crisis a 25-basis point decline in the federal funds rate was associated with an 80-basis point rise in the quarterly growth rate of cross-border bank lending, in the aftermath of the crisis was associated with a 202-basis point increase in the same growth rate. The respective negative impact on international bond issuance, which was not statistically significant prior to the crisis, also increased considerably after the GFC. In quantitative terms, the impact of a 25-basis point drop in the federal funds rate on international bond issuance surged from 36 basis points before the crisis to 202 basis points after the crisis.

During periods in which the monetary policies of advanced economies move together, a unit change in the federal funds rate could, all else the same, have a larger impact on cross-border bank lending than during periods of divergence. The monetary policy divergence metric plays a large and highly significant role in driving the sensitivity of international bank lending flows to US monetary policy within the early post-crisis period and contributes to a weakened sensitivity of these international flows post 2013.

Source: www.bis.org
China's evolving monetary policy rule: from inflation-accommodating to anti-inflation policy

Eric Girardin, Sandrine Lunven and Guonian Ma, BIS Working Papers

This paper aims to enhance the understanding of China's monetary policy rule since the mid-1990s, focusing on the role of inflation. It investigates the rule followed by the People's Bank of China (PBoC) by considering both the structural economic transformation of China and its evolving monetary policy framework. The authors' newly constructed monthly composite discrete monetary policy index (MPI), which combines price, quantity and administrative instruments, shows a change in style towards smoother but more contractionary policy moves from 2002 onwards. While the PBoC's behaviour up to 2001 was reminiscent of that in the inflation-accommodating G3 economies of the United States, euro area and Japan up to 1979, it has been characterized since 2002 by a policy rule similar to the post-1979 anti-inflation (forward-looking) policy of the G3. An accurate estimation of the monetary policy rule from 2002 needs to consider China as an open economy, as a result of its rapid liberalisation of trade and finance after its WTO accession.

While Chinese monetary policy is not officially targeting inflation, it has helped deliver good inflation performance in the new millennium, with low (2.30% on average) and mildly persistent inflation, in sharp contrast to high (8.40% on average) and persistent inflation in the 1990s. Such a major change in inflation performance raises the question of possible underlying changes in the conduct of monetary policy (policy framework and objectives) in the new millennium. Such changes may have been obscured by the multiplicity of price, quantity and unobserved instruments used to varying degrees and alternatively by China's monetary authorities, as well as evolving in a discrete way, unlike the continuous movements of reference benchmark monetary policy interest rates in most OECD countries.

The fast-evolving context of monetary policy in China points to the potential importance of three key historical transformations. The first one refers to institutional reforms that enhanced the responsibility and role of the PBoC as a central bank, whose status was legally confirmed in 1995. Monetary policy settings may also have changed with China's financial integration in the world through rapid trade and financial liberalisation, particularly since the country's WTO accession in 2001. Thus, the PBoC may have had to take global financial forces into account when navigating the trilemma through the regulation of capital flows and the sterilisation of foreign exchange inflows, particularly as the exchange rate regime switched back and forth from a de facto dollar peg to a managed float. Finally, the rapid development of and increased job creation by the private sector in the 1990s is likely to have increased the sensitivity of investment and consumption to the cost of capital and prices, generating the need for the authorities to take private agents' expectations into account in monetary policy-setting.

This paper makes three contributions to the literature as follows: First, the new MPI more accurately captures the gradual change towards a more market-oriented financial system, as well as the evolving mix of policy instruments and liquidity management tools. It also provides a way to take administrative window guidance into account. Second, the paper provides empirical evidence that highlights the contrast between the monetary policy rules over these two different
periods. From 2002, the PBoC appears to have engaged in a regime that looks a lot like informal inflation targeting, with a weight on inflation higher than unity. Finally, the authors find that constraining the estimated monetary policy to a closed-economy case (with only domestic factors) leads to an over-estimated output coefficient. They also show evidence for the impact of US monetary policy on China. Indeed, the US shadow Fed funds rate appears to have played a significant role in China's monetary policy decisions since 2002, consistent with the de facto financial opening following China's WTO accession in late 2001.

The pre-2002 policy style would have resulted in a more gradual increase of the index during the commodity price boom (around 2004-08). Thus, the authors' empirical evidence lends support to the argument that the PBoC seems to have moved from an inflation-accommodating policy before 2002 to an anti-inflationary policy thereafter. In other words, starting around 2002, the PBoC's monetary policy has come to resemble that of an informal inflation targeter.

Despite major differences in the economic context between the late 1970s and early 2000s, a comparison of the Chinese and G3 reaction functions shows some interesting similarities. First, the pre-2002 period in China may seem quite similar to the pre-1979 period in the G3 countries (as represented here by the United States), with a relatively weak overall response to inflation. Thus monetary policies during these initial periods seem to have accommodated inflation, typically raising the nominal interest rate by less than the increase in inflation, thus resulting in a lower real interest rate.

This paper aims at elucidating China's evolving monetary policy during the 1993-2013 period, specifically attempting to test the implicit inflation-targeting hypothesis (through lagged or expected future inflation). Multiple challenges stood in the way of the authors to assess the changes in the monetary policy in China and to relate them to macroeconomic developments. First, no single policy instrument represents a good proxy for China's monetary policy. Therefore, the authors have built a new composite MPI by combining several price, quantity and administrative tools. This index seems to accurately capture the important changes in China's monetary policy. Moreover, since it is scaled in policy rate-equivalent terms, it can be interpreted in line with the conventional Taylor rule based on a target interest rate.

Source: www.bis.org