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The direction and intensity of China’s monetary policy conduct: A dynamic factor modelling approach

Abstract

The recent upgrade of the People’s Bank of China’s monetary policy framework establishes a corridor system of interest rates. As the revamped policy arrangement now features a multiple-instrument mix of liquidity tools and pricing signals, we employ a dynamic factor modelling approach to derive an indicator of China’s monetary policy stance. The approach is based on the notion that comovements in several monetary policy instruments have a common element that can be captured by a single underlying, unobserved component. To clarify and interpret the derived index, we employ a baseline DSGE model that can be solved analytically and allows tracing of the expansionary and contractionary on-and-off phases of Chinese monetary policy.

Keywords: China, monetary policy stance, dynamic factor model, DSGE model

JEL Classification: C54, E52, E58, E61, E32