



China: Modernizing the monetary policy framework

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The path to modernizing China's monetary policy framework has reached an important point. The announcement by PBoC Governor Pan Gongsheng in June, introducing overnight reverse repo operations and stating the intent to narrow the interest-rate corridor, is a key step in this journey. What is the ultimate destination, and what else does the PBoC need to do to get there?

China currently operates a hybrid monetary-policy framework in which both policy rates and monetary/credit aggregates play important roles. The objective is ultimately to move away from a framework where monetary/credit aggregates serve as intermediate policy targets toward one where policy rates increasingly serve as the primary policy signal, with liquidity-management tools continuing to support policy implementation and transmission.

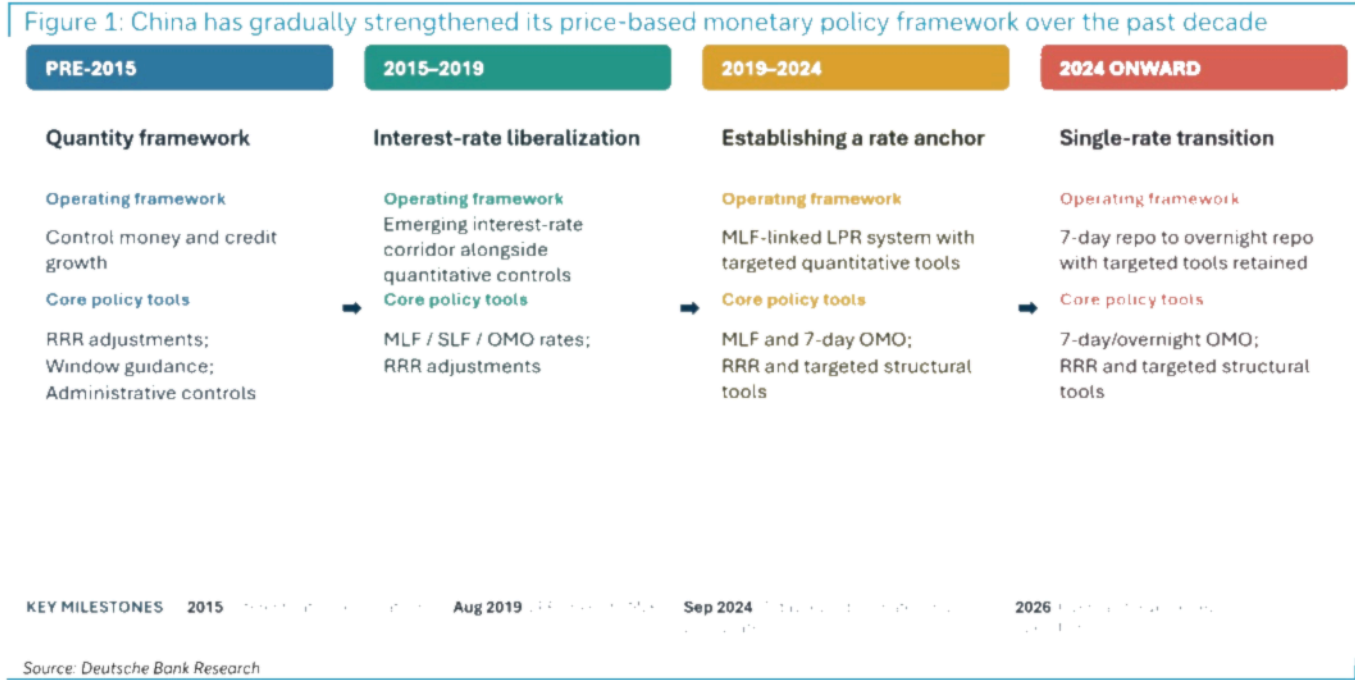
Key takeaways:

- This gradual shift in policy framework has been close to a decade in the making, with policy rates playing a larger role even as quantitative tools remain important.
- However, policy transmission remains weak. While policy rate changes increasingly influence short-term market rates, but the pass-through to long-term yields, borrowing costs, growth and inflation has been limited.
- The objective is for policy rates to play a larger role in signaling the monetary stance, while liquidity-management and structural tools help with policy implementation.
- Key reform priorities include strengthening policy expectations, reinforcing the interest-rate corridor, deepening bond-market liquidity, improving credit transmission and increasing exchange rate flexibility.
- Monetary policy modernization alone is unlikely to be sufficient. Stronger fiscal support, better monetary-fiscal coordination and a more proactive stabilization framework will be equally important in improving overall policy effectiveness.
- The market implications of this shift could be significant. If it helps improve policy transmission, and is accompanied by broader macroeconomic reforms, we believe it could help normalize the excessive flatness in the CGB yield curve, reprice medium-term IRS, and lead to accommodation of increased RMB and regional FX volatility over time.



A decade of monetary policy modernization

Over the past decade, China has undertaken one of the most significant monetary policy framework reforms among major economies (see Appendix A for a complete history of the transition). As interest-rate liberalization progressed, financial markets deepened and the economy became increasingly complex, a monetary framework centered primarily on quantitative controls became less effective. Policymakers therefore embarked on a gradual transition towards a more market-based framework, with the aim of allowing prices rather than administrative controls to play a larger role in transmitting monetary policy.



The result is a framework that today bears closer resemblance to those of major central banks than it did a decade ago. Benchmark lending and deposit rates have largely been liberalized, market-based pricing has become increasingly important, and short-term interest rates now play a much larger role in signaling the policy stance and guiding broader financial conditions. At the same time, China continues to operate a hybrid framework in which policy rates and monetary and credit aggregates both serve as intermediate targets¹

Policy implementation remains a blend of price- and quantity-based instruments, where PBoC still has both interest rate and quantity supply as intermediate policy targets.

Today, the PBoC's policy toolkit can be broadly divided into four categories:

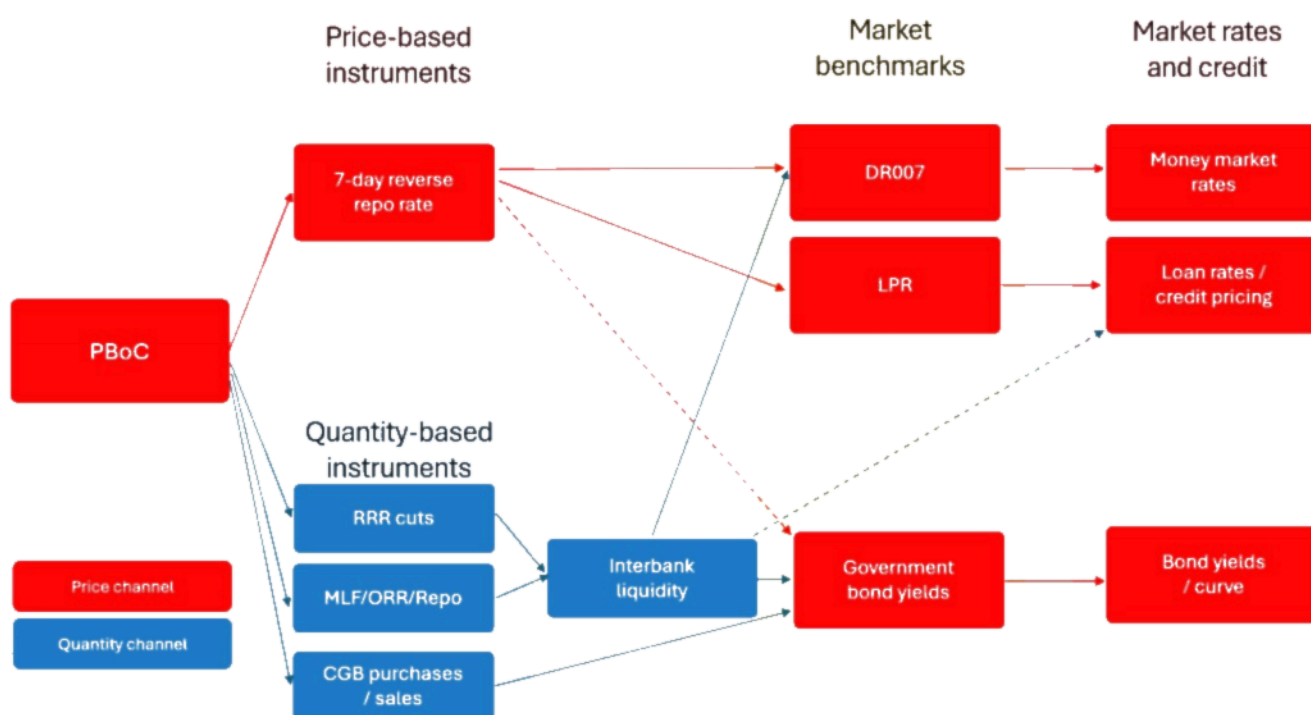
- **Policy rate:** the 7-day reverse repo rate serves as the primary policy rate and anchors short-term money-market rates.

¹ As recently as Q2 2026, the PBoC's Monetary Policy Report continued to emphasize "guiding total social financing growth in line with economic growth."



- **Short- to medium-term liquidity tools:** Reverse repos, outright reverse repos (ORR), and the Medium-Term Lending Facility (MLF), which influence interbank liquidity conditions and bank funding costs.
- **Long-term liquidity tools:** Reserve requirement ratio (RRR) adjustments and outright purchases or sales of government bonds, which affect the structural liquidity position of the banking system.
- **Structural monetary policy tools:** Relending, rediscounting and other targeted facilities designed to channel credit towards strategic sectors and policy priorities (see Appendix B for the full list of liquidity tools).

Figure 2: China's monetary framework remains a hybrid system in transition



Source: Deutsche Bank Research



Figure 3: Modern monetary frameworks rely on both price- and quantity-based instruments

Dimension	Fed	ECB	BoE	BoJ	BoK
Central bank assets (% GDP, latest)	22%	33%	22%	97%	22%
Future plan	Chair Warsh has indicated a preference for further balance-sheet reduction, but no specific end-point has been announced.	Balance-sheet policies will remain a permanent feature of the post-QE framework.	BoE reduced the annual pace of QT from GBP100bn to GBP70bn in 2025. The September review could further slow or potentially end active QT.	Policymakers have weighed whether to maintain this tapering pace or consider pausing the reduction plan beyond fiscal 2027.	BoK is not pursuing a large-scale QE framework, but targeted lending facilities could become a more important part of the policy toolkit if conventional rate policy becomes constrained.
Return to pre-2008 balance sheet?	No	No	No	No	No
Guidance on balance-sheet end state	Maintain enough securities to operate an ample-reserves regime effectively.	Keep reserves abundant through re-financing operations and structural portfolios.	Settle reserves within a Preferred Minimum Range well above pre-2008 levels.	Reduce JGB purchases and restore market pricing, not return to the pre-QE balance sheet.	Consider funding-for-lending if rates reach the effective lower bound.

Source: Deutsche Bank Research, CEIC, Fed, ECB, BoE, BoJ, BoK

Monetary policy modernization in China has therefore been less about replacing quantitative tools with policy rates than about rebalancing their relative importance. **Market-based interest rates now play an increasing role in policy implementation and transmission, while structural and quantitative instruments continue to support broader policy objectives and financial stability considerations.**

Figure 4: China's monetary policy differs from that of DMs more in objectives and implementation than tools

Dimension	PBoC	Fed	ECB	BoE	BoK
Primary objective	Price stability, growth support, credit conditions and financial stability all play important roles.	Inflation and employment	Price stability	Price stability with support for growth/employment	Price stability
Policy toolkit	Policy rate and liquidity operations	Policy rate and balance sheet	Policy rate and balance sheet	Policy rate and balance sheet	Policy rate and liquidity operations
No. of annual public communication	Quarterly monetary policy reports and occasional off-cial speeches	Minutes and votes published, over 400 off-cial speeches per year	Meeting accounts published, over 400 official speeches per year	Minutes and vote splits published, over 100 official speeches per year	Minutes and voting records published, over 100 off-cial speeches per year
Communication style	Flexibility-focused. Quarterly reports and quantitative guidance	Highly transparent and forecast-driven	Rules and forecast-based	Forecast and minutes-driven	Relatively transparent by Asian standards
Forecast publication	Limited forecast disclosure	SEP projections	Staff forecasts	Detailed MPR forecasts	Growth and inflation forecasts
FX consideration	Exchange-rate stability remains an important consideration	Little direct role	Limited	Limited	Important but secondary

Source: Deutsche Bank Research; Note: Though financial stability is an important consideration for all central banks, it is not treated as a primary objective here due to the lack of an explicit and measurable target.

As PBoC Governor Pan Gongsheng [observed](#) in 2024:

"As prescribed by law, the ultimate objective of China's monetary policy is to maintain the stability of the currency value and thereby promote economic growth. To achieve the ultimate objective, we need to keep an eye on and target some intermediate variables in the execution of monetary policy. While price-based regulation is prevalent in most of the major advanced economies, China adopts a combination of quantity- and price-based regulatory measures."



Some of the key building blocks of a modern interest-rate framework are now in place, with the 7-day reverse repo rate serving as the primary policy anchor and market-based interest rates playing a larger role in policy implementation than in the past. **The objective of China's monetary policy modernization is not the elimination of quantitative or structural tools, but the establishment of interest rates as the primary mechanism through which monetary policy influences financial conditions and economic activity.**

China has therefore moved substantially towards a more interest-rate-centric framework, but the transition remains incomplete. The interest-rate corridor is still evolving, multiple policy objectives continue to shape implementation, and quantitative as well as structural tools remain important alongside policy rates. The next phase of reform is likely to focus less on building new instruments and more on improving how policy signals are transmitted through financial markets and the broader economy.

More modern framework, still weak transmission

China's monetary policy framework has evolved substantially over the past decade, with market-based interest rates playing a larger role in policy implementation and financial-market pricing than in the past. However, a more market-based framework does not automatically imply more effective monetary policy transmission. The ultimate test of any monetary policy framework is not the sophistication of its toolkit, but its ability to influence financial conditions and ultimately the real economy. **This raises an important question: to what extent has China's transition towards a more price-based monetary policy framework improved policy transmission? Our analysis suggests that the improvement has been limited.**

To assess this question, we examine how interest rates across the yield curve respond to a 25bp² policy-rate cut and compare the results with the US. We find that policy easing in China does influence market interest rates, particularly at the front end of the curve (Figure 5). However, the impact becomes weaker as one moves further along the yield curve, and the effects appear less persistent than in the US. By contrast, US rate cuts generate larger and more sustained declines across a broader range of maturities, suggesting stronger transmission of monetary policy easing into overall financial conditions.

The difference becomes even more apparent when examining the real economy. While policy easing in the US is associated with a meaningful decline in borrowing costs and a subsequent improvement in growth and inflation, the corresponding responses in China are considerably weaker and often statistically insignificant. **This suggests that although China's monetary policy framework is increasingly capable of influencing financial prices, its ability to affect broader economic activity remains more limited.**

These findings suggest that improvements in policy implementation have not yet been matched by equally strong improvements in policy transmission. While policy signals increasingly influence short-term funding conditions and parts of the yield curve, their pass-through to long-term borrowing costs, private-sector

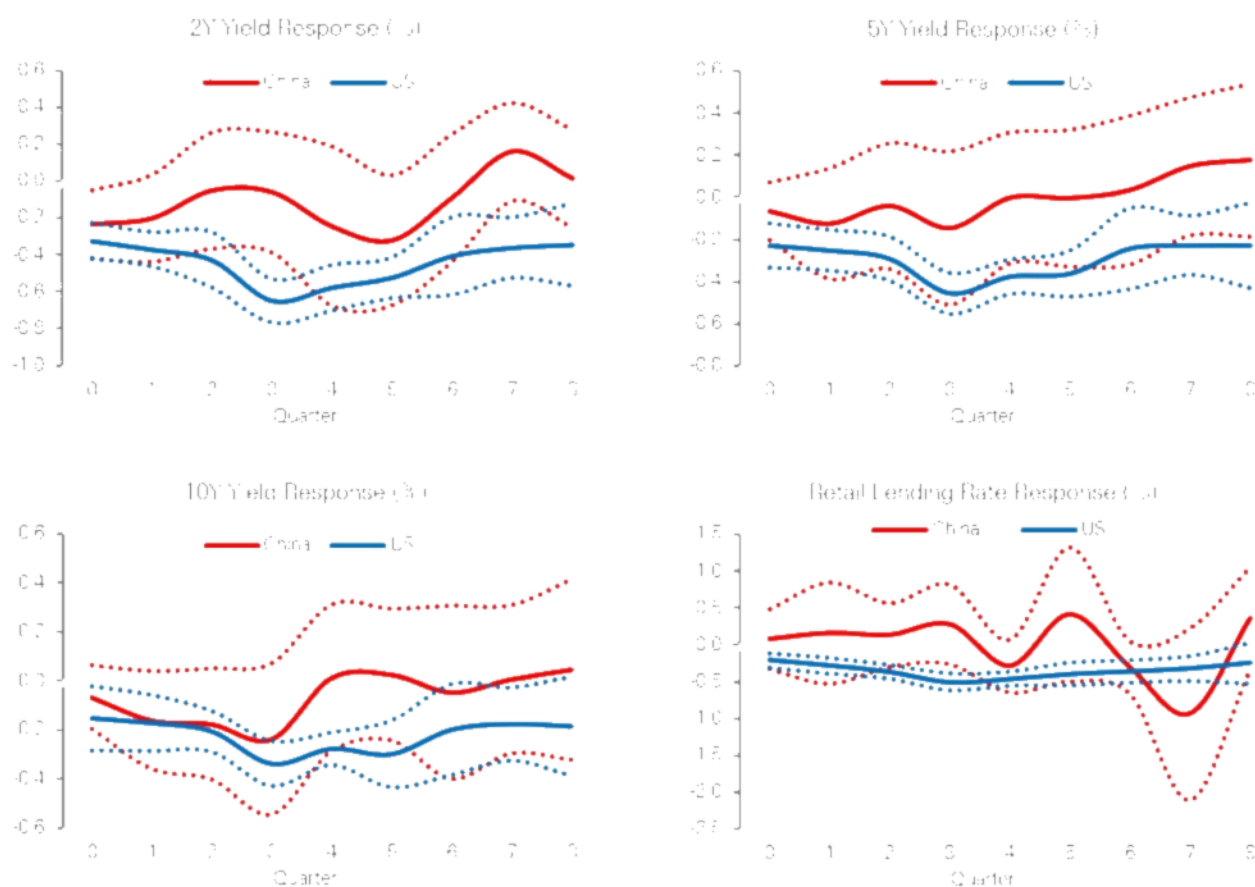
² For comparability, all impulse responses are normalized to a 25bp policy-rate shock. Actual policy-rate adjustments by the PBoC are typically smaller, often around 10bp, but scaling the responses allows a more direct comparison of transmission strength across economies.

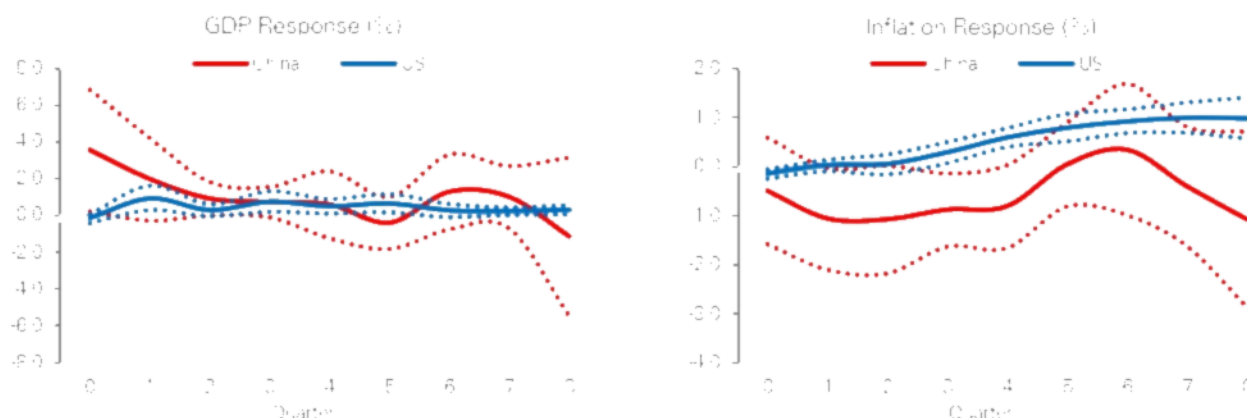


behaviour and macroeconomic outcomes remains comparatively weak. In other words, the effectiveness of monetary policy transmission has lagged the evolution of the framework itself.

As a result, the next phase of monetary policy modernization is likely to focus on strengthening the channels through which policy rates influence financial markets and economic activity. This suggests that future reforms are likely to center on areas such as expectations formation, financial-market depth, interest-rate pass-through and the broader role of market signals within the monetary policy framework.

Figure 5: Compared with the US, China still has significant room to strengthen monetary policy transmission





Source: Deutsche Bank Research, CEIC

The next chapter of monetary policy modernization

What is China's likely destination?

The evidence above suggests that China's monetary policy modernization remains incomplete. The key question for the next stage we believe is therefore not whether China will reduce its reliance on liquidity-management tools, but whether policy rates will increasingly displace monetary and credit aggregates as the primary guide for monetary-policy implementation and transmission. We believe the answer is yes. Over the past decade, policymakers have established many of the key building blocks of a more market-based framework, including a clearer policy-rate structure, greater reliance on market pricing and a reduced emphasis on monetary aggregates. As a result, the next phase of reform is likely to focus less on creating new instruments and more on strengthening the channels through which policy signals affect financial markets and economic activity.

Importantly, this does not imply convergence towards a conventional developed-market model. Structural and quantitative tools are likely to remain part of the framework, while financial stability, exchange-rate stability and development objectives will continue to influence policy decisions. Rather, modernization is likely to involve gradually increasing the role of interest rates as the primary mechanism through which monetary policy influences financial conditions, while improving the effectiveness of policy transmission within China's broader policy framework.

Moreover, China's evolving macroeconomic environment may reinforce the need for quantity-based and structural policy tools. As potential growth slows and policy rates remain structurally lower, China may increasingly face constraints similar to those experienced by other major economies near the effective lower bound. In such an environment, conventional interest-rate adjustments may become less powerful, increasing the importance of balance-sheet policies, liquidity facilities and targeted credit-support measures. Rather than disappearing, quantity-based tools may therefore become a permanent complement to interest-rate policy, much as they have in many developed economies since the Global Financial Crisis.



Priorities for the next phase of monetary policy modernization

Simplifying policy objectives to strengthen market expectations³. A key constraint on monetary policy transmission is the limited role of expectations. Modern monetary policy increasingly operates through expectations of future policy settings rather than current policy rates alone and the central of that is a clear set of policy objectives by the central bank (see Figure 4). In China, the PBoC operates under a broad set of objectives, including growth, price stability, financial stability, exchange-rate stability and broader development goals. While this provides policymakers with flexibility, it can also make the policy reaction function more difficult for markets to interpret.

Greater clarity around policy objectives would strengthen the expectations channel. This would not require adopting a formal inflation-targeting regime or a Fed-style dual mandate. A more pragmatic approach could be to streamline the PBoC's mandate around three primary objectives. While the relative emphasis differs across jurisdictions, most major central banks operate with a similar set of objectives including inflation, growth or employment as well as financial stability. Aligning the PBoC's mandate more explicitly around these objectives could improve policy transparency without requiring a wholesale adoption of a Western monetary-policy framework. A more focused mandate, supported by clear and consistent communication, would make the PBoC's reaction function easier for markets to interpret and enhance the signaling power of policy-rate changes.

Strengthening the corridor to improve short-term transmission⁴. A second priority is improving the operating framework itself. China has made considerable progress in establishing the 7-day reverse repo rate as the primary policy rate, while Governor Pan has also signaled a possible future transition towards a more overnight-rate-based framework. However, the interest-rate corridor remains less firmly established than in major developed markets, and money-market rates do not always track policy rates as closely as intended. Although temporary repo and reverse repo operations were introduced in 2024 and reformed in 2026, they have never been formally used, leaving uncertainty over how the PBoC would employ these tools in practice to keep market rates within the corridor.

In the United States, market rates such as SOFR generally trade close to policy rates within a well-established floor system. By contrast, China's corridor remains more of an evolving guide than a tightly binding operating framework. Future reforms are therefore likely to focus on narrowing the corridor, strengthening overnight liquidity operations and improving the predictability of short-term liquidity management.

A further area of development is the broader financial-stability architecture underpinning monetary operations. Recent discussions around emergency liquidity facilities for non-bank financial institutions suggest policymakers increasingly recognize the need for stronger liquidity backstops as financial markets become more market-based. A more comprehensive liquidity-safety framework could improve market resilience and support the implementation of monetary policy during periods of stress.

³ Multiple studies have shown that PBoC communication and expectations management can have a significant impact on both the real economy and financial markets. See [Jiang et al. \(2025\)](#) for one example.

⁴ Interest in strengthening China's interest-rate corridor has also increased among onshore researchers and think tanks. A recent [CF40 article](#) provides one such example.



Figure 6: The next stage of reform lies in implementation rather than instruments

Dimension	PBoC	Fed	ECB	BoE	BoK
Policy rate	7D reverse repo rate, potentially O/N repo in future	Federal funds target range	Deposit Facility Rate (DFR)	Bank Rate	Base Rate
Upper corridor	No clear existence	Discount Window rate	Marginal Lending Facility rate	Operational Standing Facility lending rate	Lending Support Facility rate
Lower corridor	No clear existence	Interest on Reserve Balances (IORB)	Deposit Facility Rate	Operational Standing Facility deposit rate	Interest on reserves
Width of interest rate corridor	Targeted corridor width of 50bp, but implementation remains evolving	10bps	40bps	30bps	10bps
Lender of the last resort	No standing facility	Yes	Yes	Yes	Yes
Forward guidance	Little	Yes	Yes	Yes	Yes
Capital control	Yes	No	No	No	No

Source: Deutsche Bank Research

Deepening secondary bond markets to improve yield-curve transmission. A third bottleneck lies in the government bond market. Although China possesses one of the world's largest bond markets, secondary-market turnover remains relatively low compared with major developed economies. Commercial banks continue to hold a dominant share of government bonds and tend to adopt buy-and-hold strategies, limiting trading activity and weakening price discovery.

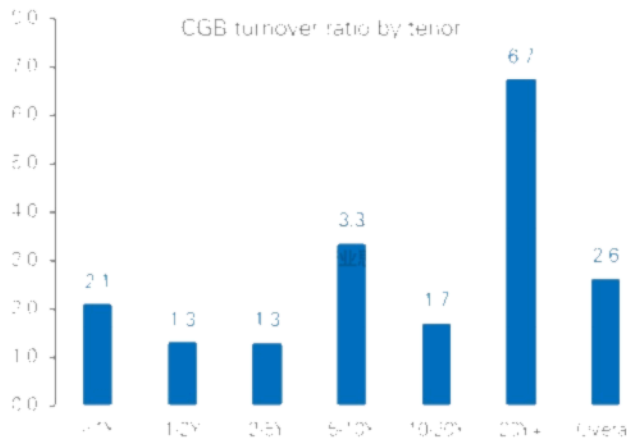
A deeper and more active government bond market would strengthen the transmission of policy expectations along the yield curve. Potential reforms include broadening participation beyond commercial banks, developing government-bond derivatives and hedging markets, improving repo and securities-lending infrastructure, strengthening market-making arrangements and enhancing transparency around issuance and liquidity operations.

These reforms would improve monetary policy transmission while strengthening the role of government bond yields as benchmarks for broader financial-market pricing.

Improving liquidity circulation and credit transmission. A fourth bottleneck lies in the credit channel. Lower policy rates do not always translate into stronger borrowing, investment, or economic activity. While China's financial system has generated abundant liquidity through high savings, a large banking sector, and repeated policy easing, this liquidity has not always circulated efficiently through the real economy. The financial system remains dominated by state-owned banks, which tend to favor lending to SOEs, limiting credit access for private firms even when overall liquidity conditions are accommodative. Meanwhile, China's financing structure remains heavily bank-based, with around 80% of corporate financing coming from loans, significantly higher than in most major economies (Figure 10). Pragmatic reforms could include broadening access to central-bank liquidity facilities for eligible smaller and non-state-owned banks, while reducing unnecessary financing constraints on private enterprises. Consistent with this objective, PBoC Governor Pan Gongsheng in 2023 [emphasized](#) expanding financing channels for private firms across debt, equity, and bank lending. That said, a lasting improvement in credit transmission will likely require measures beyond monetary policy, particularly those aimed at reviving credit demand in the real economy.

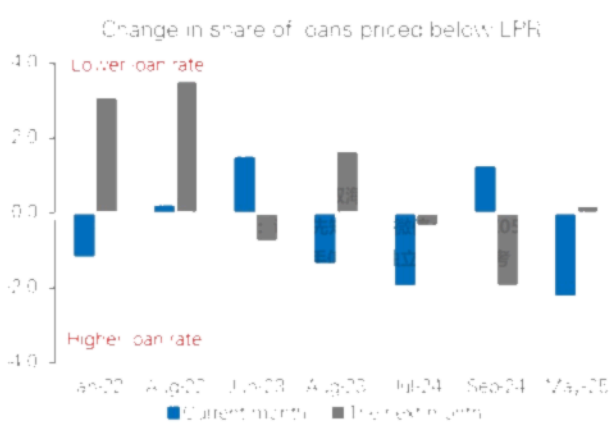


Figure 7: A more active bond market could improve price discovery and transmission



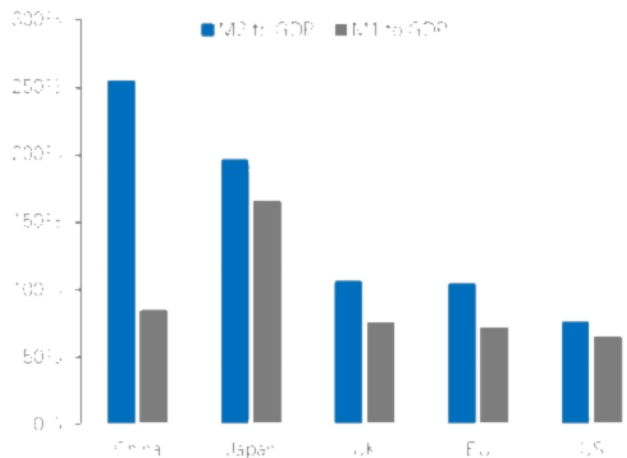
Source: Deutsche Bank Research, Wind

Figure 8: Interest rate cuts do not necessarily lead to immediate declines in loan rates



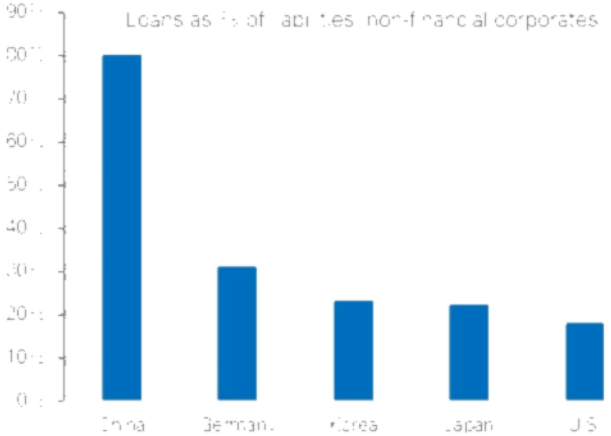
Source: Deutsche Bank Research, Wind

Figure 9: Abundant liquidity has yet to translate fully into real-economy activity



Source: Deutsche Bank Research, Wind

Figure 10: Chinese corporates rely on loans to get financed



Source: Deutsche Bank Research



Figure 11: Banking-sector reform is as important as monetary policy reform for stronger transmission

Bottleneck	Why pass-through is weak	Direction of reform
Bank NIM pressure	Banks reluctant to lower lending rates	Diversify revenue sources
Bank-dominated financial system	Limited competitive pressure	Develop capital markets
Weak loan pricing discipline	Lending rates not fully market-driven	Strengthen risk-based pricing
Low rate sensitivity of borrowers	SOEs, LGFVs and some property borrowers less responsive to funding costs	Improve capital allocation
Reliance on net interest income	Easing compresses profitability	Expand fee-based businesses

Source: Deutsche Bank Research

Allowing greater exchange-rate flexibility alongside RMB internationalization.

A fifth issue concerns the FX regime. In most major economies, exchange rates form an important part of the monetary policy transmission mechanism, with interest-rate changes influencing capital flows, exchange rates and financial conditions. In China, however, the managed exchange-rate framework and capital-account restrictions reduce the extent to which this channel operates.

As RMB internationalization deepens and China's financial markets become increasingly integrated with global markets, greater two-way exchange-rate flexibility is likely to become increasingly important. This does not imply a move towards a freely floating RMB. However, a more flexible exchange-rate regime would allow interest rates to play a larger role in macroeconomic adjustment and strengthen the relationship between monetary policy, capital flows and exchange-rate dynamics.

A modern framework, not a Western one. Ultimately, in our view, monetary policy modernization in China should not be viewed as a process of convergence towards a developed-market model. Rather, it is a process of adapting market-based monetary policy tools to China's own institutional environment. The likely end state, we believe, is a framework with a clear policy rate, deeper and more responsive financial markets, stronger policy transmission and greater transparency, while retaining broader policy objectives and strategic credit-support mechanisms. In other words, China is unlikely to become a Chinese version of the Federal Reserve. Instead, we think it is more likely to develop a modern interest-rate framework with distinctly Chinese characteristics.

Beyond monetary policy reform: A broader policy agenda

The modernization of China's monetary policy framework has brought it closer to the operational practices of many developed-market central banks. The PBoC has increasingly emphasized price-based policy instruments, strengthened its policy-rate framework, and improved the signaling and implementation of monetary



policy. These reforms should help improve policy transmission over time and represent an important step in the evolution of China's monetary framework.

However, many of the constraints on monetary policy transmission discussed in the previous section do not stem from the framework itself. Weak credit demand, subdued private-sector confidence, excess capacity in some sectors, and structural adjustment in the property market all limit the effectiveness of monetary easing. As a result, further refinement of monetary policy tools alone is unlikely to fully address China's economic challenges. Experience from developed economies also suggests that even well-established monetary policy frameworks can have limited effectiveness when economies face persistent structural headwinds.

More fundamentally, many of China's current challenges require policy coordination beyond monetary policy. We therefore view monetary policy modernization as one component of a broader reform agenda rather than a standalone solution. Stronger fiscal support, a better balance between long-term strategic objectives and near-term stabilization, and a greater role for market mechanisms would help address the structural constraints that continue to limit monetary policy effectiveness.

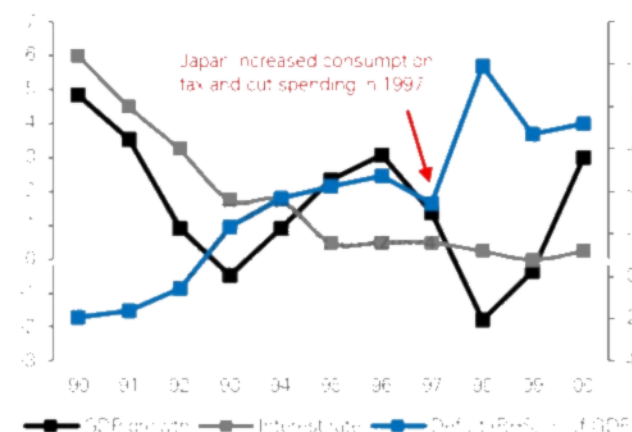
More decisive fiscal efforts from the central government. An effective transmission of monetary policy cannot happen without the coordination of fiscal policy⁵. Japan in the late 1990s provides a useful example. Despite near-zero interest rates and repeated monetary easing, fiscal policy tightened prematurely in 1997 through a consumption-tax increase and spending restraint, with deficit dropping from 2.5% to 1%. The tightening derailed the recovery, pushed the economy back into recession, and contributed to a prolonged period of deflation (**Figure 12**).

In China's case, sustaining monetary policy modernization, and potentially an easing cycle in the coming years, will require more forceful fiscal support. That said, despite a gradual expansion in recent years, China's central-government fiscal stance remains relatively restrained from a countercyclical perspective. At the same time, the central government's comparatively strong balance sheet (current central government debt is around 30% of GDP, significantly lower than other major economies, **Figure 13**) and the low-interest-rate environment provide substantial fiscal capacity. Beijing could make greater use of the central-government balance sheet to support aggregate demand while reducing the burden on already indebted local governments. More proactive fiscal support could help stabilize the property market, strengthen the social safety net, and support household consumption. Importantly, stronger fiscal support would complement monetary easing by generating demand for credit and investment opportunities, thereby improving the effectiveness of monetary policy itself.

⁵ [Das and Song \(2023\)](#) find that monetary-policy measures coordinated with fiscal policy have significantly stronger effects on economic activity than non-coordinated measures in China.

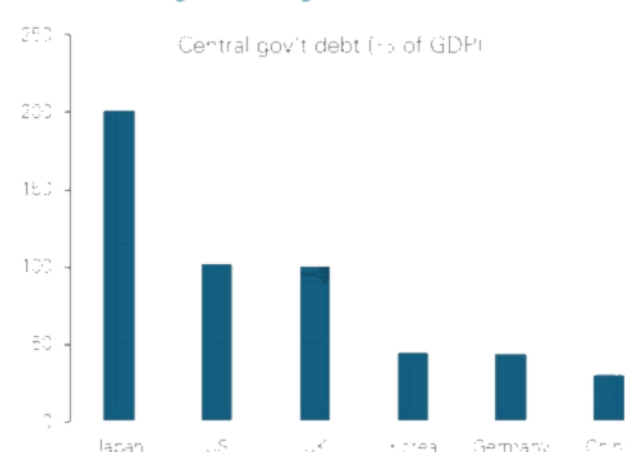


Figure 12: Japan shows uncoordinated policies weaken transmission



Source: Deutsche Bank Research, Haver

Figure 13: China's central-government balance sheet remains among the strongest in the world



Source: Deutsche Bank Research, Haver, Wind

Better balancing long-term strategic priorities with near-term economic needs.

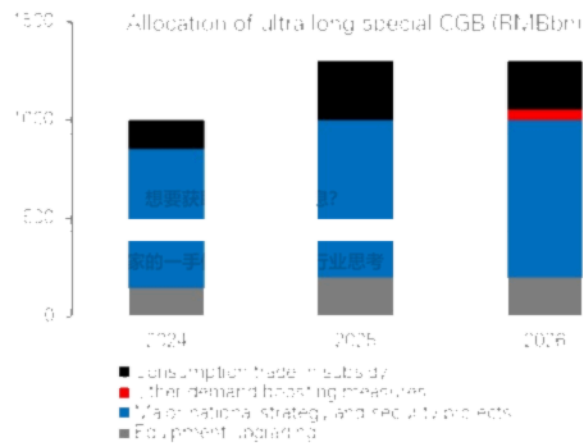
China's policy priorities have increasingly focused on strategic objectives such as technological self-sufficiency, advanced manufacturing, and future industries. Of the funds raised through ultra-long-term special government bonds between 2023 and 2026, more than 65% has been directed toward investment in strategic sectors, while only 20% has targeted near-term demand support, such as consumption subsidies (Figure 14). While progress in these areas is critical for long-term productivity growth and competitiveness, it may not directly address the economy's more immediate cyclical challenges.

Long-term development and short-term stabilization should be viewed as complementary rather than competing objectives. A stronger cyclical recovery would support profits, employment, and household income, thereby creating the confidence, demand, and fiscal resources needed to sustain China's longer-term strategic ambitions. In that sense, restoring near-term growth momentum is not a distraction from structural upgrading, but a necessary condition for its success. South Korea's experience illustrates that strategic upgrading and cyclical stabilization need not be mutually exclusive. While industrial policies have supported priority sectors such as semiconductors⁶, policymakers have also continued to respond to cyclical downturns through macroeconomic support measures (Figure 15). The key lesson is not that demand support drives long-term competitiveness, but that maintaining macroeconomic stability can provide a more favorable environment for strategic upgrading and investment. A pragmatic first step could be to take more decisive measures to stabilize the property market, which could strengthen household wealth, improve confidence, and help break the negative feedback loop between weak expectations and falling asset prices.

⁶ For further details, please refer to our recent [publication](#).



Figure 14: China directed most incremental fiscal resources to strategic sectors



Source: Deutsche Bank Research, Government Work Report

Figure 15: Korea's experience shows that strategic upgrading and cyclical growth can go hand in hand

	China		Korea	
	Name	Amount	Name	Amount
Strategic and industrial policies	Major national strategy and security projects (2024-2026)	RMB2.3tn (1.6% of annual GDP)	K-Chips Act (2023)	Tax incentive (not direct spending)
	Policy financing tool to support specific strategic	RMB1.3tn (0.9% of annual GDP)	Semiconductor Ecosystem Support Package	KRW26tn (1% of annual GDP)
			Chip fund (2026)	KRW5tn (0.2% of annual GDP)
Cyclical growth policies	Consumption trade-in subsidies (2024-2026)	RMB700bn (0.5% of annual GDP)	Budget expansion to boost economic activity (2025)	KRW20.2tn (0.8% of annual GDP)
	Childcare subsidies (2025-2026)	RMB180bn (0.1% of annual GDP)	Supply shock stimulus (2026)	KRW7.3tn (0.6% of annual GDP)

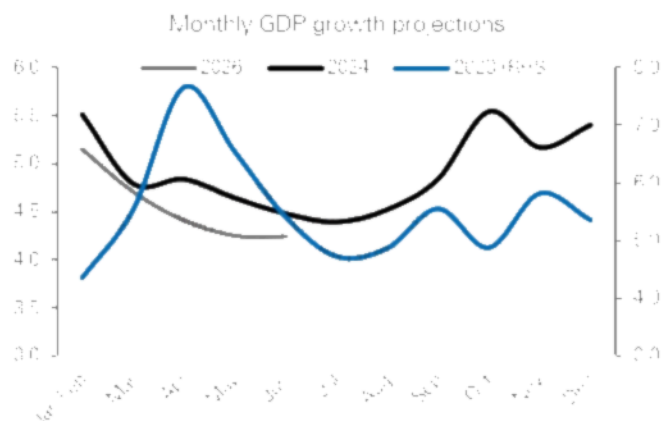
Source: Deutsche Bank Research
Note: China's strategic-sector allocation excludes investment funded by local government special bonds, which amount to around 3% of GDP annually

Proactive policy support and greater policy consistency. China's macroeconomic management has remained largely reactive rather than preemptive. Instead of providing sustained support to anchor expectations, policymakers have often relied on incremental easing measures only after growth shows signs of falling materially below target. Policy support has also tended to be cyclical and short-lived, with stimulus efforts scaled back once economic activity stabilizes. This has contributed to a recurring post-pandemic pattern in which growth starts the year on a relatively firm footing, softens through the middle quarters, bottoms out in the third quarter, and recovers modestly toward year-end as policy support intensifies (Figure 16).

Japan's experience highlights the importance of policy consistency in shaping expectations. During the 1990s and early 2000s, episodes of policy support were often followed by premature normalization, contributing to persistently weak inflation expectations and private-sector caution. A key objective of Abenomics after 2013 was therefore to establish a more durable and coordinated policy framework. The shift toward a more proactive approach helped improve confidence and expectations, supporting firmer growth and inflation over time. Although other factors—particularly post-pandemic global inflation and stronger wage growth—also played important roles, this framework helped lay the groundwork for Japan's eventual emergence from persistent deflation.



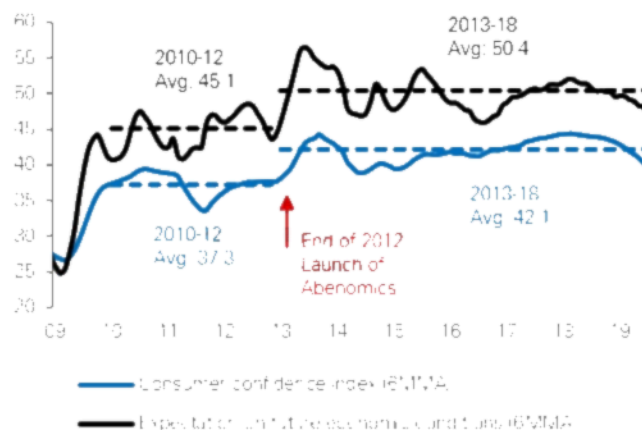
Figure 16: China's reactive policy approach has produced recurring U-shaped growth cycles



Source: Deutsche Bank Research, CEIC

Note: Monthly GDP growth is estimated by interpolating official GDP data based on our monthly nowcast.

Figure 17: Abenomics triggered an immediate and lasting recovery in consumer confidence



Source: Deutsche Bank Research, CEIC

In our view, the modernization of China's monetary policy framework should be seen as an important enabling reform rather than a complete solution to China's economic challenges. A more market-based framework we think could improve policy implementation and transmission, but its ultimate effectiveness is likely to depend on complementary progress in fiscal policy, economic rebalancing, and policy consistency. The next stage of China's policy evolution is therefore likely to be defined not by monetary policy reform alone, but by how effectively these broader reforms work together.

Market Implications

If this evolution continues, the implications would extend beyond monetary policy itself. More transparent policy signals, stronger transmission channels and deeper financial markets could gradually reshape the behavior of China's rates and FX. However, these should be viewed as contingent outcomes rather than baseline forecasts. They depend not only on continued monetary-policy modernization, but also on successful improvements in policy transmission, broader macroeconomic reforms and a recovery in private-sector confidence.

CGBs: The normalization of the term premium and a steeper yield curve

China's yield curve has flattened significantly in recent years. Part of this reflects expectations for a prolonged period of low policy rates, but it has also been reinforced by a broad-based compression in term premia. We estimate China's term premium using a yield-curve model that decomposes government-bond yields into two components: (1) the expected path of future short-term interest rates and (2) a term-premium component that compensates investors for the risks associated with holding longer-dated bonds. The model uses information across available maturities to identify the common factors that drive yield-curve movements. These factors are then used to infer the expected path of future short-term rates, while the remaining portion of yields is interpreted as the term premium—that is, the compensation required for holding longer-duration bonds. We report term-premium estimates for the 3-year, 5-year, and 10-year maturities.



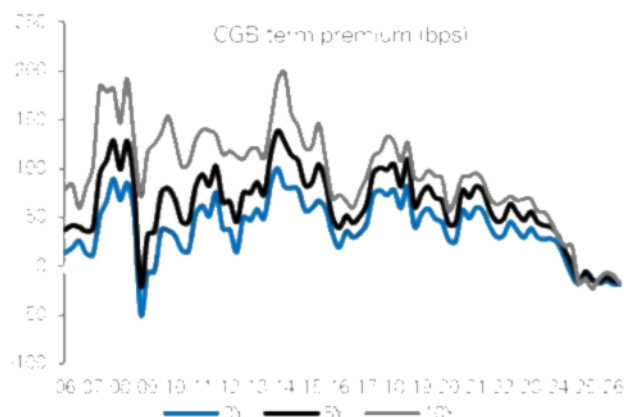
Our estimates suggest that term premia have declined sharply across maturities since 2018, with the decline accelerating after 2023. The compression has been particularly pronounced at the long end, where the 10Y term premium has fallen to levels broadly comparable with those of the 3Y and 5Y tenors. Under normal circumstances, investors require greater compensation for holding longer-dated bonds because of the uncertainty surrounding future growth, inflation and interest rates. The combination of negative term premia and a very flat term-premium structure suggests that investors continue to assign a low probability to stronger nominal growth and inflation outcomes.

If monetary-policy modernization succeeds in strengthening transmission and is accompanied by broader reforms, it could contribute to a steeper yield curve over time. A framework in which policy-rate changes are transmitted more effectively to financial conditions and economic activity could improve the ability of monetary easing to support growth and inflation. China's current situation differs from that of many emerging markets that face persistent inflation concerns. In those economies, stronger policy transmission may help anchor inflation expectations and lower risk premia. China, by contrast, continues to face weak growth, low inflation and subdued confidence. If stronger policy transmission is accompanied by broader reforms, including fiscal support and measures to restore confidence, investors may begin to assign a higher probability to stronger future nominal growth and inflation outcomes if improved transmission is accompanied by stronger confidence, firmer private-sector demand and supportive macro policies. China's experience during 2020-21 provides a useful example. As the economy recovered rapidly from the pandemic and expectations improved, the 10-year term premium rose by around 70bp from its trough (Figure 19). **That said, a meaningful normalization of term premia is likely to require a broader policy effort**, including stronger fiscal support, better policy coordination and measures to restore confidence in the private sector.

At the same time, stronger monetary transmission could give the PBoC greater scope to support the economy through conventional interest-rate adjustments, potentially exerting downward pressure on short-dated yields. **In a scenario where easier financial conditions translate into stronger growth, firmer inflation expectations and improved confidence, long-end term premia could also recover from currently compressed levels.** The combination would likely result in a steeper government bond yield curve over time, although the magnitude of any steepening would depend on broader growth, inflation and policy developments.

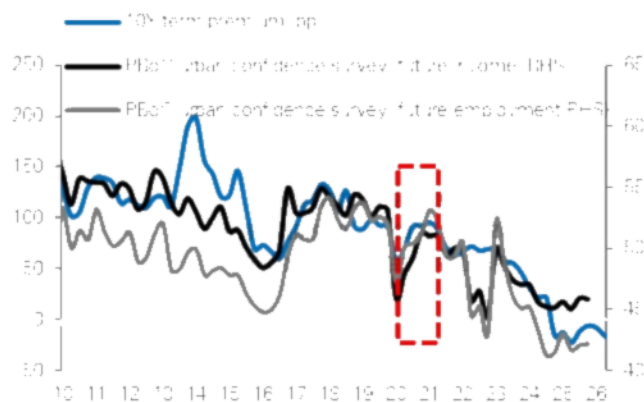


Figure 18: Broad-based collapse of CGB term premia across tenors



Source: Deutsche Bank Research, Bloomberg Finance LP

Figure 19: A rebound in economic expectations could revive the term premium



Source: Deutsche Bank Research, Bloomberg Finance LP, Wind

IRS: Near-term easing, medium-term repricing higher

Historically, China's 5Y NDIRS has tracked estimates of the nominal natural interest rate⁷ reasonably closely (Figure 20). Since 2023, both have declined significantly, reflecting a combination of weaker potential growth, cyclical demand weakness and a prolonged low-inflation environment. This suggests that the market increasingly views China's low interest rates as a persistent equilibrium rather than simply the result of temporary policy easing.

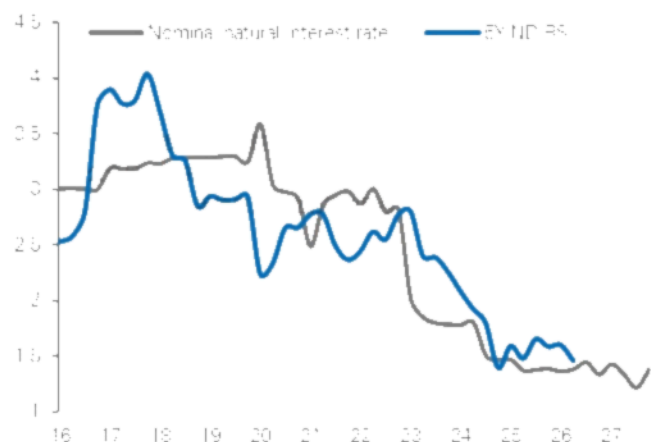
Current market pricing could prove too pessimistic if monetary-policy transmission becomes more effective and broader reforms succeed in supporting nominal growth. The persistently low level of the nominal natural interest rate suggests that markets remain cautious about China's medium-term growth and inflation outlook. A more effective interest-rate framework would allow policy easing to pass through more fully to lending rates, credit demand and aggregate activity. Although further easing could place downward pressure on short-term rates initially, a stronger growth and inflation response may eventually lift the perceived nominal natural rate if stronger transmission results in a more durable recovery in growth and inflation. The 5-year NDIRS rate could therefore rise thereafter.

If the transmission mechanism improves as intended, the adjustment could occur in two stages. In the near term, further PBoC easing could keep the 5-year NDIRS low or push it lower. Over the medium term, however, evidence that policy easing is gaining traction—through stronger credit demand, firmer core inflation, improving private investment and a stabilization in the property market as modernization progresses—should lift expectations for nominal growth and the equilibrium policy rate. This would support a repricing of medium-term interest-rate expectations and a widening of the currently compressed 2Y-5Y NDIRS slope toward levels more consistent with those observed in other Asian markets.

⁷ We estimate the real natural interest rate using the [Holston-Laubach-Williams](#) framework. The nominal natural interest rate is derived by adding CPI inflation to the estimated real natural rate. Historical estimates use realized growth and inflation data, while forward projections are based on Bloomberg consensus forecasts for growth and inflation.



Figure 20: 5Y NDIRS moves around the nominal natural interest rate



Source: Deutsche Bank Research, Wind, Bloomberg Finance LP

Figure 21: China's compressed 2Y/5Y NDIRS spread has room to normalize



Source: Deutsche Bank Research, Bloomberg Finance LP

FX: A more volatile RMB exchange rate

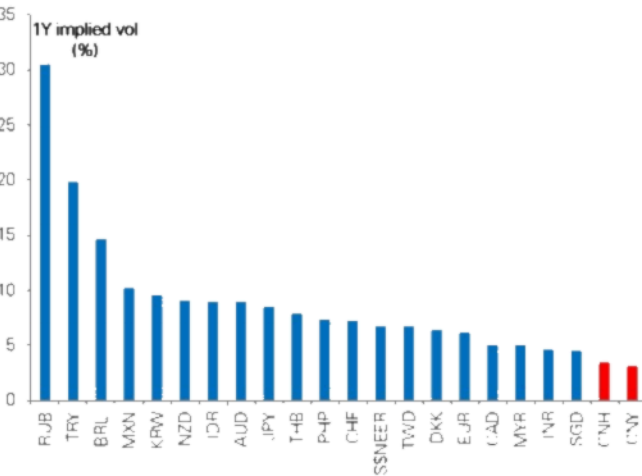
RMB volatility remains exceptionally low by international standards, reflecting Beijing's active management of the currency. As China modernizes its monetary policy framework and advances RMB internationalization, greater exchange-rate flexibility may become increasingly desirable as policymakers seek to reconcile monetary-policy modernization, capital-account opening and RMB internationalization⁸. A natural starting point would be a further widening of the RMB trading band, allowing market forces to play a larger role in exchange-rate determination while preserving the authorities' ability to manage excessive volatility.

Greater two-way RMB volatility would be a natural consequence of a more market-based monetary regime. While this could increase short-term uncertainty for investors and corporates, we believe it would also improve price discovery, enhance the RMB's role as a market currency, and facilitate deeper FX hedging and derivatives markets. Given China's central role in regional trade and financial flows, a more flexible RMB would likely transmit greater volatility across Asian FX markets, particularly among economies with strong trade linkages to China.

⁸ The Impossible Trinity (or monetary policy trilemma) states that an economy cannot simultaneously maintain a fixed exchange rate, full capital mobility, and an independent monetary policy.

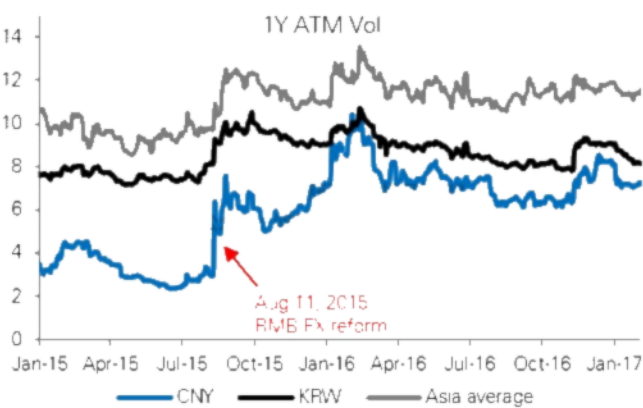


Figure 22: Rising RMB volatility could lift volatility across Asian FX markets



Source: Deutsche Bank Research, Bloomberg Finance LP

Figure 23: RMB FX regime change could have a significant impact on regional volatility



Source: Deutsche Bank Research, Bloomberg Finance LP



Appendix A

- Prior to 2015, the PBoC operated under a quantity-based monetary policy framework, with monetary and credit aggregates—most notably M2 growth and later Total Social Financing (TSF)—serving as the primary policy targets. Monetary policy implementation relied heavily on quantitative tools, including reserve requirement ratio (RRR) adjustments, window guidance, and administrative credit controls.
- This framework was well suited to an earlier stage of China's economic development, when bank lending dominated financial intermediation and monetary aggregates maintained a relatively stable relationship with economic activity. As China's financial system became increasingly market-oriented and diversified, however, these relationships gradually weakened, creating the need for a new monetary policy framework.
- 2015-2019: Interest-rate liberalization. Starting in 2015, the PBoC began transitioning from a quantity-based to a price-based monetary policy framework as money aggregates became less effective in impacting the real economy. This shift was marked by the introduction and expansion of a range of interest-rate instruments, including the Medium-term Lending Facility (MLF), Standing Lending Facility (SLF), and open market operation (OMO) rates. However, with policy rate transmission to the retail side still incomplete, the PBoC continued to rely on administrative guidance alongside market-based rates, resulting in a dual-track system of monetary transmission.
- 2019-2024: Clearing of interest rate policy anchor. As the interest-rate framework matured, the focus shifted from creating policy instruments to strengthening monetary transmission. A key milestone was the 2019 reform linking the Loan Prime Rate (LPR) to the MLF rate, which helped anchor bank lending rates to the policy framework. During this period, the PBoC increasingly relied on interest rates to guide financial conditions, while the role of quantity-based targets gradually diminished.





Appendix B

Figure 24: Full list of China's liquidity toolkit

Facility	Launch time	Availability	Tenor	Role and purpose	Funding capability	Counterparty	Collateral
Repo	1998 (was made daily in Feb 2016; overnight repo introduced in Jun 2026)	PBoC gauges repo/reverse repo demand in the primary market everyday	1D, 7D, 14D, 28D and 91D	Primary short-term liquidity tool, 7D repo rate serves as the interest rate benchmark	Large	Primary dealers (policy and large commercial banks as well as a small number of securities firms)	CGB and policy bank bonds
Short-term Liquidity Operations (SLO)	Jan-13	Discretionary, a complement to open market operation	Within 7D in general, extended only during public holidays	Complimentary emergency liquidity tool when Repo was not daily, obsolete since 2016	N/A	Between PBoC and financial institutions, mainly SME banks	CGB, PBoC bills, policy / financial bonds and IG bonds
Standing Lending Facility (SLF)	Early 2013	Unconventional operation, requested by financial institutions to meet their liquidity needs	7 days to 1 month	Standing liquidity facility to provide last resort liquidity. Barely used since 2020.	Small	Between PBoC and financial institutions, mainly SME banks	Mainly government bonds, PBoC bills, policy banks' financial debt and high-rating bonds; sometimes unsecured loans if necessary
Medium-term Lending Facility (MLF)	Sep-14	Monthly. PBoC gauges the liquidity demand	12 months	Primary medium-term liquidity tool, serving as interest rate benchmark between 2019 and 2024.	Large	Primary dealers (policy and large commercial banks as well as a small number of securities firms)	Government bonds, PBoC bills, policy banks' financial debt and high-rating bonds such as AA+ and AA corporate bonds
Targeted Medium-term Lending Facility (TMLF)	Dec-18	Quarterly. To encourage commercial banks to increase lending to small and private enterprises	12M, but can be rolled over twice	Discounted funding for targeted industries, obsolete since 2020.	Large	Primary dealers (policy and large commercial banks as well as a small number of securities firms)	Government bonds, PBoC bills, policy banks' financial debt and high-rating bonds such as AA+ and AA corporate bonds
Contingent Reserve Allowance, replaced TLF	Jan-18	Discretionary	30 days	Decided by PBoC	Large. Banks can withdraw up to 2% of their outstanding deposits	5 large banks	None
Pledged Supplementary Lending (PSL)	Mid-2014	Discretionary	Medium to long term	Provide longer-term low-cost funding to help support key sectors and promote structural reforms. Reduced usage since 2024.	Large	PBoC targeted lending to policy banks; reported qualified commercial banks used in infrastructure and strategic areas	May require government bonds, PBoC bills, policy banks' financial debt and high-rating bonds
Re-discounting	Jan-86	Discretionary	Long term	Support financing for rural development, SMEs, and private enterprises	Large	Commercial banks licensed to operate nationwide, locally incorporated banks, and foreign-funded banks	Discounted bills held by banks
Re-lending	January 1999, earliest one	Discretionary	7 day, 20 day, 3 month, 6 month and 1 year	To provide low-cost funding to key sectors for economic development	Large	Mostly nationwide financial institutions	Unsecured loans and secured loans
Outright reverse repo	24 Oct	Monthly. PBoC gauges the liquidity demand	3 month and 6 month	Medium-term liquidity injection tool designed to reduce reliance on MLF and enrich the policy toolkit	Large	Primary dealers (policy and large commercial banks as well as a small number of securities firms)	Government bonds, PBoC bills, policy banks' financial debt and high-rating bonds such as AA+ and AA corporate bonds
CGB purchase	24 Aug	Discretionary	N/A	Liquidity management and yield-curve guidance	Large for intervention purpose	Secondary market	N/A
Securities, Funds and Insurance companies Swap Facility (SFISF)	24-Oct	Discretionary	1 Year	Provides liquidity against eligible assets to support capital market stability and encourage institutional equity purchases	Small	Securities firms, mutual funds and insurance companies	ETFs, CSI 300 constituents and other approved assets

Green = actively used; yellow = occasionally used; red = officially discontinued or de facto phased out.

Source: Deutsche Bank Research



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