On the Impact of MLF Decline on Macroeconomy

Pingping Yue

Zhengzhou University, Zhengzhou 450001, China.

Abstract: MLF is a monetary policy tool used by central banks to provide medium-term base money. Medium-term lending facility rate plays the role of medium-term policy interest rate, which influences the balance sheet of financial institutions and market expectations by adjusting the cost of medium-term financing to financial institutions. Since the implementation of MLF monetary policy tool in 2014, it has attracted great attention from all aspects. In January 2022, the MLF rate dropped 10 basis points from 2.95 percent to 2.85 percent. This paper analyzes the impact of MLF decline on the stock market, real economy and commercial banks.
Keywords: MLF; Macroeconomy; Stock Market; Real Economy; Commercial Bank

1. The Development Of MLF

In order to maintain the overall stable and appropriate liquidity of the banking system and support the reasonable growth of money and credit, the central bank needs to continuously enrich and improve the portfolio of tools according to the duration, subject and purpose of liquidity demand, so as to further improve the flexibility, pertinence and effectiveness of regulation. In September 2014, the People's Bank of China created the Medium-term Lending Facility (MLF). The medium-term lending facility is a monetary policy tool used by the central bank to provide medium-term base money for commercial banks and policy banks that meet the requirements of macro-prudential management. It can be carried out through bidding and issued as collateral, and high-quality bonds such as national bonds, central bank bills, policy financial bonds and high-grade credit bonds [1] should be provided as qualified collateral. The term of interest rate is 3 months or 1 year, and the borrowing banks can obtain the lending facility by pledging interest rate bonds and credit bonds. In terms of the use of funds, the MLF requires banks to provide loans for agriculture, rural areas, small and micro loans and green loans.

The medium-term lending facility plays the role of medium - and long-term liquidity regulation in the market, which can not only meet the requirements of the current central bank to stabilize the interest rate, but also does not directly inject basic money into the market. By adjusting the cost of medium-term financing to financial institutions, the balance sheet of financial institutions and market expectations will be affected, and the banking financial institutions will be guided to provide low-cost funds to the real economy sector [2] in line with the guidance of national policies, so as to reduce the loan interest rate of commercial banks and social financing costs, and promote the development of the real economy. In addition, in the case of a gradual slowdown in the issuance of base money through foreign exchange outstanding channels, the medium-term lending facility has played a role in filling the liquidity gap and is conducive to maintaining a neutral and appropriate liquidity level. The medium-term lending facility rate also means that the central bank's monetary policy framework is further transformed from quantitative tools to price tools. While constructing the interest rate corridor, it further promotes the interest rate marketization and guides the interest rate downward. The medium-term lending facility will also be more transparent. The medium-term lending facility reflects the adjustment of the basic policy of China's monetary policy, namely, targeted regulation, and is pre-adjustment and fine-tuning.

2. The Impact Of MLF Decline on The Stock Market

The medium-term lending facility can be adjusted in specific areas, so its transmission mechanism to the stock market [3] is different from the traditional monetary policy tools, mainly through interest rate transmission and signal transmission.

The first is interest rate transmission. The central bank affects the changes of money market interest rates through the amount of basic money it releases. However, under the influence of the dual-track system of interest rates, it is difficult for the policy interest rate to affect the actual loan interest rate of the real economic sector through effective transmission, but the interest rate transmission of the medium-term lending facility helps to dreg this interest rate transmission process. In the interest rate transmission process of the MLF, the MLF rate is priced by adding the quoted interest rate of the loan market. Through the transmission channel of the interest rate of the medium-term lending facility, the transmission efficiency of monetary policy is improved and the financing cost of small and micro enterprises is effectively reduced. Low financing costs make the market liquidity of sufficient funds, through affecting the market supply and demand relationship, thus reducing the volatility of the stock market.

Second, signal transmission. Due to information asymmetry and increased market uncertainty brought about by the financial crisis, it is difficult for all market players to form consistent positive expectations, thus increasing the risk premium. However, if the monetary authority transmits positive signals to the market through some channels, it will reduce the uncertainty and information asymmetry in the financial market, thus boosting market confidence, forming consistent positive expectations among market players, reducing the interest rates in the money market and the bond market, thus reducing the financing costs of real enterprises and promoting the adjustment and optimization of economic structure. The reduction of financing cost will affect the relationship between market supply and demand and the trading behavior of investors. The medium-term lending facility rate can play the role of lender of last resort, enhance the liquidity level of the market, mediate investors' expectations of future capital shortage, and play the role of stabilizer, thus helping to stabilize the stock market.

3. The Impact Of The Decline In MLF On The Real Economy Such As Manufacturing

There is an inseparable relationship between the central bank and the balance sheet of the real economy and the financial institutions. The various monetary policy tools used by the monetary authorities will directly affect the balance sheet of the financial institutions, and the adjustment of the balance sheet of the financial institutions will affect the balance sheet of the micro entities of the real sector. Due to the information asymmetry between the lenders and the borrowers, It makes the financing cost of different economic entities differ greatly. The difference in enterprise financing costs will affect their financing decisions, further affect their investment end, and even have a direct impact [4] on the real economy. Therefore, by adjusting its balance sheet, China's central bank can influence the economic behavior of financial institutions and real economic sectors.

The People's Bank of China issues medium-term base money to banks and other financial institutions through the medium-term lending Facility to realize the impact on the liability side of commercial banks. However, because commercial banks have a certain degree of autonomy in whether to make loans or not and the lenders, and because of the instinct to seek profits and avoid risks, they will not focus their investment on agriculture, rural areas, farmers, small and micro enterprises, green enterprises and other weak areas of the national economy, there will be two kinds of results. The liquidity funds targeted by the monetary authorities will be idled in the financial system. This will further aggravate the imbalance of economic structure. The advantage of MLF lies in the setting of the range of collateral. The collateral of MLF includes high-quality small and micro enterprises, green, agricultural, rural financial bonds, high-quality small and micro enterprise loans and green loans, etc. The setting of the collateral of MLF virtually increases the credit guarantee for these fields. Therefore, the People's Bank of China can improve the quality of the balance sheet in specific areas through the reduction of the medium-term lending facility interest rate, ensure that liquidity support can flow from the asset end of financial institutions to the debt end of the real economy sector, improve the credit availability of enterprises, investors will have a good expectation on the future business conditions of enterprises, and affect the market supply and demand relationship. Thus reducing the cost of social financing.

4. The Impact of MLF Decline on Commercial Banks

Compared with the mature capital market and money market in developed countries such as Europe and America, our multi-level capital market is not fully developed. In the total amount of social financing, the loan provided by commercial banks still accounts for as high as two-thirds [5], among which the most critical is still the financing method of the real economy. All the time, the main profit of Chinese commercial banks comes from the traditional business, namely the spread of deposit and loan. Although commercial banks have been involved in all kinds of financial market businesses in the past few years, the most direct expression is that the profit proportion of traditional business of commercial banks has declined. However, with the advent of the era of strong supervision, commercial banks have put the development center on the traditional loan business [6]. However, against the background of interest rate liberalization and the decline of medium-term lending facilities, the interest margin between deposits and loans of commercial banks is getting narrower, which brings difficulties to the profit growth of banks.

The decline of medium-term lending facility also puts forward higher requirements for cost management and risk management of banks. At present, the use of commercial bank assets is dominated by all kinds of commercial loans, and the forms of use have strong homogeneity. In addition, such risk exposure probability is not evenly distributed over time, and the increase of risk exposure amount and the increase of non-performing loan ratio promote each other, coupled with a certain long tail effect, the bank's break-even point keeps rising. Such a series of circumstances will surely put pressure on the safe boundary of bank operation and the condition of meeting important regulatory indicators, and the contradiction between capital constraint boundary and scale expansion will be further highlighted. Especially for small and medium-sized banks, various risks caused by interest rate liberalization make small and medium-sized banks with weaknesses in air duct management and technical ability face greater pressure and even lead to a serious crisis. The above challenges to the management of commercial banks brought by the reform of medium-term lending facility mechanism objectively require managers to strengthen interest rate risk control, reprice risks, conduct stress tests, pay attention to the steady development of intermediate business, and enhance resilience in the face of risks.

5. Conclusion

The medium-term lending facility acts as a lender of last resort. The decline in the medium-term lending facility rate has helped stabilize the stock market and the real economy by enhancing market liquidity and increasing investors' positive expectations of future easing. The fall in the medium-term lending facility rate will shrink banks' lending and deposit spreads and increase their risk exposure.

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