Balancing Act: Monetary Policy Interventions and the Evolution of China's Stock and Bond Markets

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Abstract

This paper examines the transformation of China's financial system from a highly centralized structure to a more diversified framework, focusing on the shifting dynamics between monetary policy and political power. It analyzes key reforms that have reshaped China's bond and stock markets, interbank systems, and regulatory landscape. The study highlights how these changes have redistributed control over financial markets while maintaining strategic state oversight. By exploring the roles of institutions such as the People's Bank of China (PBOC), China Securities Regulatory Commission (CSRC), and nonbank financial institutions (NBFIs), the paper illustrates the complex interplay between market liberalization and state control in China's unique economic context. The research draws on historical mapping of the money-politics power interaction to demonstrate how China has navigated the challenges of financial innovation and systemic stability in pursuing a modern, market-oriented financial system.

Keywords: Financial Diversification, Interbank Markets, Non-Bank Financial Institutions (NBFIs), Interest Rate Liberalization, Bond Market Reforms

Key Institutions and Entities

People's Bank of China (PBOC): PBOC is the central bank of the People's Republic of China, responsible for formulating and implementing monetary policy, regulating financial institutions, and maintaining financial stability.
China Securities Regulatory Commission (CSRC): CSRC is the primary regulatory body that oversees China's securities and futures markets. It develops and enforces regulations, supervises market participants, and protects investors' interests to ensure the orderly functioning of capital markets.
State Administration of Foreign Exchange (SAFE): SAFE is a government agency under the PBOC that administers and regulates foreign exchange market activities in China. It manages foreign exchange reserves, implements policies, and monitors cross-border capital flows to maintain balance of payments stability.
Ministry of Finance (MOF): MOF is a central government department responsible for managing China's fiscal policies, budget allocation, and financial regulations.
Communist Party of China (CCP): CCP is the founding and ruling political party of the People's Republic of China, exercising leadership over governance and policymaking.
State-owned Enterprises (SOEs): SOEs are economic entities in which the Chinese government holds a controlling ownership stake. They play a strategic role in China's economy by operating in key industries and executing state-directed policies.
Non-bank Financial Institutions (NBFIs): NBFIs provide various financial services without holding a full banking license. These include insurance companies, asset management firms, and finance companies that diversify China's financial system by offering alternative investment options.

Technical Terms

Interbank Reforms: Interbank reforms refer to regulatory and structural changes in China's interbank market aimed at enhancing efficiency, transparency, and stability by fostering liquidity circulation and interest rate liberalization.
Monetary Policy Power (MPP): Monetary policy power refers to the authority of a central bank to influence economic conditions through control over money supply, interest rates, and other monetary tools.
Quasi-monetary Policies (QMP): Quasi-monetary policies are measures implemented by financial authorities that indirectly affect monetary conditions without directly manipulating traditional monetary policy tools.
Exchange Bond Market: The exchange bond market is a centralized platform where bonds are publicly traded on stock exchanges in China. It facilitates transparent bond issuance and trading for corporations and government entities while offering investment opportunities.
Enterprise Bonds: Enterprise bonds are debt securities issued by large state-

owned enterprises in China, often with implicit government backing, serving as key financing instruments for SOEs.

QFII (Qualified Foreign Institutional Investor): The Qualified Foreign Institutional Investor program allows approved foreign institutions to invest in China's domestic securities markets under regulatory oversight.

RQFII (RMB Qualified Foreign Institutional Investor): The RMB Qualified Foreign Institutional Investor program extends QFII by allowing offshore RMB reinvestment into China's securities markets to promote renminbi internationalization.

Interbank Bond Market: The interbank bond market is an over-the-counter market where financial institutions trade bonds directly without formal exchanges, serving as a key platform for liquidity management.

Interbank Reserve Settlement Systems: Interbank reserve settlement systems are mechanisms used by banks to settle transactions and manage liquidity within the interbank market efficiently.

Corporate Bonds: Corporate bonds are debt securities issued by private or public corporations to raise capital for purposes such as expansion or refinancing.

General and Special Bonds: General bonds finance public welfare projects, while special bonds are linked to revenue-generating projects. Both are issued by local governments as part of China's municipal bond market.

Securities Investment Deposits: Securities investment deposits are quasi-monetary instruments offered by NBFIs that allow investors to deposit funds for higher returns than traditional bank deposits while maintaining liquidity.

Stock Connect: Stock Connect links mainland China's stock exchanges with Hong Kong's exchange, enabling cross-border trading between these markets under daily quotas.

Bond Connect: Bond Connect is a mutual market access scheme allowing investors from mainland China and overseas to trade bonds through infrastructure linkage in Hong Kong.

A-shares: A-shares are equity securities of Chinese companies listed on mainland stock exchanges such as Shanghai or Shenzhen, denominated in Chinese renminbi (RMB).

B-shares: B-shares are equity securities listed on mainland stock exchanges but denominated in foreign currencies (U.S. dollars in Shanghai or Hong Kong dollars in Shenzhen).

H-shares: H-shares are equity securities of mainland Chinese companies listed on the Hong Kong Stock Exchange or other foreign exchanges, denominated in Hong Kong dollars and freely tradable internationally.

Introduction

China's financial markets have radically transformed, reshaping the relationship between monetary policy and political power. Over the last few decades, the country has shifted from a tightly centralized financial system in which the state directly controls capital and credit to a more market-driven framework with growing involvement from private businesses and NBFIs. This shift is not just about economic reforms; it reflects a deeper rebalancing of monetary and political dynamics as the state navigates an increasingly complex financial landscape while holding regulatory control. This paper explores how China's transition to a more diversified financial system balances innovation with state oversight. Although diversification has brought about more diverse funding options and financial innovation, the state continues to exert influence indirectly through regulations and monetary tools. This interplay between money and politics shows how China is redefining the state's role in fostering economic growth, maintaining financial stability, and managing market liberalization.
This paper further uses a historical approach to track key policy changes and their impact on financial market structures. Examines the evolution of bond and stock markets, reforms led by institutions such as PBOC and CSRC, and the emergence of financial instruments and markets such as corporate bonds and the Interbank Market. This paper also highlights significant changes in capital flows, institutional roles, and regulatory strategies by comparing China's pre-reform centralized system with its current distributed model. This paper is structured in a way that first reviews the existing literature on China's financial system, identifying gaps in understanding monetary policy reforms. Next, it argues that China's financial evolution reflects a dynamic shift in monetary-political relations. This argument is supported by an analysis of changes in capital flow mechanisms, institutional involvement, and regulatory approaches. The conclusion outlines the implications of these findings for academic research, policymaking, and future studies.

Literature Review of Transformations in China's Financial Markets and Systemic Challenges

Various studies and reports highlight that China's financial markets have experienced remarkable changes over the past few decades. The bond market, for instance, has grown significantly, evolving from a system dominated by government and policy bank bonds to one that includes a variety of instruments such as corporate bonds, asset-backed securities, and Treasury futures. These developments of various financial instruments have improved liquidity and helped integrate China's bond market into the global financial system, mainly by including major international indices and exchanges like the Hong Kong and New York Stock Exchange. However, regulatory gaps and the potential for systemic risks remain, requiring careful management to balance liberalization with financial stability (*China's Bond Market..*).

Similarly, the stock market has undergone a fascinating transformation. As outlined in *What Does History..*, its roots can be traced back to imperial China, but its modern form began to take shape in the 1990s with the establishment of the Shanghai and Shenzhen stock exchanges. While these markets have multiplied in size and activity, they remain volatile and heavily influenced by retail investors. Efforts such as circuit breakers introduced after the 2015-2016 crash show how regulators work to stabilize this vital part of the financial system (Pao 10).

China's broader financial system has also seen dramatic shifts. According to *China's Financial System..*, state-owned banks once dominated credit allocation, but reforms have introduced new financing channels like shadow banking and Wealth Management Products (WMPs). These alternatives have diversified funding sources but created new risks due to their lack of transparency. The resulting hybrid system supports both SOEs and private firms but still needs to improve credit allocation, particularly for small and SMEs. This imbalance highlights the need for further reforms to ensure fairer access to capital.

Furthermore, monetary policy interventions during crises illustrate the complexities of China's financial evolution. Research on central bank actions during the COVID-19 pandemic shows that coordinated monetary-fiscal measures were more effective than standalone policies in stabilizing financial markets(*China's Bond Market..*). Regulatory bodies like PBOC and CSRC have played a key role in shaping these changes. Recent reforms have focused on balancing market liberalization with risk management. For example, initiatives like the QFII program have encouraged foreign investment in China's bond and equity markets by granting approved foreign investors access to previously restricted domestic financial markets. At the same time, stricter Know Your Customer (KYC) requirements aim to enhance transparency, while regulations on derivatives markets help curb speculative risks (*Further Facilitating Foreign Investors*). These measures show a commitment to fostering healthy market growth while maintaining systemic stability.

Despite the advancements mentioned above, It is valuable to explore how political forces influence the financial transformations within China's financial system. Much existing research focuses on structural or regulatory changes without fully exploring how diversified impacts state control over financial markets. Furthermore, more attention should be paid to how monetary policy decisions reflect broader political objectives or how new financial instruments and non-financial institutions influence traditional state market dynamics. Addressing these gaps is essential for understanding how China balances diversification with state oversight in its rapidly evolving financial system.

China's Centralized Financial System Before the Interbank Market

To take a closer look, we can start with China's financial system before the Interbank Market setup in 1997. At that time, the system was highly centralized, with capital flows tightly controlled by the PBOC and state-owned banks. The PBOC and the Ministry of Finance directed capital allocation top-down, ensuring that funds flowed primarily to SOEs (*MU*). This financial framework enabled the state to exercise rigid economic oversight through highly streamlined and direct channels of capital movement. The PBOC dictated reserve requirements and lending volumes in this financial system, determining how funds were allocated between sectors and enterprises.

Meanwhile, Large state banks were essential players in this centralized system, acting as the primary channels for implementing monetary policy. These banks prioritized lending to large SOEs via the exchange bond market, as shown in Figure 1, a critical tool for achieving macroeconomic objectives and carrying out state-directed economic adjustments. In contrast, private enterprises faced significant barriers to accessing credit due to stricter loan quotas and approval processes. This imbalance reinforced the dominance of large SOEs in the economy while marginalizing private businesses (*Brandt*).

This centralized control by PBOC and CSRC was evident in the preferential treatment given to SOEs regarding credit access and investment opportunities, while private enterprises were primarily excluded from significant financial resources (*China's Financial System..*).

Later, reforms in China's financial system marked a significant shift toward diversification, which aimed to integrate private enterprises and foreign investors fully into the economic system. Programs like the Qualified Foreign Institutional Investor (QFII) initiative encouraged foreign investment in China's bond and equity markets, broadening access to capital for a broader range of participants.

Before Interbank Bond Market

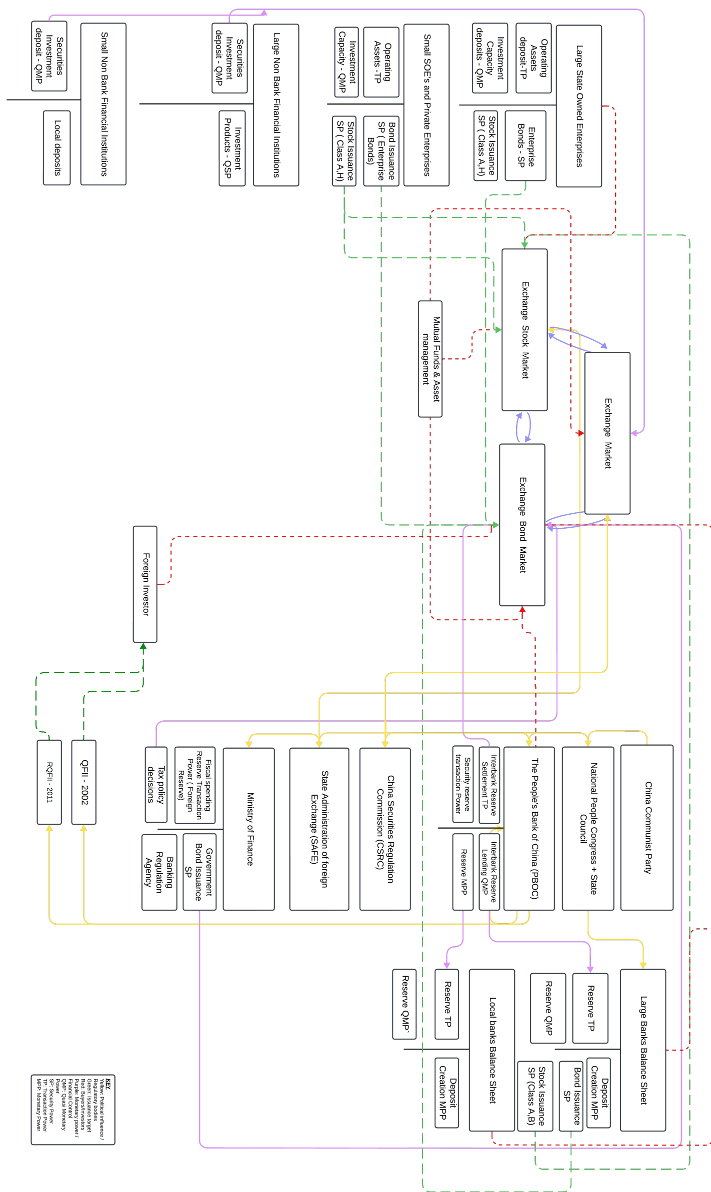

Figure 1: Illustration of China's Financial Market Evolution before Interbank Bond Market

Monetary Power Dynamics Before Interbank Reforms (Explanation of Figure 1)

Before China's interbank reforms, PBOC controlled interbank reserve transactions and reserved monetary policy power (MPP), which directly influenced the balance sheets of local banks. As shown in Figure 1, lines connect PBOC liabilities to the assets of the large and local banks. The PBOC regulated interbank reserve lending through its quasi-monetary policies, ensuring that large banks aligned with its directives. These large banks dominated the exchange bond market and amplified the PBOC's influence, creating a direct link between monetary policy and the political control of bond markets, which we can see by the green dashed line explaining the issuance power of these banks.

Large and small SOE private enterprises could issue enterprise bonds in the exchange market, which were purchased by mutual funds, asset managers, and foreign investors (represented by a red dotted line) through programs like QFII and later RQFI in 2011, via the setup of the interbank bond market. This interconnected system allowed the PBOC to maintain indirect control over funding flows while enabling broader participation in the bond market.

NBFIs also played a key role in this framework. Large NBFIs, such as insurance companies and fund managers, operated under the regulation of the CSRC and managed securities investment deposits through quasi-monetary policies. Smaller NBFIs catered to niche markets but had less influence than larger institutions.

In addition to bonds, stocks issued by large SOEs, small SOEs, and large banks were traded on the Shanghai and Shenzhen stock exchanges. State-owned enterprises held a dominant position in these markets, owning approximately 50% of the total market capitalization. This dominance underscored their strategic importance within China's economic framework (*China's Financial System..*).

This centralized system created a tightly controlled financial network where the PBOC's policies cascaded through large banks, SOEs, and financial markets. While reforms introduced mechanisms for broader participation, such as foreign investment channels and diversified funding options, the state maintained overarching regulatory control to balance market activity with political objectives.

Key Reforms Driving Diversification in China's Financial System: From Centralized Control to Market-Driven Mechanisms

China's financial system has undergone significant reforms like Bond connect, RQFII to diversify its capital allocation and monetary policy mechanisms. These reforms aim to reduce the dominance of state-owned banks and centralize controls, enabling a more market-oriented and diversified financial structure. Developing China's interbank markets has been a critical step toward decentralization. Historically, China's banking system relied heavily on PBOC for liquidity management. However, with the expansion of interbank markets, banks have gained the ability to lend and borrow funds, creating a more distributed network for liquidity circulation. This shift has reduced dependency on the central bank, allowing financial and non-financial institutions to manage their short-term funding needs independently. Moreover, interbank markets have become critical platforms for interest rate discovery, an essential step toward transitioning from administratively set rates to market-determined ones.

In tandem with the expansion of interbank markets, regulatory adjustments have played a crucial role in supporting the transition to a market-driven financial system. One of the most significant changes has been the liberalization of interest rates. By gradually removing administrative controls over lending and deposit rates, regulators like PBOC and CSRC have allowed market forces to play a more significant role in determining borrowing costs. (*Chen*) This reform has fostered competition among financial institutions and improved resource allocation efficiency. These regulatory adjustments have also created an environment where decentralized decision-making can thrive within a structured and stable framework.

Another important aspect of China's financial diversification has been the introduction of quasi-monetary instruments such as repos and commercial papers. These instruments provide alternative channels for liquidity management and enable broader participation by NBFIs in money markets. Unlike traditional bank loans, often subject to administrative controls, quasi-monetary instruments operate within market-driven frameworks, offering greater flexibility and efficiency. Their growing use has supported the development of a more market-oriented monetary policy framework, further reducing the PBOC's direct involvement in liquidity provision (*Chen*).

Another notable development is the increasing role of NBFIs and private enterprises in the financial system. NBFIs such as trust companies, insurance firms, and asset managers have emerged as major players in capital allocation, providing alternative funding sources outside traditional banking channels. These institutions are particularly active in bond markets, where they help channel funds from savers to borrowers. This shift represents a critical opportunity for private enterprises to access financing without relying solely on state-owned banks. The growing influence of NBFIs reflects a broader transition toward market-based financing mechanisms prioritising efficiency over administrative directives (*Allen*). At the same time, the PBOC has adopted a more indirect approach to monetary policy implementation, relying on tools that leverage market mechanisms rather than direct administrative controls. For example, adjustments to the reserve requirement ratio (RRR) allow the PBOC to influence liquidity levels without micromanaging individual institutions. Similarly, open market operations (OMO), through which the central bank buys or sells government securities, have become essential for managing short-term liquidity and guiding interest rates. Perhaps most significantly, the liberalization of interest rates has reduced the PBOC's direct role in credit allocation while empowering market participants to play a more significant role in determining borrowing costs. Lastly, in China's diversified financial system, the corporate bond market has expanded rapidly in recent years, providing companies with an alternative to traditional bank loans for raising capital. This development has been significant for private enterprises seeking long-term financing outside state-dominated banking channels. Similarly, stock market reforms have attracted both domestic retail investors and international institutional investors, increasing market depth and liquidity.

After Interbank Bond Market:

Monetary Power Dynamics (Explanation of figure 2)

The monetary power dynamics in China have undergone significant changes following the interbank reforms, creating a more decentralized financial system while maintaining political and financial authority, as shown in Figure 2. Key institutions such as CCP, PBOC, CSRC, SAFE, and MOF all hold distinct but interconnected powers in this evolving framework. These reforms have redistributed control over bond and stock markets while preserving strategic oversight by key state actors.

The PBOC retains substantial financial control over the interbank bond market, either by some direct ownership(shown by red dashed line) or having direct control over major players who have substantial control in the market(Purple line towards banks, similarly to time before when interbank formation), which has become a critical platform for liquidity management and monetary policy implementation. Through its interbank reserve settlement systems transaction power, the PBOC oversees liquidity flows among local and large banks, ensuring smooth monetary operations. However, its influence does not extend to the exchange bond market, which operates under different CSRC and SAFE regulatory frameworks(shown by the yellow line). This distinction reflects a partial diversification of financial authority, as the PBOC's role is confined to managing interbank reserves and liquidity rather than directly controlling all aspects of bond trading.

The Ministry of Finance is equally important in shaping fiscal policy and its intersection with financial markets. The MOF holds significant authority over tax policy decisions that impact the exchange bond market and oversees government bond issuance, directly influencing the interbank bond market. This dual role gives the MOF considerable leverage in determining funding conditions across both markets. Government bonds issued by the MOF are primarily traded in the interbank bond market, linking fiscal policy with monetary operations overseen by the PBOC.

Interbank reforms have also empowered local and large banks with expanded bond issuance security powers. Local banks can now issue general and special bonds traded in the interbank bond market. In contrast, large banks have gained the authority to issue corporate bonds alongside traditional deposit-creation functions. These developments have strengthened their ability to provide financing to each other within the interbank system, solidifying their dominance over this market. Local and large banks own approximately 60-70% of the interbank bond market, making them key players in liquidity provision and resource allocation (*China's Financial System..*).

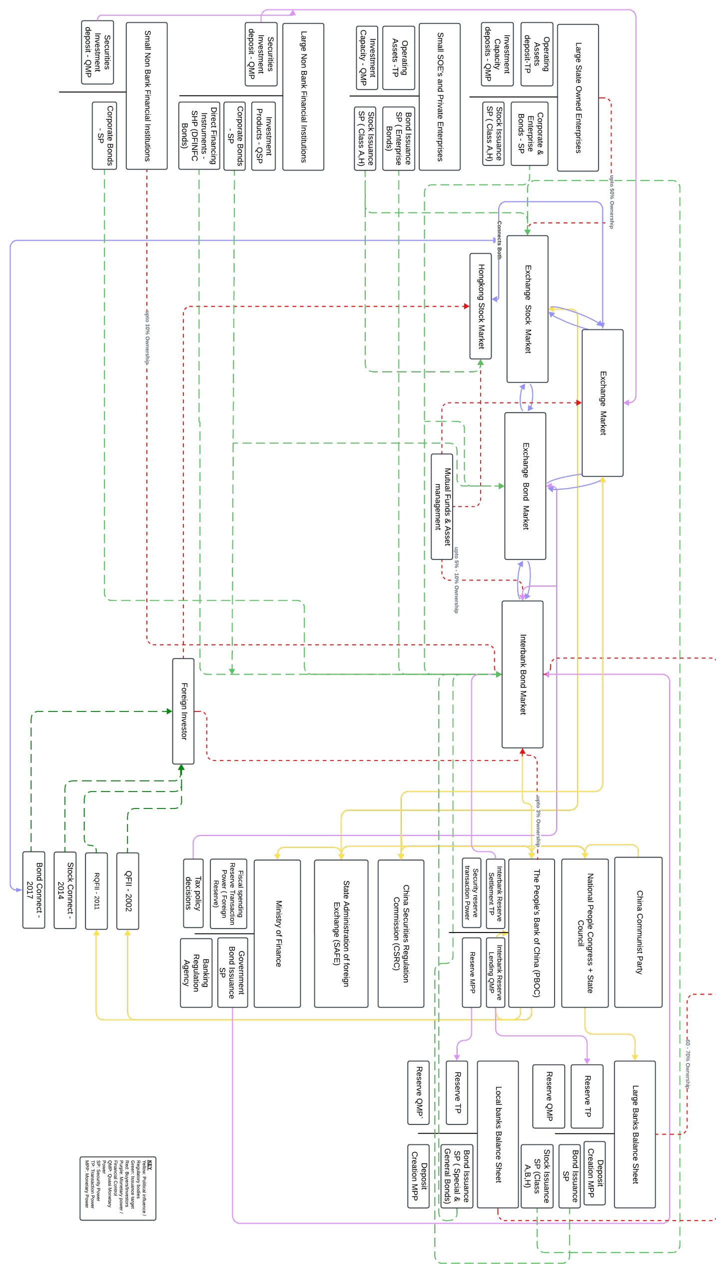

Figure 2: Illustration of China's Financial Market After Interbank Bond Market

Beyond banks, large SOEs, small SOEs, and private enterprises have also gained enhanced powers to issue bonds and stocks. These entities can now issue enterprise and corporate bonds traded in interbank and exchange bond markets. This diversification has broadened access to funding sources while introducing greater competition among issuers. Large SOEs dominate China's stock markets due to their substantial ownership stakes, controlling about 50% of the exchange stock market.(*China's Financial System..*) This dominance provides an indirect mechanism for state control over capital markets, as many large SOEs remain closely tied to government objectives.

NBFIs have emerged as influential players in this diversified system. Asset management firms, mutual funds, and other NBFIs actively participate in interbank and exchange bond markets as buyers of corporate bonds issued by banks and enterprises. Large NBFIs possess quasi-monetary powers through their ability to create securities investment deposits (financial instruments that function as quasi-monetary assets), which are invested in the Exchange market owned majorly by SOEs. These instruments grant NBFIs significant financial influence over exchange markets, further diversifying China's financial ecosystem.

This new framework has also evolved the connection between bond and stock markets. Large banks now have stock issuance security powers, allowing them to issue shares across multiple classes (A, B, H) traded on domestic exchanges and Hong Kong's stock market. In contrast, large and small SOEs usually issue Class A and H shares; integrating mainland China's stock markets with Hong Kong through programs like Stock Connect has facilitated cross-border trading opportunities for investors from both regions. These initiatives enhanced liquidity and transparency while attracting international investors to China's capital markets.

The introduction of Bond Connect in 2017 further bridged mainland China's financial markets with global capital flows via Hong Kong. This program allows foreign investors to access China's interbank bond market while enabling domestic investors to participate in overseas bond markets through Hong Kong. By linking these markets, Bond Connect has enhanced cross-border investment opportunities while integrating China's financial system into global networks (*Allen*).

Ownership distribution within China's interbank bond market, which is shown with a red dotted line in Figure 2, underscores its diversified yet interconnected structure. Local and large banks collectively own 60-70% of the market, reflecting their dominant role in liquidity provision and resource allocation. Mutual funds and asset management firms hold approximately 5-10%, highlighting their growing influence as non-bank participants. Meanwhile, the PBOC retains around 3% ownership through its monetary policy operations(*China's Financial System..*)

Balancing Diversification and State Control

After forming the interbank market, The PBOC's continued control over reserve settlement systems ensures its central role in liquidity management within the interbank market, even as it relinquishes direct control over other areas like

exchange bond markets. These developments and reforms regarding forming the Interbank market and Programs like Bond Connect underscore the political challenges of balancing market liberalization with state control. On one hand, decentralization fosters innovation and efficiency by allowing market forces to play a more significant role in resource allocation. On the other hand, it introduces risks that require careful management to ensure systemic stability. For example, increased reliance on NBFIs and quasi-monetary instruments can create vulnerabilities if these entities are not adequately regulated or their activities lead to excessive risk-taking. The Chinese government has sought to address these challenges by strengthening macroprudential regulations designed to monitor systemic risks associated with greater reliance on market mechanisms. Stress tests and enhanced supervision of financial institutions are among the measures implemented to ensure resilience against economic shocks (*Richard Herring*). This cautious approach reflects China's recognition that while decentralization offers significant benefits, it must be accompanied by robust oversight mechanisms to mitigate potential risks.
Decentralization also creates tensions between market forces seeking autonomy and state authorities striving for control. These tensions are evident in several areas of China's financial system. For instance, the growing role of private enterprises challenges the dominance of SOEs in key industries. Furthermore, greater integration with global financial markets exposes China to external risks while limiting its ability to insulate the domestic economy from international volatility. Despite these challenges, China's approach to decentralization reflects a pragmatic balance between fostering innovation and maintaining control. The government continues to rely on state-owned banks and SOEs for strategic objectives while encouraging private enterprises and NBFIs to play a more significant role in financing economic growth. This dual-track strategy underscores China's commitment to building a modern financial system that supports its broader economic goals without compromising stability.

Conclusion

In conclusion, China's shift towards decentralizing its financial system marks a significant transformation to enhance efficiency, innovation, and stability. Key reforms such as expanding interbank markets, introducing quasi-monetary instruments, and liberalizing interest rates—have laid a solid foundation for this change. The current dynamics reflect a growing role for NBFIs and private enterprises and the PBOC's use of indirect monetary policy tools. Regulatory changes have also broadened access to both bond and stock markets. This study contributes to the existing literature by offering a detailed look at China's process of financial decentralization, focusing on the delicate balance between liberalization and state control. It highlights China's unique approach, combining gradual reforms with careful oversight and sheds light on the challenges and opportunities of transforming financial systems in emerging economies. From a policy perspective, the research underscores the importance of designing reforms that encourage market-driven processes while ensuring overall stability. Policymakers can learn from China's dual-track strategy, which blends state-owned institutions with the dynamic role of the private sector. This approach could serve as a model for other developing countries working to modernize their financial systems while managing potential risks. Several important questions for future research emerge: How will China's increasing financial market integration with global systems affect its domestic economic stability? What are the long-term effects of NBFIs on China's financial stability and the effectiveness of its monetary policy? How can China refine its regulatory framework to support diversification while minimizing systemic risks? How will financial technology shape the future of China's diversified financial system? Understanding these dynamics is crucial for evaluating the opportunities and risks in China's evolving financial landscape. The ongoing interaction between market forces and state control will play a pivotal role in shaping China's economic future and its position in the global economy.

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