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Monetary Policy Transmission in China: A DSGE Model with Parallel Shadow Banking and Interest Rate Control

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Abstract

The paper sheds light on the interplay between monetary policy, the commercial banking sector and the shadow banking sector in mainland China by means of a nonlinear stochastic general equilibrium (DSGE) model with occasionally binding constraints. In particular, we analyze the impacts of interest rate liberalization on monetary policy transmission as well as the dynamics of the parallel shadow banking sector. Comparison of various interest rate liberalization scenarios reveals that monetary policy results in increased feed-through to the lending and investment under complete liberalization. Furthermore, tighter regulation of interest rates in the commercial banking sector in China leads to an increase in loans provided by the shadow banking sector.

Keywords: DSGE model, monetary policy, financial market reform, shadow banking, China

JEL Classification: E32, E42, E52, E58

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