



RESERVE BANK OF AUSTRALIA

16-17 May 2011

BOFIT Workshop on China's Monetary and Exchange Rate Policy

Comments on “China’s reserve requirement: practices, effects and implications”

Markus Hyvonen*

* The views expressed here are my own and do not necessarily reflect those of the Reserve Bank of Australia

Overview

A very practical, useful & timely paper:

- Lack of real-time explanation by the People's Bank of China (PBC) for its policy decisions
- Information vacuum creates demand for comment from media, market participants, academia
- Global financial markets paying more attention to developments in China; PBC policy moves tend to generate volatility
- Noise for policymakers
- Papers such as these can 'set the record straight'

Overview

The paper provides a nice framework for thinking about the use of reserve requirement ratios (RRRs) in China:

- RRRs linked to sterilising foreign exchange reserve accumulation
- International context: RRRs among highest in the world
- Reasons for preference of RRRs over other sterilisation tools discussed
- The effects of use of RRRs
- Future prospects for use of RRRs

Comments

- Banks reliance on deposit funding
- Link between RRRs and Net Interest Margins (NIMs)
- Rather than a tax burden, RRRs better thought of as an element of 'financial repression'
- Financial disintermediation not necessarily undesirable

Importance of Deposit Funding

- It is not surprising that the banking sector provides most of the financing and remains larger relative to equity and non-intermediated debt financing
- The dominance of deposits on the liability side of Chinese banks' balance sheets also matters
 - At end of March, Chinese financial institutions had CNY 75 trillion outstanding in deposits
 - Account for around 90 per cent for 'sources of credit funds'
- Deposits funding much lower share of banks' funding in other economies, though recovering post-GFC

RRRs & NIMs

$$\text{Net interest margin} = \frac{\text{interest income} - \text{interest expense}}{\text{interest earning assets}}$$

- Required reserves (RRs) are an interest earning asset for banks;
 - if compensation for holdings RRs < return on other assets, higher RRRs can mechanically decrease NIM

RRRs & NIMs

Items	2010	
	Average balance	Average interest rate
Domestic RMB businesses		
Interest-earning assets		
Loans	3,895,037	5.07%
Investment debt securities	1,435,273	2.78%
Balances with central banks	1,123,481	1.54%
Due from banks and other financial institutions	549,417	2.18%
Total	7,003,208	3.81%
Interest-bearing liabilities		
Due to customers	5,782,407	1.48%
Due to banks and other financial institutions and due to central banks	836,546	2.16%
Other borrowed funds	98,876	3.95%
Total	6,717,829	1.60%
Net interest margin		2.27%

Source: Bank of China 2010 Annual Report (page 22)



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 - In the case of BoC, reserves are the lowest yielding asset type; almost certainly true for other banks
 - The overall effect on NIM depends on whether a bank is close to the 'threshold'

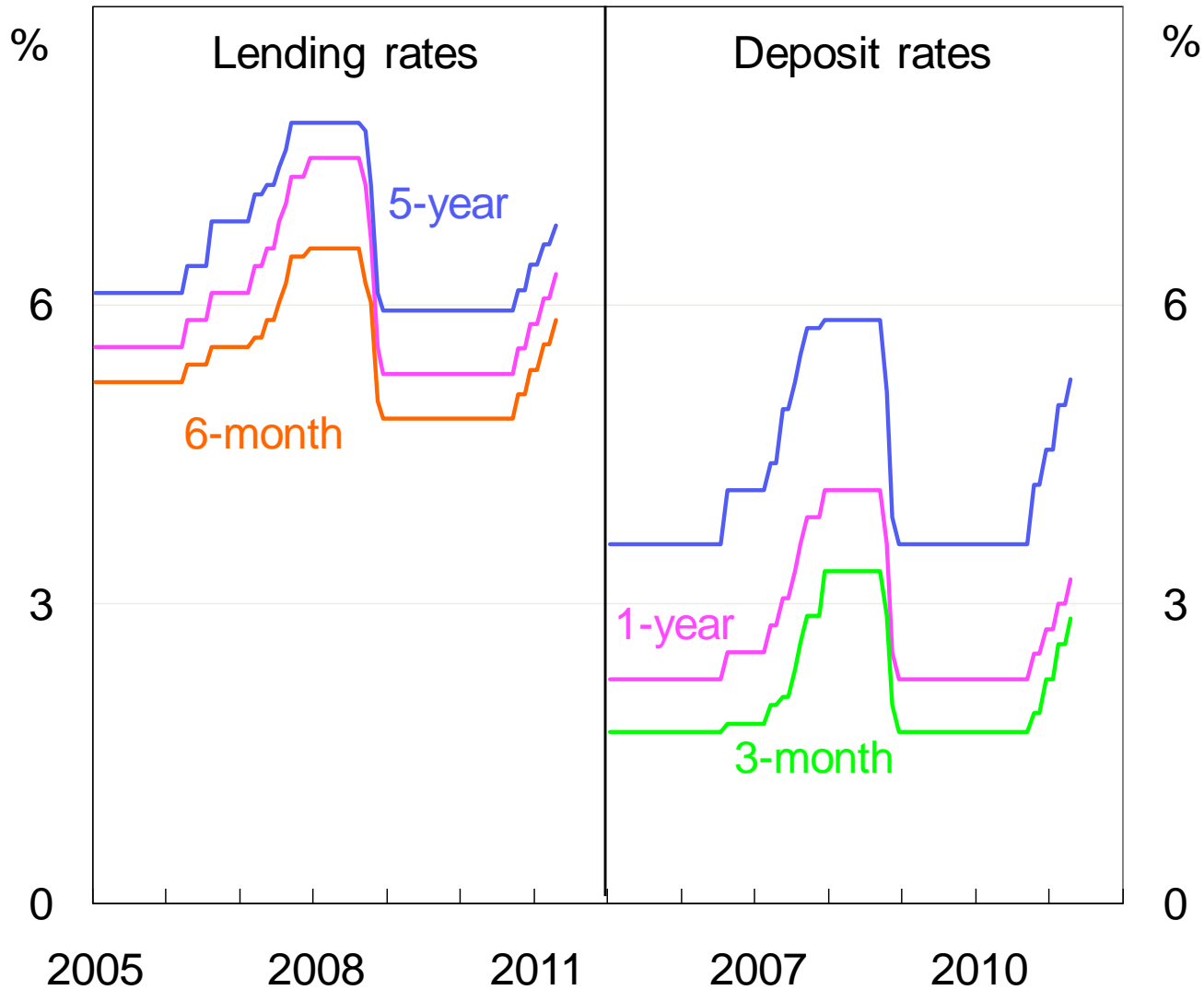
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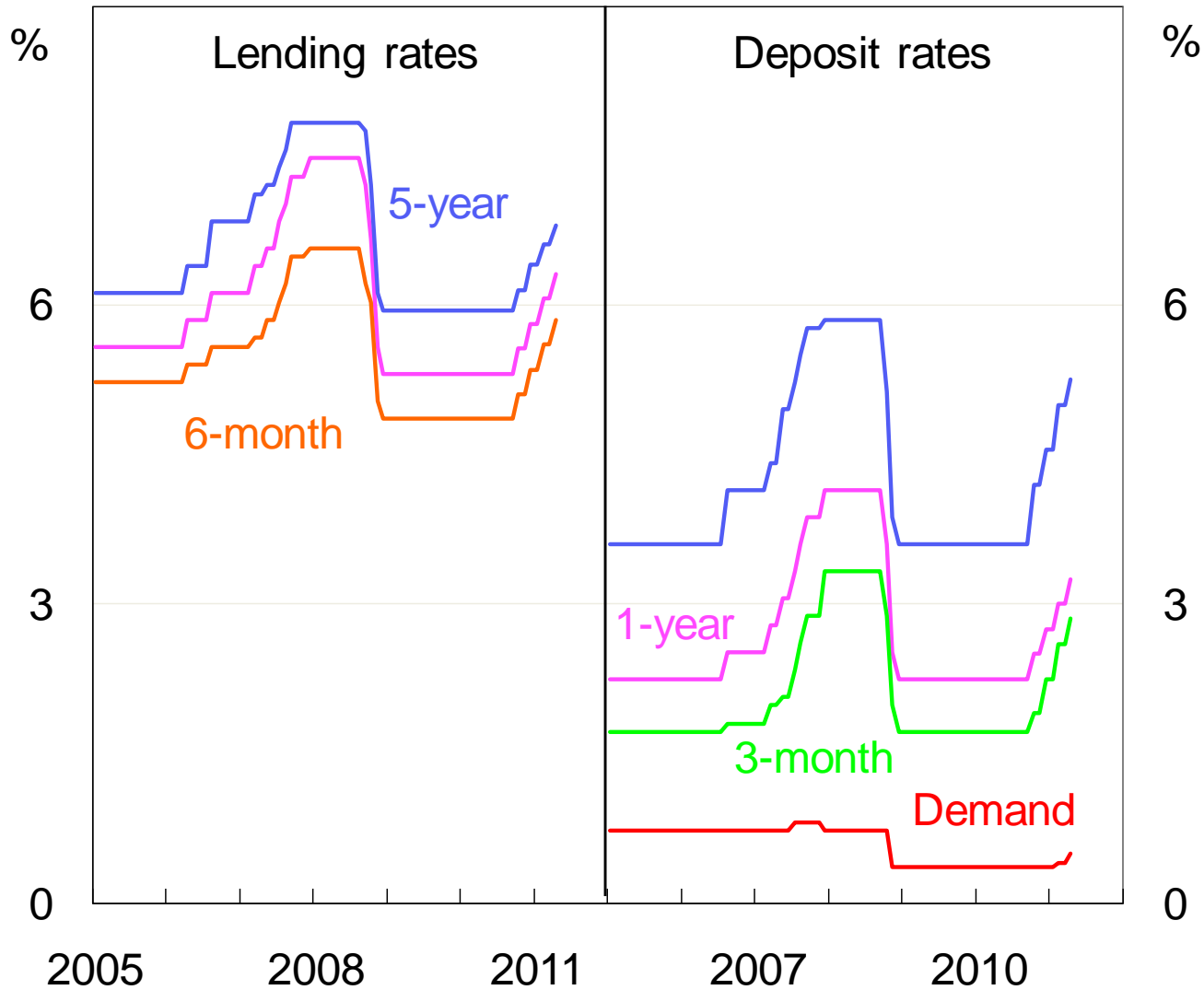


China – Benchmark Interest Rates



Source: CEIC

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Source: CEIC

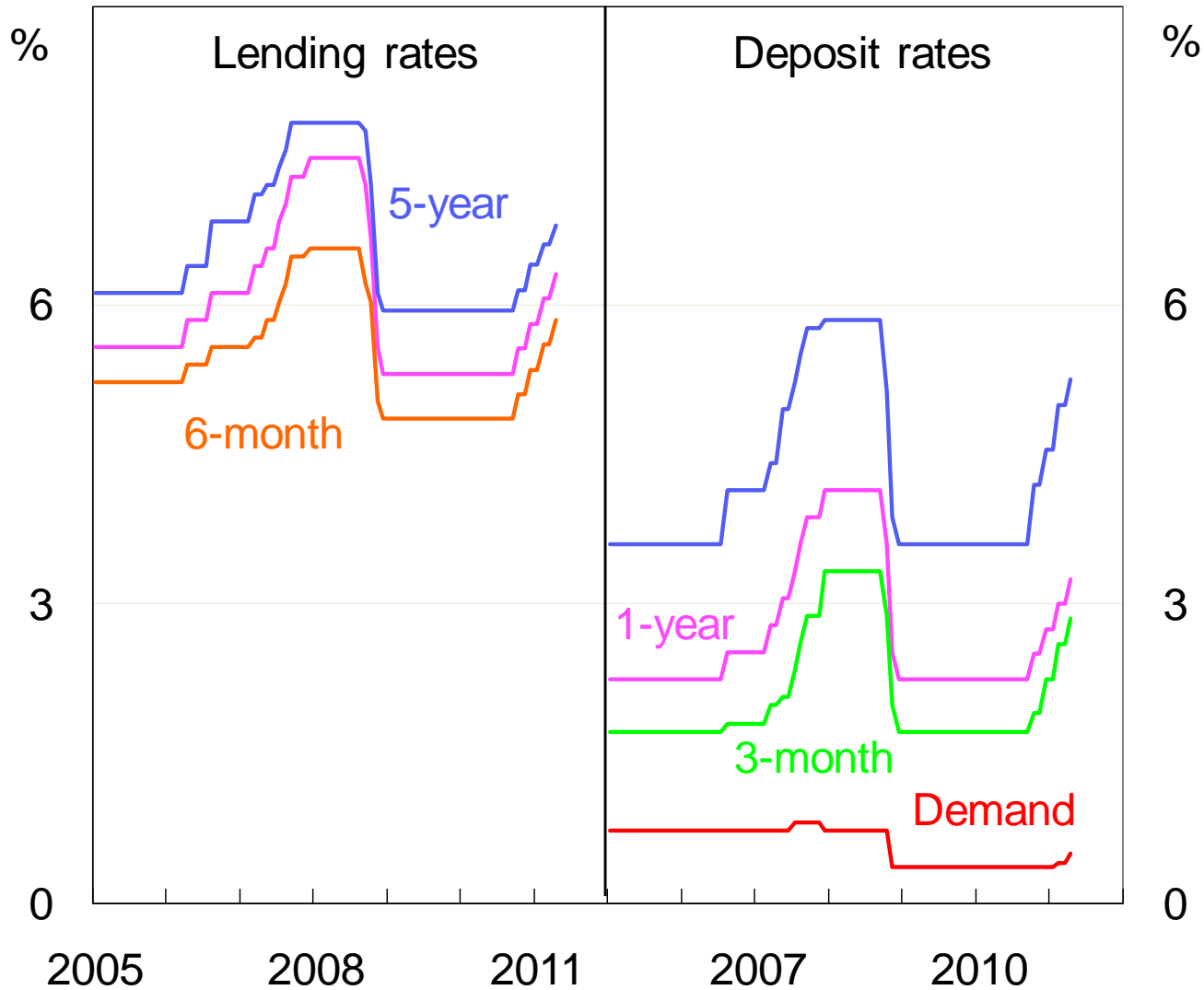
RRRs & NIMs

Items	2010	
	Average balance	Average interest rate
Domestic RMB businesses		
Loans		
Corporate loans	2,624,132	5.33%
Personal loans	1,122,147	4.72%
Trade bills	148,758	3.24%
Total	3,895,037	5.07%
Including:		
Medium and long term loans	2,693,845	5.22%
1-Year Short term loans and others	1,201,192	4.74%
Due to customers		
Corporate demand deposits	1,731,069	0.71%
Corporate time deposits	1,044,392	2.17%
Personal demand deposits	800,863	0.37%
Personal time deposits	1,773,809	2.24%
Other	432,274	1.87%
Total	5,782,407	1.48%

Source: Bank of China 2010 Annual Report (page 24)

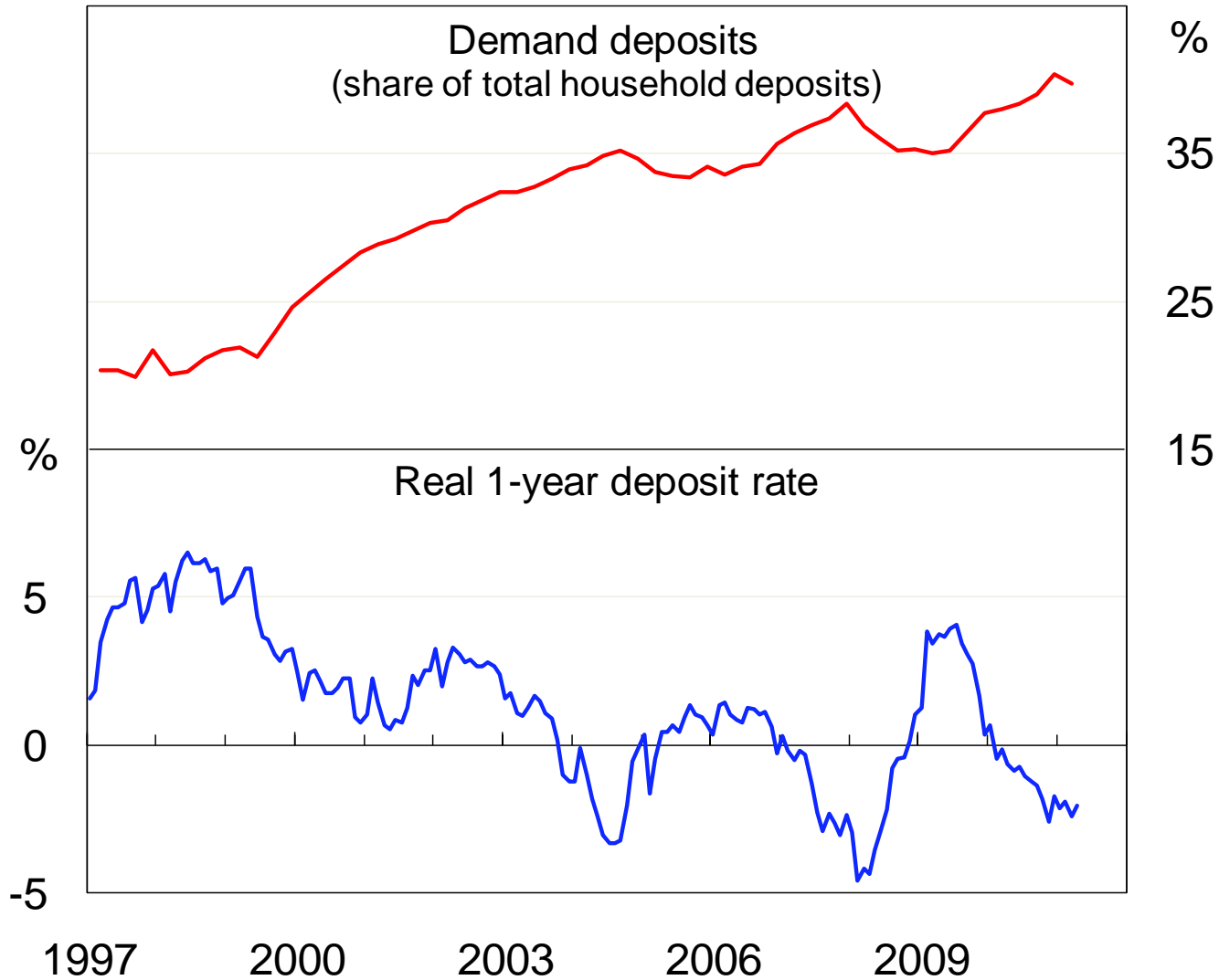


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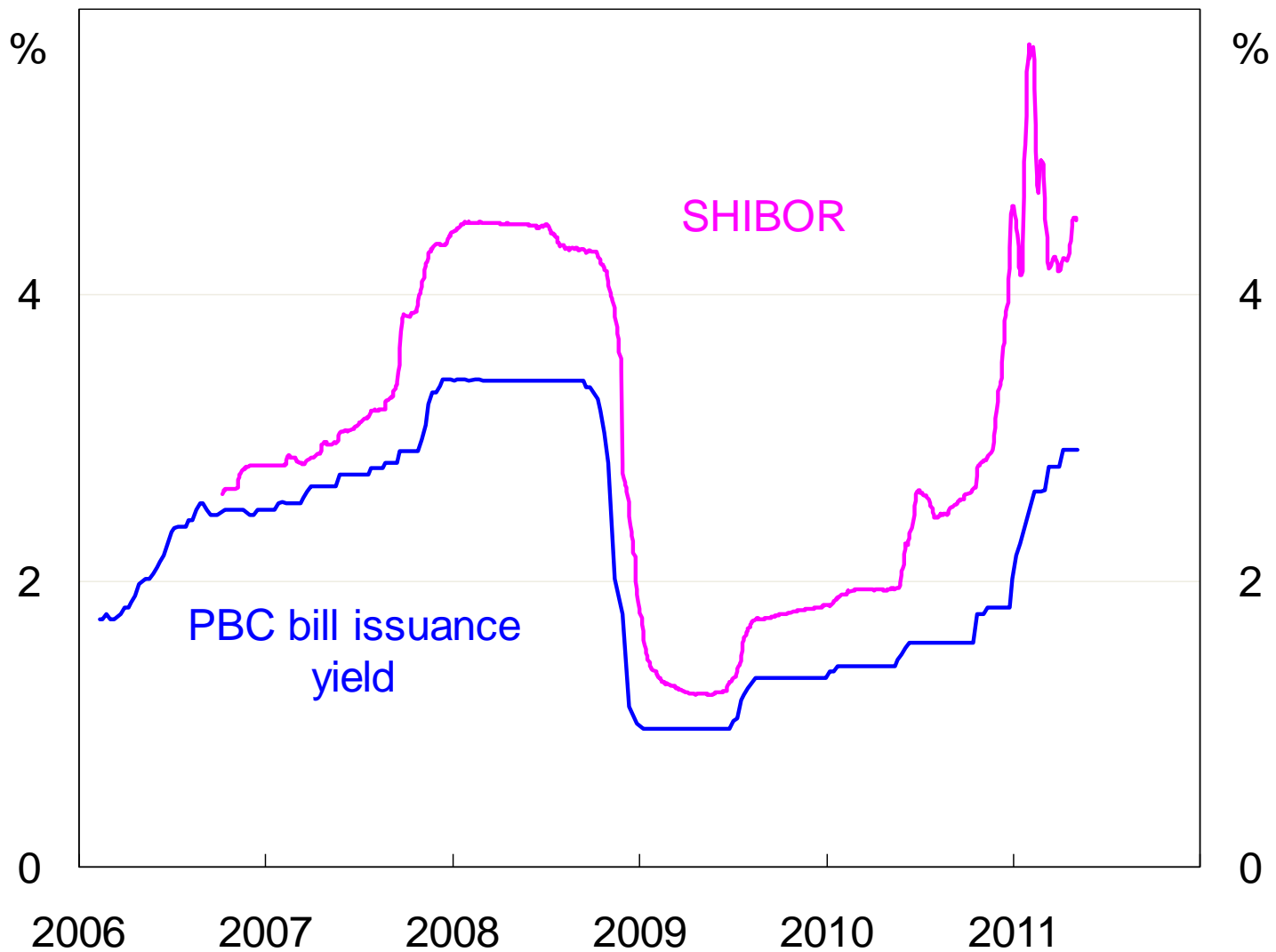
Source: CEIC

China – Household Deposits



Sources: CEIC, RBA

China - 3-Month Interest Rates



Source: CEIC

RRRs & NIMs

- Higher RRRs themselves over 2010 not necessarily the cause of higher NIMs
- PBC still has a large degree of influence over banks' NIM, in quite subtle ways
 - Composition of deposits and 'term structure' of benchmark interest rates matter
- Could argue that PBC has compensated banks for higher RRRs by keeping demand deposit rates very low
- Similarly, RRRs can be thought of as another element of 'financial repression'
 - The PBC plays a role in pushing cost of higher RRRs onto customers

Financial Disintermediation

- Regulatory arbitrage/avoidance can lead to undesirable outcomes
- However, needs to be distinguished from general development of Chinese financial markets
 - Authors show increased used of debt securities as a funding source for non-financial corporations
 - Financial institutions also have potential to shift their funding towards debt securities (and away from deposits)
- The PBC's new estimates of Total Social Financing (TSF) show that while declining, intermediation remains important

Concluding thoughts

- Outlook for RRRs?
 - PBC can continue to compensate banks for further RRR increases, meaning practical ceiling for RRRs quite high
 - PBC Q1 2011 Monetary Policy Report:
 - “no absolute upper limit on the RRR”
- Any further insight into dynamic differentiated RRRs?



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