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China's evolving reserve requirements

Summary

"We examine the role of reserve requirements as a cheaper substitute for the open market operations of the People's Bank of China (PBC) to sterilise foreign exchange interventions in recent years. China's reserve requirements have also been used to address a range of other policy objectives, not least macroeconomic management, financial stability and credit policy. The preference for reserve requirements reflects the size of sterilisation and the associated costs, in a quantity-oriented monetary policy framework faced with policy dilemmas. The PBC often finds it easier to make reserve requirement adjustments than interest rate decisions and enjoys greater discretion in applying this tool. The monetary effects of reserve requirements need to be explored not in isolation but in conjunction with other policy actions. Depending on the policy mix, higher reserve requirements tend to signal a tightening bias, to squeeze excess reserves of banks, to push market interest rates higher and to help widen net interest spreads, thus tightening domestic monetary conditions. Reserve requirements, however, impose an implicit tax burden on Chinese banks, albeit the latter seem to pass through a large but incomplete portion of these costs to their customers."

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