China's reserve requirements: practices, effects and implications

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Abstract

This paper examines the evolving role of reserve requirements as a policy tool in China. Since 2007, the Chinese central bank has increasingly relied on this tool to withdraw liquidity surplus from domestic money markets, mostly as a partial substitute for other more traditional FX sterilisation instruments in this period of rapid foreign reserve accumulation. China's reserve requirement system has also become more complex and been used to address a range of other policy objectives, not least being countercyclical macroeconomic and macroprudential stability. The preference for using reserve requirements reflects the size of China's FX sterilisation task and the associated cost considerations, quantity-oriented monetary policy framework in an environment of the predominance of banks in financial intermediation, importance of policy dilemmas, and other tactical considerations. Higher reserve requirements tend to squeeze excess reserves of banks, push market interest rates higher and widen net interest spreads, helping to tighten domestic monetary conditions. There are however costs to using this policy tool. Reserve requirements impose a tax burden on Chinese banks, currently at 0.3% of GDP and comparable to an average emerging-market economy. Chinese banks appear to shift much of the tax burden onto their customers, mostly depositors and small- and medium-size firms.

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