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What the China Reserve Requirement Ratio Means for the Markets, Economy

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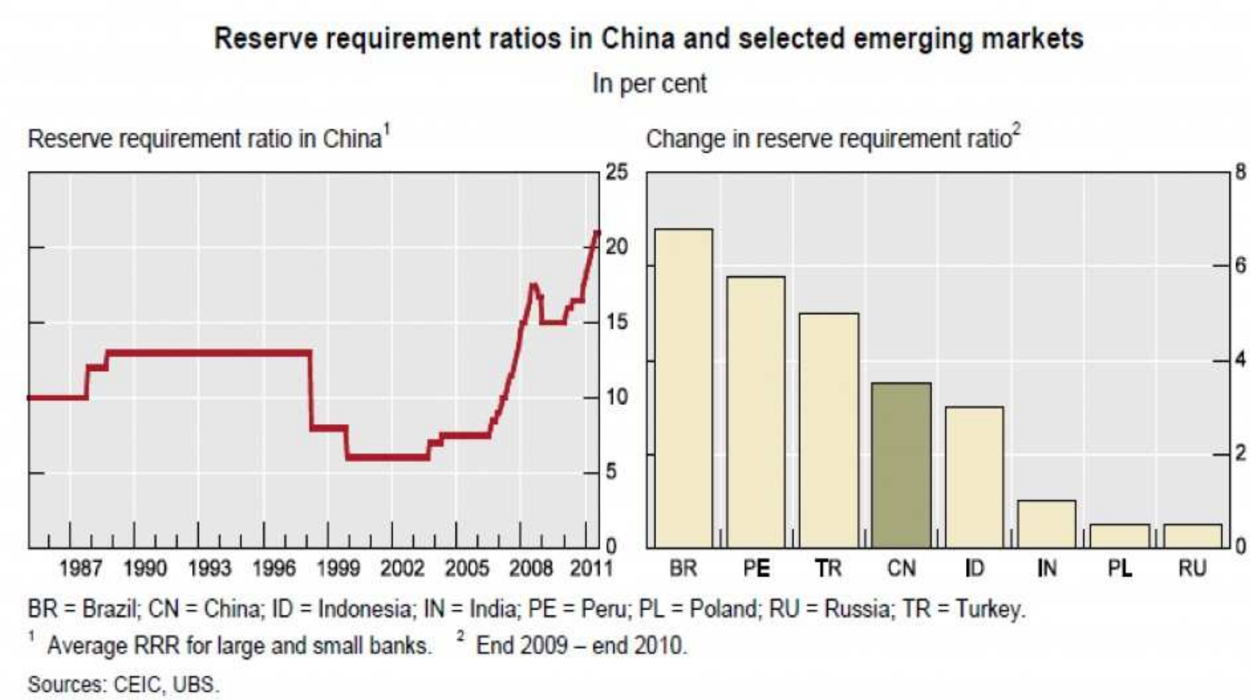
Forget changing interest rates. China's main weapon of choice to influence liquidity is changing its reserve requirement ratios. This tool dictates the percentage of commercial bank deposits that must be kept in the central bank.

Between July 2006 and June 2011, China's reserve requirement ratio was changed 35 times, which averages to one change every two months, according to the Bank for International Settlements.

During this period, it rose from 7.5 percent to 21.5 percent (for large banks), which is among the highest in the world.

(Graph below from BIS)



Currently, China's benchmark lending rate is only 6.56 percent, which is low compared to many countries, leading some to assume that China has a moderate monetary policy. Neighboring Pakistan's interest rate, for example, is at a whopping 12 percent.

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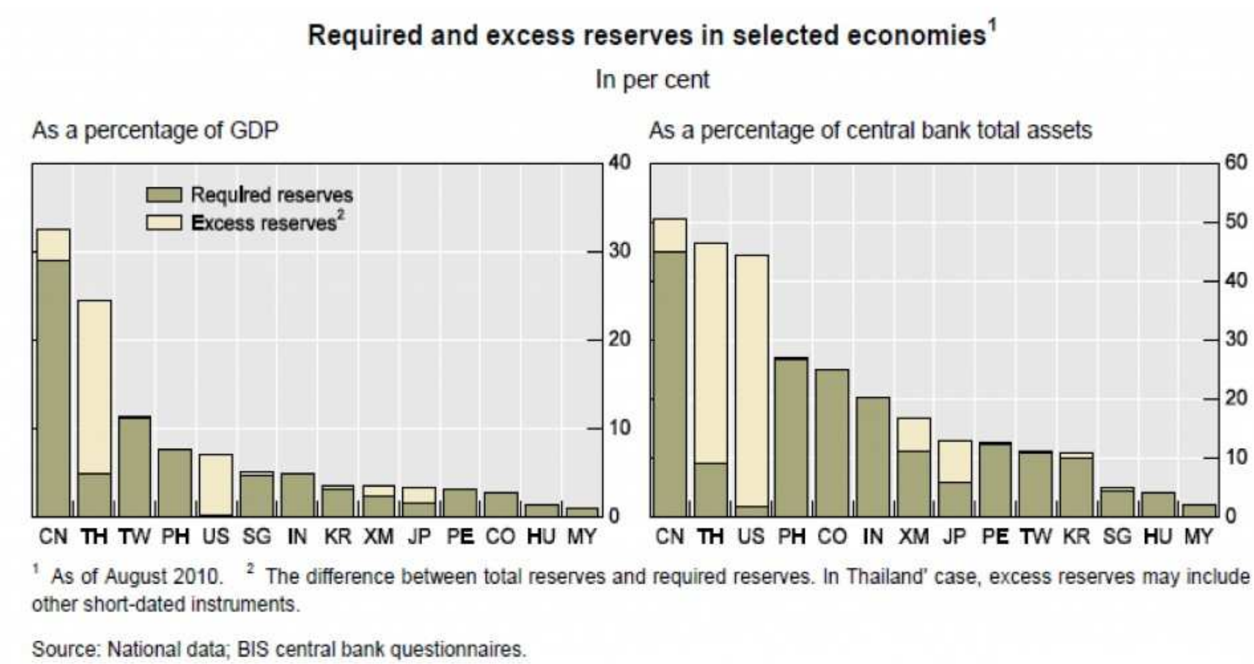
However, judging by the metric of total required bank reserves, which is almost 30 percent of GDP, China has the tightest monetary policies in the world.

(Graph below from BIS)



A key reason China resorts to the tool of reserve requirement ratio is its foreign exchange interventions.

While China no longer maintains a hard peg to the U.S. dollar, it still keeps its currency artificially undervalued against other major currencies by buying those currencies with newly printed yuan.

The side effect of this exercise, however, is that the newly printed yuan stokes inflation. (This is why many experts note that China, on some level, adopts the monetary policy of countries like the U.S.)

To counter this yuan printing, China chooses to raise reserve requirement ratios.

Many government use open markets operations – borrowing and lending directly in the financial system – to control liquidity.

China, however, chooses to use reserve requirement ratios because it is a more permanent and cheaper (i.e. it pays less interest rates) way to limit liquidity from foreign exchange interventions.

The Chinese central bank's required reserve liability (i.e. what it owes its commercial banks in deposited required reserves) totaled $2.1 trillion, according to a CCBIS Research note posted by the Financial Times on May 20, 2011.

Unless China plans to forever keep its reserve ratio at 21.5 percent, it needs to release a part of this massive cash hoard back to the financial system.

When it does, it will likely spark a surge in lending, which could lead to an acceleration in inflation. This scenario played out in Malaysia in the mid-1990s, according to John Greenwood of the Cato Institute.

Greenwood also pointed out a theoretical ceiling to raising the reserve requirement ratio: the size of China's commercial bank deposits.

That is, at some point, the reserve ratio would become so high that the central bank would drain the majority of China's bank deposit.

When this point approaches, China will likely have only two choices: allow the yuan to appreciate or allow newly printed yuan to circulate in the banking system and stoke inflation.

Both scenarios will likely lead to increased imports from abroad, the first scenario favoring foreign consumer goods and the latter scenario favoring commodities.

It will likely take a while before this or any tipping point occurs. In the meantime, what matters for the global markets and economy is how China's deals with an increase in liquidity.

When liquidity increases in countries like the U.S., it tends to only boost financial asset prices because U.S. financial institutions are unwilling to step up their lending. Instead, they are buying financial assets or parking the money in the Federal Reserve in the form of excess reserves.

When liquidity increase in China, it is crucial to see how it responds.

If it does nothing, lending will surge, the economy bill boom, global commodities prices will soar, and countries like Australia will prosper. If it raises its reserve requirement ratio, it will counter these trends. If it lowers its reserve requirement ratio, it will amply these trends.

China is a booming economy and a major source of incremental economic growth for the world. It also holds enormous financial "firepower" in the form of its massive central bank balance sheet – on both the assets and liabilities side.

What it decides to do with its reserve requirement ratio and other monetary policy tools will have a big impact on the global economy and financial markets.

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