FINANCIAL TIMES

China's reserves and the PBoC's balance sheet

January 16, 2012 3:28 pm by Claire Jones

The People's Bank of China will welcome the news that China's foreign exchange reserves dipped for the first time in a decade in the final quarter of 2011.

This from the FT's Simon Rabinovitch in Beijing:

> *A more serious problem for China has been the need to cancel out the domestic inflationary effect of the reserve accumulation.*
>
> *The root cause of the growth in currency reserves has been Beijing's policy of keeping the renminbi in a managed float against the dollar. The semi-pegged currency obliges the Chinese central bank to buy most of the foreign exchange coming into the country, injecting fresh renminbi into the financial system in return.*
>
> *To prevent that newly created money from pushing prices higher, the People's Bank of China must constantly engage in what are known as "sterilisation operations". It issues bills to banks or forces them to set aside a portion of their deposits as required reserves to mop up the excess liquidity.*

Not only are these "sterilisation operations" burdensome for the central bank, they are also costly.

Until the recent fall in reserves, the PBoC was estimated to have mopped up between three-fifths and four-fifths of the excess liquidity in recent years.

The central bank had preferred forcing banks to set aside more deposits as required reserves to issuing bills. No doubt because this was the cheaper option.

The yield on one-year PBoC bills issued at the end of December was 3.5 per cent (the central bank temporarily suspended issuance in early January) against interest on required reserves of 1.62 per cent.

However, 1.62 per cent is still far greater than the 0.1 per cent yield on one-year US Treasuries, in which a sizeable chunk of China’s reserves are invested. With a reserves stockpile of almost $3.2tn, the difference adds up and results in losses on the central bank’s balance sheet (See here for more on the associated losses and their implications).

Are the costs of China’s reserves stockpile now consigned to the past?

Rabinovitch writes that analysts see the recent fall in China’s reserves stockpile as a temporary blip. But, even so, the proportion of excess liquidity that the central bank sterilises is likely to fall as growth slows and price pressures diminish.

In the longer term, the problem should lessen as trade in renminbi picks up. Though if recent evidence is anything to go by, this may take a while yet.

Posted in People's Bank of China, Uncategorized | Permalink