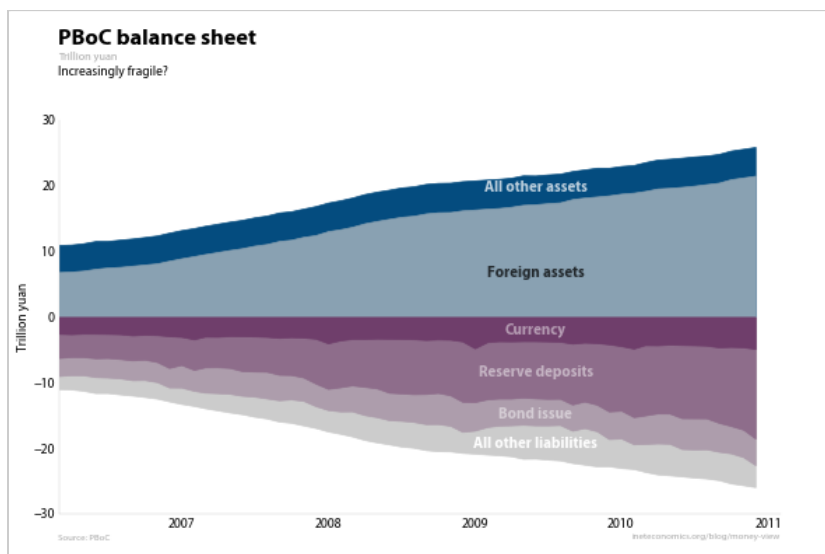


## The Money View

### A PBoC balance sheet primer

by Daniel H. Neilson on July 05, 2011 2 comments

Last time, I [looked](#) at the Chinese property market. The last link in that chain of financial interlinkages is the People's Bank of China, the Chinese central bank. This post gives a quick introduction to the main monetary challenges faced by the PBoC. Next time I'll connect the property bubble to the central bank.



The graph shows the PBoC balance sheet from 2006 through the end of 2010, in my preferred representation (see [this post](#) and [this post](#) for the Fed's balance sheet in a comparable format). Assets are shown as positive numbers, liabilities as negative numbers.

The organizing principle of the PBoC balance sheet is the secular expansion in foreign assets, which are the quantitative consequence of the country's exchange-rate policy. The effect is almost mechanical: China pegs the dollar/renminbi exchange rate, and to hold the peg, it must stand ready to buy and sell renminbi at that price. Over the period shown, pressure has always been for renminbi appreciation, so holding the peg means that the PBoC must buy dollars and sell renminbi. (If it did not, renminbi would be in excess demand, dollars in excess supply, and the renminbi would have to appreciate, breaking the currency peg.)

Dollars enter China through its export sector, so the central bank buys them from exporters' banks by issuing new liabilities, mostly bank reserves.

What happens now? This newly created high-powered money eases commercial banks' reserve constraint, and if no other action were taken, the banks would be free to expand renminbi lending proportionally. This lending would go to fund new domestic spending, whether on investment or consumer goods.

Such credit expansion would likely lead to domestic inflation, and the Chinese government is quite sensitive to the social consequences of rapid price rises. So the PBoC tries to offset the effect on domestic prices. This used to be done with so-called sterilization bonds (which sought to "sterilize" the inflationary consequences of exchange-rate intervention), which show up in the graph as "Bond issue". These bonds replace a more money-like liability of the central bank, reserve deposits, with a less money-like liability—a bond that cannot fund credit expansion.

These days sterilization bonds are less used, with the preferred policy tool now being the required reserves themselves. Rather than compelling banks to buy bonds, it simply raises the amount they have to hold in reserve against deposits. Now newly-created renminbi reserves do not immediately translate into new lending, and so domestic price rises are contained.

The system has basically worked, at least in the medium run—China has shown consistently high

### About this Blog



The idea of this blog is to engage current financial news and policy debates from the standpoint of the classics of monetary theory. We ask, "What would Bagehot say?", "What would Minsky say?", "What would Fischer Black say?" Like them, our starting point is the idea that capitalism is essentially a financial system, which means that we need to take a money view in order to understand how it works.

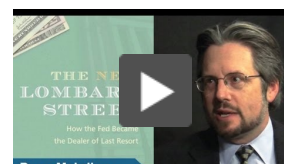
- Perry Mehrling
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Perry Mehrling is the author of [The New Lombard Street](#), which traces the evolution of ideas and institutions in the American banking system since the establishment of the Federal Reserve in 1913.

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growth while price rises have been contained.

But this masks an increasingly fragile financial configuration. Internally, repeated reserve increases limit lending by the formal banking system. But while export demand is high, investment demand and thus demand for loans will also remain high. This creates opportunities for the informal banking sector. And these loans add to price pressures anyway, negating the whole intent of the policy.

There are external fragilities too. We see signs that the PBoC is interested in diversifying out of dollars. Yet as long as the US continues to run the trade deficit that is the counterpart of China's trade surplus, it will mostly continue to accumulate dollar-denominated assets. If the PBoC wants to sell a large amount of dollars for some other currency, it will drive down the dollar exchange rate, quite possibly causing the renminbi to appreciate, again negating the intent of the policy.

The property bubble has the potential to put particular strain on the PBoC balance sheet, as we shall see next time.

**The Money View Empirical Macroeconomics China United States Deficits Globalization The Fed**

Posted by **Daniel H. Neilson** at 11:12 am  
[Daniel H. Neilson's blog](#)

**Comments**

**Submitted by jesper jespersen, Roskilde University on Fri, 07/08/2011 - 1:56am.**

Dear Daniel,

I like your writing style. I always tell my students: put the arguments as simple as possible; but never too simple! This is a delicate balance.

I think, when you write: 'Such credit expansion would likely lead to domestic inflation, and the Chinese government is quite sensitive to the social consequences of rapid price rises' - you make the argument too simple:

- a. there is not a one-to-one causal relation from increased bank deposits to bank lending
- b. increased bank lending does not automatically lead to 'domestic inflation' - it depends (and a real expansion of 8 percent a year has to be financed anyhow!)

Best wishes with your interesting project

jesper

[reply](#)

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**Submitted by Daniel H. Neilson on Fri, 07/08/2011 - 2:44pm.**

Jesper, thanks for the comments, both of which are quite valid. While I agree that I was simplifying, I stand by my post at least as a broad-strokes discussion of the policy concerns. I'm attentive to the subtler questions as well, but the blog format only allows so much depth.

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