Reserve Requirement and Optimal Chinese Stabilization Policy: Discussion

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This Paper

• Welfare implications of monetary policy in a distorted economy like China
  • New insight, nice empirical evidence and solid quantitative exercise

• Two distortions: $R_s \neq R_p$ and $(R_s - 1)(1 - \tau) = R - 1$
  • From government guarantee for SOEs, which is hard to correct by R policy due to the perfect R transmission for SOEs holding RRR fixed
  • From off-balance-sheet loans for private firms (“reduced-form”) and RRR, a wedge that can be used to correct the first distortion

• Mechanisms:
  • $\text{RRR} \uparrow \rightarrow R_s/R \uparrow \rightarrow \text{Private sector} \uparrow + \text{Bailout} \uparrow$
  • Much richer policy implications in DSGE framework
Interest Rate vs. RRR
Interest Rate vs. RRR
Stock Market Responses (RRR ↑ R unchanged)
Stock Market Responses (RRR ↓ R unchanged)
So, Why Is RRR Adjustment Needed?

• Distorted interest rate
  • Weak R transmission mechanism
  • Asymmetric financial frictions

• Quantity vs. price rules
  • Low R elasticity of money supply
  • The legacy of planned economy (e.g., loan quota)

• Caveat: Unintended consequences ...
Quantitatively Small Welfare Gain?

• Start with the case in which the price rule doesn’t work very well for China (weak R transmission / low R elasticity of money supply / other shocks)

• Find bigger welfare gains by conducting optimal RRR policy