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The Relationship between Reserve Requirement Ratio and Inflation in China

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ABSTRACT

This thesis studies how the central bank sets the reserve requirement ratio in China. The monthly series of reserve requirement ratio and inflation data from January 1999 to May 2011 are used to examine both the long-run relationship and the short-run dynamics between changes in reserve requirement ratio and inflation pressure.

Our results show that there is a quite weak long-term relationship between reserve requirement ratio and inflation, reflecting the fact that as a tool of monetary policy, reserve requirement ratio is rather ineffective in China. This may be attributed to the macro-economic regulatory objective of keeping the currency at a relative stable level, stimulating economic growth and creating more job opportunities.

In the short-run, the reserve requirement ratios of both large and complex financial institutions and small and medium financial institutions respond somewhat to inflation pressures, and changes in inflation has a greater influence on changes in reserve requirement ratio for small and medium financial institutions than that for large and complex financial institutions. However, the extent of disequilibrium at time (t-1) has little effect on reserve requirement ratio.

LIST OF FIGURES AND TABLES

Figure 1: Reserve requirement ratios and inflation rates……14

Table 1: General descriptive statistics of sample data……..15

Table 2: Correlation coefficients of sample data……..15

Figure 2: Flow chart of the whole process……...17

Table 3: Unit root test……...18

Table 4: Johansen co-integration test……...19

Table 5: Pair-wise Granger causality test……20

Table 6: Long-term relationship……21

Table 7: Symmetric adjustment speed……22

Table 8: Asymmetric adjustment speed……24

Table 9: Mean adjustment lags in months……...…27

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LIST OF ABBREVIATIONS

The following is a list of abbreviations used throughout this thesis. The abbreviations are also explained on their first subsequence chapters.

PBOC	People's Bank of China
RMB	Renminbi
CPI	Consumer Price Index
GDP	Gross Demestic Product
LCFI	Large and Complex Financial Institutions
SMFI	Small and Medium Financial Institutions
RRR	Reserve Requriement Ratio
RRR1	Reserve Requriement Ratio of Large and Complex Financial Institutions
RRR2	Reserve Requriement Ratio of Small and Medium Financial Institutions
OLS	Ordinary Least Squares
ECM	Error-correction Methodology
VARs	Vector Auto Regressions
ADF	Augmented Dickey Fuller (one type of Unit Root test)
P-P	Phillips –Perron (one type of Unit Root test)
AIC	Akaike Information Criterion
SIC	Schwarz Information Criterion
HQC	Hannan-Quinn Criterion

CONTENTS

CHAPTER 1: INTRODUCTION 1

CHAPTER 2: LITERATURE REVIEW 6

2.1 Interest Rates Channel..... ……6
2.2 Competition Enhances Monetary Policy Transmission ……...6
2.3 Asymmetric Manner and Causes ..... ……..7
2.4 Studies on Chinese Interest Rates Setting..... …….7

CHAPTER 3: RESERCH METHODOLOGY..... .9

3.1 Long-run Model 9
3.2 Short-run Model under Symmetric Assumption 9
3.3 Short-run Model under Asymmetric Assumption 11

CHAPTER 4: FINDINGS..... 14

4.1 General Description of Sample Data.....14
4.2 Correlation Coefficients 15
4.3 Unit Root Test 16
4.4 Johansen Co-integration Test 18
4.5 Granger Causality Test…… 19
4.6 Estimated Coefficients of Long-term Relationship.....21
4.7 Symmetric Error Correction Model 22
4.8 Asymmetric Error Correction Model 24
4.9 Mean Adjustment Lags 26

CHAPTER 5: CONCLUTIONS..... 28

REFERENCES 29