

CENTRAL BANK WATCH: China Juggles Stability and Growth

By James T. Areddy

SHANGHAI (Dow Jones)--For the first time in several years, China's central bank has started applying brakes to the economy, trying to ensure sizzling growth doesn't spark inflation.

Complicating its job, however, are risks that clamping down too hard could send parts of the fragile economic system into a skid. At the top of this list are China's banks.

The People's Bank of China has taken steps in recent months to control credit expansion and lower the temperature, just as the U.S. Federal Reserve does in a high-growth environment. It has tightened credit and has even adopted a Fed style bill-issuance program to send monetary policy signals.

Yet, the PBOC is also undermining these efforts by adding fiscal stimulus, a novel approach aimed at mitigating the impact of its very own cooling efforts.

A dance of three-steps forward and two-steps back by the central bank reflects how tightening credit in China requires balancing the interests of those parts of the economy that can sustain themselves as credit costs rise and the sectors that have more trouble doing so.

No industry better reflects the quandary than China's banking system. Four big banks lord over massive deposits, which gives these giants the wherewithal to absorb higher credit costs or see a slowdown in lending associated with efforts to cool the economy.

But the PBOC has also bowed to the interests of hundreds of China's smaller banks. These institutions run the gamut between poorly run cash boxes of local governments to dynamic institutions geared more toward consumer credit than loss-making state enterprises. Now, analysts and industry officials say many are feeling squeezed, often because their smaller deposit base leaves less wiggle room to handle changes in the credit system.

Bank industry variables are just one consideration the central bank is juggling as it seeks to cool the economy. Another challenge is slowing growth in the cities even before their obvious boom spills into the countryside, where incomes continue to falter. And the central bank can't ignore how the government is being crunched by a rise in the cost of its massive debt financing program.

The rub is, trying to serve everyone has made the "PBOC's efforts to tighten halfhearted," according to a report this week from G7 Group Inc., a Washington-based think-tank.

All the while, concerns are mounting that China's US\$1.27 trillion economy may be overheating. Some economists believe it is already growing several percentage points faster than indicated by official data. The government said last week that gross domestic product expanded 9.1% year-on-year during the third quarter. The consumer price index already has banged past 1%, hitting 1.1% in September.

In this heady environment, G7 Group's China analyst Steven Sun questions whether the PBOC is working hard enough to ensure fast growth doesn't backfire for the economy. Without action soon, "a boom-bust credit cycle is thus possible," his report says.

For the banks specifically, trying to ensure industry wide stability in the short term runs the risk of later saddling one of the world's most debt-burdened financial systems with even more bad loans. That's because, as money supply expands, even poorly conceived projects can look worthwhile.

An irony is that even though they represent most of the industry's US\$500 billion in dud loans, China's biggest four banks are best positioned as credit tightens. The four - Industrial & Commercial Bank of China (ICBC.YY), Bank of China (BCH.YY), China Construction Bank (CCB.YY) and Agricultural Bank of China (AGBC.YY) - also hold most of China's US\$2.6 trillion in customer deposits. And this cash horde surged almost twice as fast as economic growth itself: 17% in the first nine months of this year.

But tighter credit conditions do pinch small banks, which represent about 35% of the industry. They have fewer deposits and in fact tend to be borrowers themselves from bigger banks.

Concerns about this situation are now being expressed by the central bank itself. The PBOC's quarterly statement this week said its moves to slow credit growth in August opened a "liquidity hole" at small banks. It didn't name them but suggested more forthright tightening could have made some institutions insolvent.

Its highly technical moves in recent months have included China's first credit tightening since the mid-1990s in August and active weekly bill sales since April.

Yet, by its own admission, nearly each time the PBOC has withdrawn funds from the banking system to push market interest rates higher, it has made an offsetting injection of funds to soften the blow.

Among the policy flips was on the one percentage point increase in August of the amount of deposits banks need to hold on reserve, to 7.0%. It was supposed to remove the equivalent US\$18 billion from the banking system.

It was called the most aggressive credit tightening in years and the PBOC gave banks a month to adhere. But even so, this week's quarterly report noted, "in the face of abrupt liquidity demands of commercial banks, the PBOC conducted preventative operations" and pumped US\$11 billion right back into the banking system before the move took effect.

Another compromise is undermining the government's contention it has the wherewithal to resist lifting the exchange rate, as the U.S. has pressed China to do. A marked slowing in efforts to "sterilize," or freeze, the inflationary impact of foreign exchange inflows has been seen in recent weeks. The PBOC says it has added a net US\$38 billion in newly minted yuan to the banking system so far this year, a major reason money supply growth remains supported around 21%.

What's needed now, many analysts believe, is another tightening of the reserve requirement ratio or even higher interest rates.

The PBOC indicated this week it expects big banks to sharply cut loan growth in the fourth quarter, to 11% from the 19% that prevailed in the first nine months. But it also said it intends to continue walking a tightrope, "to prevent various lending and liquidity risks."

- James T. Areddy; Dow Jones Newswires; (86) 1370 1700 594; james.aredy@dowjones.com
(Linda Lin contributed to this story.)