

FRBSF ECONOMIC LETTER

Number 2004-31, November 5, 2004

Reflections on China's Economy

This Economic Letter is adapted from remarks delivered to the International Financial Institutions Association of California and the National Association of Chinese American Bankers in Santa Monica, California, on October 15, 2004.

Asia has been an important focus for the San Francisco Fed for many years, in terms of both our supervisory function and our research. Therefore, like my predecessors, I traveled to the region recently, spending several days in China visiting central bank officials, members of economic and regulatory commissions, academic economists, and local entrepreneurs.

A main topic of discussion was how China can keep its economy from overheating, a concern that began to emerge toward the end of 2003, when GDP grew at a rate of around 10%. One key factor supporting this growth has been investment, which grew at an average rate of almost 17% over the last four years, exceeded 25% last year, and jumped more than 40% over year-ago levels in the first quarter of 2004. Another key factor is exports, which have been rising at an annual rate of almost 30% in the last two years.

“Overheating” usually means that an economy is suffering from excess demand, which then causes inflation to rise. In China, concerns about excess demand are centered in sectors such as real estate, cement, and steel, where investment has been so strong that government officials and many outside observers are concerned about the development of overcapacity, leading to a boom-bust cycle. A related concern is that the bank lending that is financing these investments could result in a new crop of nonperforming loans. With respect to broad price trends, some officials argue that general inflation is not a serious issue at this stage, even though it recently exceeded 5% on a year-over-year basis. They note that price increases are concentrated in food and are due to poor harvests last year. Core inflation has been near zero. Other observers, how-

ever, fear that price inflation and shortages in some price-controlled sectors like electricity portend more pervasive inflationary pressures.

Monetary policy challenges

These conditions have set up some real challenges for the policymakers at the People's Bank of China. First, they want to slow the economy enough to achieve a “soft landing,” having suffered through two “hard landings” (1985–1989 and 1992–1994), when growth dropped severely. In China, a “soft landing” means bringing growth in at close to 7%, because that rate is viewed as necessary to create enough jobs to absorb surplus rural labor and workers laid off by state-owned enterprises. China has the “potential” to grow rapidly.

Second, the government has been trying to move not only toward a market-based economy, but also toward market-based policymaking. That would imply that the central bank would engineer a slowdown by raising interest rates. However, its approach has been more along the lines of directed controls. Although the government has tried to slow the economy through higher reserve requirements and liquidity tightening in the banking system, it also has used sector-specific administrative measures intended to cool those industries I mentioned earlier—real estate, cement, and steel—while allowing the rest of the economy to continue growing strongly. This use of directed controls rather than raising interest rates—or revaluing the currency—raises questions about whether the country's progress toward a market-based financial system has slowed. [Editor's note: On October 28, as this article was in press, China did, indeed, raise one-year benchmark lending rates and deposit rates by 27 basis points.]

Third, controlling the money supply has been complicated by China's policy of maintaining its exchange rate peg at its current level of 8.3 renminbi per dollar in the face of rapidly increasing foreign investment inflows, especially over the last two years. Direct investors have expanded their



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operations in China, and portfolio investors have speculated on a currency revaluation, generating so-called “hot money” inflows. To maintain the peg, the central bank has intervened by selling domestic currency in exchange for foreign reserves; as a result, the quantity of foreign reserves has ballooned—it increased over \$100 billion in the last year—putting pressure on monetary aggregates and inflation. So far, the central bank has managed to offset much of this pressure through sterilization policies that soak up the excess liquidity associated with the money inflows. But it’s not clear that sterilization will be effective in the longer term. For one thing, China’s domestic bond markets are relatively shallow. For another, so long as the prevailing interest rate on the bonds is so low, it may be difficult to attract buyers.

At this point, it is unclear how successful China’s efforts at slowing the economy have been and whether the government will resort to two broader-focused policy options—raising interest rates or revaluing the currency. Both the central bank Governor and the Vice Governor have discussed the first option, namely, raising the base lending rate above 5.3%, the level that has prevailed since 1995. In separate statements, these officials said that the People’s Bank would consider it if inflation exceeded 5%, or if CPI growth caused a negative real lending rate. The CPI inflation figures of 5.3% for July and August breached this threshold. More recently, the Governor said that Chinese policymakers will decide whether to raise interest rates soon after reviewing the August economic reports.

Yet reluctance to raise interest rates appears to remain for several reasons. First, insofar as policymakers believe that much of the inflation is attributable to food prices and that grain prices are poised to decline, it is unclear to them whether higher interest rates are needed to reduce inflation. Second, there are concerns that higher rates would not necessarily significantly damp the excessive investment in large industrial projects, which would still be funded by state-owned banks; instead, higher rates might stifle growth in well-performing sectors and squeeze credit to smaller and medium-size private firms. Third, there is a concern that higher rates would attract even more foreign “hot money” from abroad, thus boosting money growth. Finally, higher interest rates would lower the value of the government bonds held in bank portfolios, harming their capital positions.

The second option—using a revaluation as a macro-economic tool to slow the economy by making its exports more expensive—would be consistent with the Chinese government’s apparently genuine desire to move to a more flexible exchange rate regime. And there’s plenty of speculation about whether the government will revalue. But in the near term, it seems unlikely; instead, it’s more likely to occur as part of a longer-term strategy to reform China’s exchange rate management and capital control policies. For the short-term, China has tried to ease pressure on the exchange rate recently by imposing more controls on “hot money” inflows.

Reforming China’s financial system

A very important stumbling block along the road toward market-based monetary policymaking—and a precondition for liberalizing both capital flows and the foreign exchange market—is massive reform of China’s financial system, and, in particular, its banking sector. About two years ago, China separated the supervisory functions from its central bank, creating the China Banking Regulatory Commission. The Commission has had to tread a fine line between improving bank conditions and not undermining the government’s economic growth targets or exacerbating social unrest—a tall order, since curtailing credit to a state-owned enterprise could lead to laying off thousands of workers.

The Commission is focusing on three areas: improving the condition of the “Big 4” banks, restricting loan growth, and overseeing the expansion of foreign banks in China. The first area—improving the “Big 4” banks—is also the Commission’s first priority. The banking sector’s biggest problem is asset quality—not surprising, given its historical relationship with state-owned enterprises. The official aggregate nonperforming loan ratio is now below 20%, but many analysts estimate that the true level exceeds 40%. To put the size of the problem in perspective, Standard & Poor’s estimates that the full cost of writing off these loans could be \$656 billion, or about 43% of forecasted 2004 GDP. Given the government’s ownership, this has become a huge fiscal issue. Last January, the government recapitalized two of the healthier “Big 4” banks, China Construction Bank and Bank of China, injecting \$22.5 billion into each institution and enabling them to write down bad loans; however, as I said, many have questioned the accuracy of reported asset quality improvement.

This uncertainty has led to repeated postponements in the IPOs for these two banks—the dates are now scheduled for 2006 or 2007. It's worth noting that the Chinese government appears to feel that the main purpose of these IPOs is not to raise cash, but to impose market discipline on bank management and on the government itself to improve business operations and allow the banks to run as commercial entities. Whether it will work is far from certain, given that the government will retain majority ownership.

Second, the Commission is restricting bank loan growth, which has been dramatic over the past two years, topping 20% in 2003. Doing so serves two purposes. First, it helps cool the economy through higher reserve requirements and sector-specific lending moratoriums, as I mentioned earlier. Second, it addresses the asset quality problems created by aggressive expansion and lax underwriting. The Commission is beginning to tackle the asset quality problem by enforcing more stringent loan classification and underwriting standards and by making it easier for foreign banks to buy distressed loans. Together these actions have finally slowed loan growth in the last few months.

Third, the Commission is preparing for the 2007 WTO deadline by eliminating most major financial sector trade barriers. It's widely known that many Chinese banks are ill-equipped to face the increased foreign competition that liberalization will bring. Much to its credit, the Commission is courting foreign institutions to partner with Chinese banks as a way to provide financial support and sorely needed technical expertise. A key example of this foreign investment strategy is Hong Kong Shanghai Banking Corporation's recent purchase of a \$1.7 billion stake in the Bank of Communications, China's fifth largest bank. HSBC expects to become involved in helping BOCOM upgrade its risk management, internal control, and IT systems.

Currently, foreign banks comprise only 2% of the Chinese market, but they are targeting the best customers, the emerging urban middle class that is estimated to be 110 million people, roughly the size of Japan's market. These customers can afford to pay for more innovative financial services and want the expertise of foreign banks to provide sophisticated investment products to plan for a future without the traditional "iron rice bowl" social welfare system.

Clearly, China faces several challenges in creating a vibrant and fully privatized banking sector. I've already discussed the huge nonperforming loan overhang, and I'll highlight two more. First is the simple lack of skilled personnel. People with training in risk management and loan underwriting are scarce, since it was impossible to gain such experience under the previous system. Without these skills, it is unclear whether banks can pursue new types of lending without significantly increasing credit risk. The problems in recent growth portfolios, like real estate and auto finance, cast doubt on potential success in the newest area of expansion, consumer lending. And the prospect of interest rate liberalization raises questions about bankers' ability to price loans and deposits appropriately.

A more daunting challenge is dealing with the country's political situation. Although the policy consensus at the top is strong, it won't be easy to overcome the considerable political power at the provincial level and ensure that reforms actually "stick." Moving to a market-based system means radically transforming the banks' established role in the economy and will require a shift in power and incentives. In their historical role, the banks developed very close relationships with state-owned enterprises and local governments, even closer than their relationships with their own bank headquarters. For example, hiring decisions for bank managers were typically made by the local government, not by management at the bank headquarters. These practices have led to corruption and poor corporate governance, and local governments are not likely to relinquish their power without resistance. Even if that happens, bank management may have difficulty adjusting to an incentive system in which senior positions and salaries are determined by performance, not rank or political connections.

Let me conclude by giving you my overarching impression from this trip. Even though these challenges are daunting, top Chinese officials are committed to continuing to pursue financial sector reform, and they appear on track for WTO liberalization by 2007. We can't lose sight of the fact that many of the changes the country has made were unthinkable just a few years ago. So for the time being, we have reason to be guardedly optimistic about the outlook for the banking sector.

Janet L. Yellen
President and CEO

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