People's Bank of China – neither hero, nor villain

- **PBoC probably did not plan the interbank rate spike**
- **They were not sorry to see it happen; but were surprised by the impact**
- **Debt overhang creates need for reform – and obstacle to it**

I spent most of last week in Beijing on behalf of OMFIF (www.omfif.org). During this time, I and John Plender of the *Financial Times* and also a Director of OMFIF met with official bodies – including, but not limited to, the People's Bank of China (PBoC) and the State Administration of Foreign Exchange (SAFE) – as well as with independent analysts and senior financial services executives. This was preparatory to an OMFIF report that will be published later this summer. However, the timing – coming immediately after the interbank rate spike – was fortuitous, as many of the people we spoke to were still trying to understand exactly why it had occurred and what it meant.

Broadly speaking, there are two hypotheses. One is that the PBoC orchestrated the interbank liquidity crunch as a warning shot to the banks and to the shadow banking system.[1] An alternative view is that it was caused by an unusual confluence of usual seasonal events, exacerbated by the Federal Reserve's signal some days earlier about the likely imminent tapering of its quantitative easing.[2]

Judging by the talks over the week, it seems on balance that the PBoC did not intentionally cause the interbank liquidity crunch; but also that the central bank was not unhappy that it occurred. It certainly did send a signal to the banking system – not so much to the four large state-controlled banks, whose liquidity is in any case ample – but to the second- and third-tier banks. These are more heavily involved with and exposed to the shadow banking system. They are also the ones where it is most likely that there will be a failure, if the PBoC decides that it needs to let a commercial bank go under, *pour encourager les autres*.

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[1] The Chinese shadow banking system mainly consists of companies that receive money from savers in return for short-term wealth management products (WMPs) that pay higher interest rates than the state-mandated deposit rate; and lend it out to companies. They also serve as conduits for business-to-business lending. Banks are frequently involved with the shadow banks, as part of their competition for deposits; the advantage is that the deposit liabilities of a commercial bank's shadow bank affiliate are not subject to the bank's reserve requirement ratio and can therefore be lent in full. However, apart from other consequences, this creates the impression that the banks stand behind the shadow banks; and that their liabilities are also contingent liabilities of the banking system. More on this in the forthcoming OMFIF report.

[2] Among these usual seasonal events were the need for commercial banks to briefly bring the proceeds from WMPs back on-balance sheet at the quarter end, partly to ensure that their loans/deposit ratio stays beneath the 70% legal maximum, but necessitating a need for funds to fulfil the reserve requirements ratio; company dividend and tax payments; unusually high sales of domestic bills in early June, partly connected with changes in local administration; etc.

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However, the PBoC's subsequent reactions in trying to calm markets by pointing out the existence of ample liquidity and urging banks to improve their liquidity management, also implies that the central bank was surprised by the strong impact of events. Moreover, the Bank almost certainly did not expect that the lack of liquidity would, as it did, lead to an *increase* in shadow banking activity, as banks scrambled to issue new wealth management products in order to grab as much cash as possible. Most importantly, it also seems clear that the incident drove home to the authorities that Chinese monetary policy now has an impact well beyond the country's border and that this impact needs to be taken more into consideration in the future.

The incident also highlights some of the problems facing China as the leadership attempts to transform the economy and as monetary policy is supposed to shift from a quantitative set of tools (reserve requirement ratio, money and credit targets or indicators etc) to a more interest-rate based policy-making.

A key problem is that the current system, with a deposit rate ceiling and a lending rate floor, coupled with a lack of alternatives to bank saving, has transferred wealth and capital from households to companies and local authorities and so been instrumental in encouraging corporate and local authority borrowing and excess investment. But there is now a massive overhang of debt. In theory, China has the fiscal capacity to deal with this. Local authority debt is approximately 20 trillion yuan (not all of it bad). China's foreign exchange reserves are some 18 trillion. Government debt is low. While the debt may mean that there is systemic crisis risk, ultimately, the government could therefore deal with it.

However, this also complicates the reform process. On monetary policy, dealing with a possible debt crisis and attempting to stem a credit boom, is more suited to quantitative measures than to a mainly interest-rate based policy. In terms of structural economic reform, the debt is manageable as long as the economy grows at an acceptable pace – be that 6%, 7% or 8% or another number per annum. But shifting to a greater share of household consumption in GDP means that household consumption growth must outpace GDP growth for the foreseeable future. This means that you can no longer use financial repression as a way of bailing out over-indebted local authorities and companies, since financial repression curtails household spending.

Local authorities get money from two sources – from the central government, which is trying to cut down on transfers while at the same time loading local government with more responsibilities; and from real estate sales (more correctly, selling development rights to real estate). This gives local authorities an incentive to continue to push up real estate prices at the same time as the central government is attempting to cool down the property market. Moreover, it becomes even more important for the authorities to dampen investment growth – another favourite of local government – since if this is not done, household consumption growth will not be able to outpace GDP growth, meaning the share of household consumption in the economy will not rise.

It is difficult to draw firm conclusions from all this. What can be said is that the new leadership has shown in deed as well as in word that it is committed to structural reform. The PBoC is equally committed to monetary policy reform. It has shown that it is willing to try to curtail excess lending. So far, so good. But

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there is likely to be more interest-rate turbulence; it turns out that the control of the authorities over the shadow banking system is not as absolute as they had hoped; and although the PBoC has made great play of its promise to inject any liquidity needed, it has to be assumed that, at some stage, at least some (small) financial institution is likely to be let fail and some local government will need to be bailed out by the centre. Not too long ago, this would have been of only marginal concern to the world outside China. Now, it is likely to have financial market repercussions well outside the country’s borders.

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