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Opinion | OP-ED CONTRIBUTOR

China’s New Central Banker Is Just as Important as the Fed’s

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By ESWAR PRASAD MARCH 19, 2018

The recent appointment of Jerome Powell as chairman of the Federal Reserve was the subject of intense scrutiny. After all, the Fed’s every action reverberates in international financial markets. The announcement on Monday of Yi Gang as the new governor of the People’s Bank of China, China’s central bank, received somewhat less notice.

The world should pay more attention. This choice is as important as any Fed nomination. It isn’t simply that China is the world’s second-largest economy, a crucial market for everything from American aircraft and soybeans to German cars. Its monetary and financial policies affect the whole world.

The central bank’s previous governor, Zhou Xiaochuan, engineered significant reforms. He freed up banks to set deposit and loan rates based on market conditions rather than by decree and also allowed capital to start moving more freely into and out of China. After a 15-year tenure, Mr. Zhou is turning over the keys to China’s economy to Mr. Yi, his trusted deputy, and leaving him with a great deal of unfinished business.

Unlike the Fed, China's central bank is not independent. Major policy decisions are made by an elite government committee, and China's president has to sign off on them. But President Xi Jinping came to trust the central bank under Mr. Zhou's leadership and has given it a lot of leeway in setting and carrying out policies in key areas of the economy.

The People's Bank of China sets short-term interest rates (like the Fed) and tries to control bank lending to support growth while keeping inflation low. It also determines how freely the Chinese currency's exchange rate can move and manages restrictions on the flow of money in and out of China. Last week, the government increased the central bank's oversight responsibilities, putting it in charge of drafting key banking regulations.

What Mr. Yi will do with all this power matters for the whole world.

China's mostly state-owned banking system is burdened with bad loans to state-owned enterprises, many of which are unprofitable, and the pet projects of powerful provincial leaders. Mr. Yi must push these banks to clean up their books. Otherwise, depositors might eventually lose confidence and pull out their savings. China's banks manage investments and make loans in many other countries, so turbulence in those banks could infect financial markets worldwide.

And if China's banks falter, that could set off a sharp drop in growth because China would no longer be able to rely on debt-fueled spending to keep its economy growing. If China's growth slows, Chinese consumers and companies would import less, and the government would then try to increase exports to resuscitate growth — exactly the opposite of what the United States and most other countries want. That could set back economic recovery for the rest of the world, depress international prices of commodities and other goods, and escalate trade tensions.

Mr. Yi must come up with a policy that changes the incentives for banks. As long as loans to state-owned enterprises are guaranteed by the government, banks will keep making them. Mr. Yi can't end that policy on his own, but he can tell bankers that they can recognize bad loans on their books without worrying so much about keeping their unprofitable state-sponsored clients afloat. And he can encourage

them to focus instead on lending to private firms at the higher interest rates that they are now allowed to charge.

Otherwise, China's government will not be able to shift its growth model from one driven by (often wasteful) investment in unproductive factories and ghost cities to one driven by consumer spending. This, too, matters to the world as much as to China. If China allows its banks to keep financing industries such as steel, aluminum and cement that produce more than the domestic market needs, it will have no alternative but to export its excess supply to the rest of the world.

If Mr. Yi succeeds, Chinese banks will be more willing to lend to the services sector and to smaller businesses. Service sector jobs are a crucial way for China to increase employment and household income, especially in rural areas. The resulting boost to household consumption would bring down China's trade surplus because Chinese families would have more to spend on imported goods. That would make China's trading partners happier, and if its trade surplus starts to shrink, the rationale for a trade war begins to disappear.

Whatever he does, Mr. Yi needs to be more transparent about it to the rest of the world. In August 2015, the central bank changed its exchange rate policy — allowing its currency to move more freely — but did so with no warning or explanation. As a result, this well-intentioned reform turned into an own goal. Financial markets worldwide were jolted, spurring a wave of panic-driven capital outflows from China and currency speculation. Stabilizing the exchange rate cost the Chinese government nearly $1 trillion in foreign exchange reserves and needlessly upset the world's currency markets.

The new governor's main advantage is that the rest of the Chinese leadership recognizes that, unless the financial system works better, China cannot continue posting high and stable growth. Mr. Yi should use that leverage to move forward with reforms, rather than just waiting for problems and cleaning them up. The whole world should be watching.

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