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China to Flood Economy With Cash as Global Markets Lose Faith

Step to counter effects of yuan devaluation comes as Beijing's policy-making tools are questioned

An investor watched a stock price display at a brokerage in Beijing on Friday. China's struggles this summer have spooked many investors. *PHOTO: NG HAN GUAN/ASSOCIATED PRESS*

By **LINGLING WEI** and **MARK MAGNIER**
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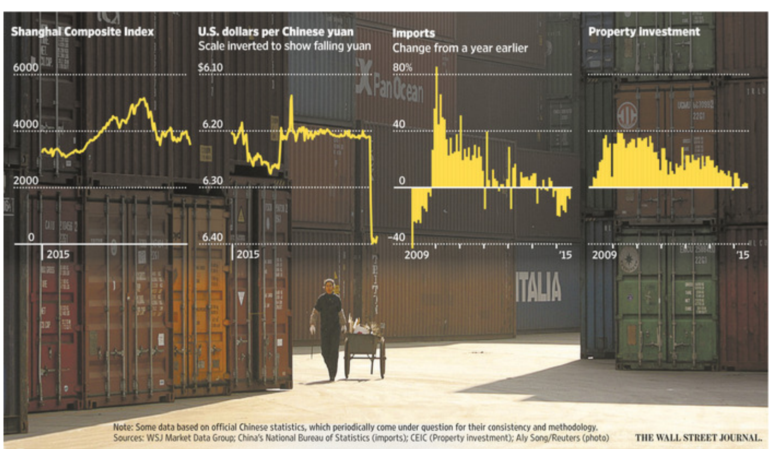
BEIJING—As global markets appear to lose faith in Chinese leaders' ability to control the world's No. 2 economy, China is looking to flood its banking system with new liquidity to offset effects of its recent surprise currency devaluation, according to Chinese officials and advisers to the central bank.

The expected move to free up more funds for lending—by reducing the deposits banks must hold in reserve—is directly aimed at countering the effects of a weaker currency, which could send more funds away from Beijing's shores. The moves reflect an economy increasingly failing to cooperate with Chinese leaders' playbook.

Beijing's struggles this summer have spooked many investors into viewing China as a threat to, rather than a rescuer of, global growth. During the financial crisis of 2008 and early 2009, China, with a colossal stimulus plan, acted as a shock absorber. Lately, it is China that is providing the shocks.

Over the past week, it has grown clear how dependent a growth-starved world is on China, which accounts for 15% of global output but has contributed up to half of global growth in recent years.

Given this dependency, one reason markets have been so unnerved is that China's economy remains something of a black box. For starters, analysts have long wondered about the accuracy of government economic statistics. And levers pulled by Chinese policy makers can be unconventional. This is seen in Beijing's desire to micromanage the yuan's value, which undercuts its ability to pursue an independent monetary policy because of spillover effects on domestic liquidity.



The cut in bank reserves, which could come as early as this week, would follow several others this year and four interest-rate cuts since November that have failed to juice growth and channel bank lending to the so-called real economy.

A key problem is that risk-averse banks continue to favor state-owned companies, eschewing private enterprises with less-traditional collateral and balance sheets. This often leaves entrepreneurs with higher growth potential to fall back on high-interest nonbank financing or go without. Meanwhile, many state-owned companies, already awash in cheap capital, are reluctant to borrow because of overcapacity in various industries.

High-tech entrepreneurs say they are having even more difficulty securing financing since the steep Chinese stock-market fall that started in June, as investors grow more cautious. Zhong Shaofeng, founder of a venture-capital firm in Shenzhen called Zhijin VC, said that instead of asking wealthy individuals to commit large sums for his latest startup investment fund, he has created a new fund that invests small amounts in specific projects. In this climate, "it's easier to ask more people for small amounts of money," he said.

The People's Bank of China's latest planned move, which could come before the end of this month or early next month, would involve a half-percentage-point reduction in banks' reserve-requirement ratio, potentially releasing 678 billion yuan ($106.2 billion) in funds for banks to make loans.

One option being considered at the PBOC is to aim the planned reserve-requirement cut only at banks that lend significantly to small and private businesses, the ones deemed key to the country's future growth. Such strategies, however, haven't proved effective in the past in channeling credit to particular borrowers.

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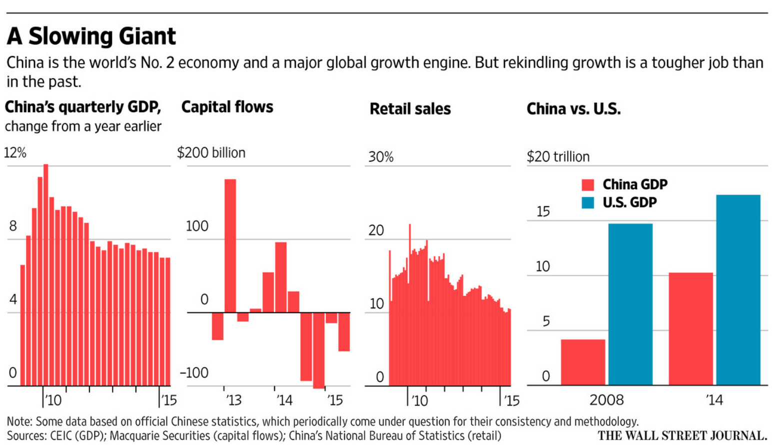
On Friday, a long stream of bleak economic news from China appeared to reach critical mass. When a private survey showed manufacturing sentiment as the worst in six years, markets around the world tanked. U.S. stocks suffered their worst one-day loss in four years, oil futures hit multiyear lows and emerging-market currencies gyrated on devaluation fears.

"Views about China's economic prospects appear to be shifting from serious concern to near panic." said Eswar Prasad, a Cornell University professor and former China head for the International Monetary Fund.

China's economy is still growing at a fast clip compared with Western nations. And China has a vast $3.7 trillion in foreign-exchange reserves to help it weather shocks.

But its current target of 7% growth this year would be China's slowest in about a quarter-century, and Beijing clearly doesn't have the same control over its economy as it has demonstrated in past years, such as during the financial crisis.

Earlier in 2015, Beijing hoped to use a rallying stock market to channel funds to indebted companies. But when stocks fell in June and July, a flurry of interventions to prop up the market just exacerbated the impression of leaders losing control.



Then, after China devalued the yuan earlier this month, surprised markets drove the yuan down more than Beijing expected, prompting the central bank to intervene again.

Also this month, the government's slow response to a chemical disaster in Tianjin added to a perception of wobbly crisis management.

"The world is starting to realize China is not nearly as competent as thought, especially in the economic sphere where everyone gave it good grades," said Fraser Howie, co-author of "Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise."

Some of the tools China has traditionally relied on to support growth are losing effectiveness as their repeated use runs up against structural inefficiencies and a larger economy. China's $10.3 trillion economy in 2014 is five times its size a decade ago.

"The room for fiscal expansion is rather limited," said a senior economic adviser to China's leadership, adding that policy is less effective as the economy gets bigger. “In the past, you would only need one yuan of investment to achieve a certain growth rate, but now it probably would require twice that amount,” the adviser said.

At just-completed summer talks at the northern seaside town of Beidaihe, China’s senior officials were divided over how to stimulate the economy, according to people familiar with the matter.

It wasn’t a disagreement over whether to accept slower growth, one of the people said. “The question is more about what to do to reach the 7% growth target for this year,” said this person, who added: “The government has a much tougher job of maintaining growth now compared to seven years ago.”

The old recipe, relying on state investment and exports, is losing effectiveness faster than expected. Exports fell 8.3% year-over-year in July, factory orders are down, and construction starts fell 16.8% over the first seven months of 2015 from a year earlier.

Even China’s car factories are feeling the squeeze, with General Motors Co. and Volkswagen AG now running their plants in China below full capacity for the first time.

New would-be drivers of the economy—high technology and entrepreneurship—aren’t filling the gap quickly enough.

In southern China, Shenzhen’s Nanshan district is buzzing with activity from hundreds of technology firms, from Internet giant Tencent Holdings Ltd. to tiny startups confident of continued growth in the Internet sector. But despite double-digit growth rates, the sector’s size isn’t enough to replace the old economy any time soon.

Chinese Internet-search company Baidu Inc., for example, has roughly the same stock-market value as CRRC Corp. —a company formed this year from the merger of China’s two largest railway-equipment makers—but has half the revenue and only one quarter the staff.

And some big-name Chinese technology companies are reporting softening markets. Electronics maker Lenovo Group Ltd. called the past quarter “perhaps the toughest market environment in recent years.”

Phone maker Xiaomi Corp., which had ridden the wave of first-time smartphone buying in China to rack up triple-digit growth in recent years, now has to look for such growth elsewhere. For the first time in six years, China's smartphone sales are declining.

The lights are dimming for some old-economy industries. In an energy sector that for decades scrambled to keep up with demand from China's factories, companies such as state-controlled power producer Huadian Power International Corp. are reporting sharply falling production as manufacturers close.

In an industrial suburb of Chengdu, Huang Mingjian's income from a laundry service he opened 17 years ago has fallen by a third as the main source of his livelihood, a nearby steel plant, is preparing to close. "I've been feeling the business pressure for months," Mr. Huang said.

As some factories close and construction projects stand idle, the flow of migrant workers to cities is starting to reverse, particularly in China's northeast, according to labor activists.

A construction worker who gave his name as Bao said he left Shenyang, the capital of Liaoning province, to return to his hometown about two months ago. "Things started to get worse from the middle of last year. Many construction projects were halted, and those that continued paid workers less," said the 34-year-old Mr. Bao. "Many of my friends have left as well."

China's government says that nationwide, employment is holding up well. Still, according to China Labour Bulletin, a Hong Kong-based watchdog, the number of worker protests and strikes more than doubled in the second quarter from a year earlier.

As various levels of government in China are struggling to repay debt, fiscal problems are especially acute in Liaoning. The province's revenue plunged 23% in the first half of this year.

Within the PBOC, doubts remain about the effectiveness of more bank-reserves cuts, according to Chinese officials and advisers to the central bank. "The central bank would have preferred not to flood the market again with liquidity, if only it had a choice," said an official close to the central bank.

Beijing's desire to control the yuan's value means that unlike the U.S. Federal Reserve and other central banks, the PBOC still lacks the ability to conduct an independent monetary policy. Buying or selling the yuan to influence its exchange rate affects domestic liquidity, causing the central bank to have to adjust its monetary policy as a result. “We call it Zhou Xiaochuan’s dilemma,” said Wang Jian, an analyst at Orient Securities, referring to the PBOC’s long-serving governor.

Beijing is even having trouble getting some people and institutions beholden to it to follow its directives.

In April, Premier Li Keqiang lashed out at inactive “local functionaries” for not investing fast enough. Last week, a commentary on the website of state broadcaster CCTV said that reforms were facing “unbelievably” fierce resistance and cited the need to “reconfigure the lifeblood of this enormous economy, making it healthier. The scale of the resistance is beyond what could have been imagined.”

On Friday, China’s banking regulator and its top planning organization called on policy banks to lend more in support of government projects, citing funding shortfalls as the main cause of slowing investment growth.

Han Zhifeng, head of the National Development and Reform Commission’s investment department, told reporters at a briefing that China Development Bank, a state policy bank, promised to issue 1.16 trillion yuan ($181.4 billion) for 11 key investment projects rolled out by the government this year, but has issued only 71.9 billion yuan so far. Another policy bank, Agricultural Development Bank of China, promised to provide 46.2 billion yuan for these projects but has issued only 2.8 billion yuan of loans, he added.

Some economists say global markets may be overreacting. They point to bright spots: Property sales in major Chinese markets are starting to recover, while high down-payment requirements reduce the systemic risk of default. And growth in retail spending has remained above 10%, with shifts to online shopping and services not fully captured in official statistics.

The transition, albeit a slow one, to a more labor-intensive service economy will help protect employment, economists say.

For many Chinese, in fact, it is business as usual.

“My job is still stable and my income is the same as it has been,” said Liu Yang, a 36-year-old engineer at an auto company in China’s northeast city of Changchun, who says he still shops, buys clothes and eats out as before.

In March, Premier Li said China still has several tools to use if the job market weakens significantly or growth slows to the lower band of the reasonable range. He didn't elaborate.

Some economists say China's best near-term option is to continue ramping up fiscal and monetary stimulus to meet growth targets. "Now they need to double down on stimulus," said ING economist Tim Condon.

—Chun Han Wong and Chuin-Wei Yap contributed to this article.

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