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China Lifts Banks' Reserve Ratio

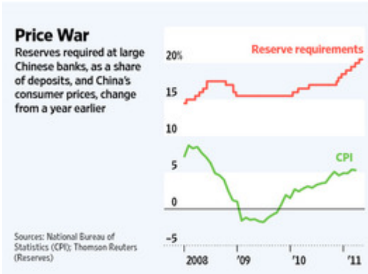
By BOB DAVIS

BEIJING—**China** moved again to head off inflation by requiring **banks** to hold more of their deposits in **reserve**, the eighth such move since November, despite little evidence that measure is taming prices and worries that it is depriving needy smaller companies of capital.

The 0.5-percentage-point increase in the **reserve** requirement **ratio** was announced Thursday, a day after **China** reported inflation hit 5.3% in April, with food prices galloping at 11.5%, the sixth straight month in which food prices have risen at double-digit rates.

Japan agrees to bail out Tepco as news develops that a nuclear reactor suffered a partial meltdown in the Fukushima plant. And in the latest effort to rein in inflation, **China** orders **banks** to raise **reserve** ratios. WSJ's Jake Lee and Peter Stein discuss.

The inflation figures were slightly lower than in March, but still represented a significant risk that the authorities haven't put a lid on inflationary pressures. And there were other worrying signs: A higher number of bank loans than expected in April, at $112 billion, and a wider-than-expected trade surplus of $11.4 billion, up from $139 million in March, meant more cash flooding into the economy, increasing the need to soak up liquidity.



Unlike most major economies, **China** uses **reserve** requirements as its first line of defense against inflation, figuring the tool will make it tougher for **banks** to lend and thus cool an overheating economy. When the move takes effect on May 18, China's largest **banks** will face a 21% **reserve** requirement, among the highest in the world. By comparison, the U.S. **reserve** requirement is 10%.

Many analysts think several more **reserve**-rate requirements are in the works, which could bring the **ratio** to as high as 23%.

But Chinese economists say that squeezing the **banks** has a variety of unintended consequences, including encouraging **banks** to skirt the requirements by lending in ways that aren't covered by the regulations—thus reducing the anti-inflationary effect of **reserve** increases. Chinese **banks** have been especially aggressive in trying to attract deposits so they can continue lending, fueling a proliferation of lightly regulated wealth-management products. That may potentially cause headaches for regulators down the road.

The requirements also tend to hit smaller **banks** much harder than larger ones and to crimp lending to small and medium-size enterprises, instead favoring huge state-owned companies. Many economists argue that **China** needs to boost smaller firms to encourage the innovation needed if **China** is to continue to continue to grow rapidly at a sustained pace.

Raising **reserve** requirements "may result in credit being rationed to more productive sectors of the economy, thereby weakening one ally—productivity growth—in the fight against inflation," said Cornell University **China** expert Eswar Prasad.

In Wenzhou, an entrepreneurial center on China's eastern coast, bank lending has sharply slowed as the **reserve** **ratio** has climbed, says Zhou Wende, chairman of a Wenzhou trade association of smaller companies. He estimates that 70% of the group's members can't get loans, and those that do pay rates of 12% to 24% annually, after adding in various charges. Those who turn to private lenders, like pawnshops or wealthy businessmen, rather than **banks**, pay rates of as much as 100% annually.

"Currently many companies are in a state of shutdown or half shutdown," Mr. Zhou said.

China is wary of raising interest rates directly—the preferred anti-inflation instrument in much of the world. Such increases work across the economy to slow activity, with less credit-worthy customers facing the toughest time, whatever the size of the companies. Currently, China's benchmark one-year lending rate is just 6.31%, about one percentage point higher than expected inflation, which is considered a relatively modest constraint to lending.

China has raised interest rates four times since October and most analysts expect only another one or two 0.25-percentage-point boosts.

Why the hesitation? Raising interest rates has a host of consequences that can damage the government, including increasing the cost to the central bank of the bonds it sells to "sterilize" the massive inflow of dollars from abroad, to prevent them from sharply increasing the value of the yuan. In that operation, the People's Bank of **China** sells yuan bonds roughly equal to the amount of dollars coming into the country.

Essentially, says Lu Feng, Director of Peking University's **China** Macroeconomic Research Center, the PBOC faces a conflict of interest. If the central bank raises interest rates, it raises its own costs, which could produce losses. Mr. Lu said one possible solution is to have the Ministry of Finance create a special account to absorb foreign-exchange losses and also issue future sterilization bonds. That would free the central bank to conduct monetary policy without worrying about the effect on its balance sheet.

But he says that is a tough sell in **China** because it would constrain government spending decisions and force Beijing to recognize that its huge buildup of foreign-exchange reserves has a big economic downside. "You'd have to accept that the previous policy of foreign-exchange accumulation is causing huge loses and needs a special rescue package," Mr. Lu says. "That may be hard to do."

Raising interest rates also could harm China's huge state-owned **banks**, says Carl Walters, a former J.P. Morgan Chase & Co. senior executive in **China** who is a co-author of the book, "Red Capitalism." He estimates that 30% of the big state lenders' assets are invested in Chinese securities that are unprofitable but haven't been marked to market. Higher interest rates could worsen the problem. "The interest rate risk is huge," said Mr. Walter.

Economists also say that Chinese leaders, many of whom were educated as engineers, are simply more comfortable tinkering with specific parts of the economy rather than giving broader sway to market forces, as represented by interest rates. Government officials, for instance, have leaned on domestic and multinational food and beverage producers to postpone increases.

Bank of America-Merrill Lynch economist Lu Ting says the latest **reserve-ratio** increase "is aimed at showing the public that they are doing something about inflation." But, he says, "The economic impact will be small, because the actual amount of monthly lending is controlled anyway by the PBOC."

—Helen Qu contributed to this article.

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