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IMF Calls for China Banking Revamp

By BOB DAVIS

BEIJING–China needs to revamp its banking system so that it relies more on market mechanisms, such as interest rates, to head off a "steady build-up of financial sector vulnerabilities," the International Monetary Fund said, in its first broad review of China's financial system.

While the IMF applauded what it called Beijing's "remarkable progress in its transition toward a more commercially-oriented and financially sound system," it said in a review publicly released on Tuesday that Beijing's financial system still depended too much on the state for direction. The state all but guarantees profits to big state-owned banks by barring them from competing for deposits and setting lending rates well above deposit rates.

The result, the IMF said, is a system that tilts heavily to state-owned firms, encourages over-investment and creates asset bubbles, especially in real estate. Citing work by other economists, the IMF said that since 2001 China invested 40% more for every $1 of GDP created than Japan and South Korea did when they were at a similar stage of development. "The cost of these distortions is rising over time, posing macro-financial risks," the IMF warned.

China's central bank on Tuesday said it found the overall report to be constructive but lodged objections to timeline and sequence of the IMF's suggested reforms.

A few points in the report "are not sufficiently comprehensive or objective," the People's Bank of China said in a statement, adding that "the time frame and suggested priorities of some proposed reform measures need to be further analyzed."

The PBOC didn't specify what specific reform suggestions it was objecting to, but it said that interest-rate and exchange-rate reform have already "made significant progress." The concrete timetable for such reforms should remain flexible based on the country's situation, it said.

In its report, the IMF listed interest-rate and exchange-rate reform as "high" priorities to be achieved in the medium term, which it defines as within three to five years.

The IMF review, called the Financial System Stability Assessment, was largely a snapshot of the Chinese financial system at the end of 2010, when work on the report concluded. It took many months for China to approve publication of the report–different from the IMF's annual review of China's economy, which was completed in June and published in July. Chinese authorities blamed the assessment's publication delay on the need to get approvals from different financial agencies reviewed.

There may have been political reasons too. The IMF, for instance, criticized China's financial-crisis management system because it reported to the State Council, the country's top government body. In effect, that meant that the state could be counted on to bail out the country's largest banks, thus reducing the banks' incentive to make prudent decisions. "This implies significant moral hazard," the IMF said, financial lingo for an institution not having to worry about the consequences of its decisions.

But the China Banking Regulatory Commission was wary of criticizing its bosses in the State Council or seeking more independence. Reporting to the council "serves as a check and balance on the CBRC and other government agencies to exercise authority in accordance with the law," the CBRC said in a response included in the IMF report.

The IMF said it conducted basic stress tests of the 17 largest commercial banks, in conjunction with the People's Bank of China and CBRC and found that they "appear to be resilient to isolated shocks," including a sharp deterioration in real-estate markets or changes in the exchange rate. "If several of these risks were to occur at the same time, however, the banking sector could be severely impacted," the IMF said, though it said its analysis of such a possibility was hindered by lack of data.

"The notion of China having a solid banking system is based on a set of indicators that clearly present only a partial picture," said Eswar Prasad, a China expert at the Brookings Institution, in an email. "That the Chinese banking system gets so few unsatisfactory (materially noncompliant) ratings conveys a sanguine picture about banking system stability that belies the reality."

Stress tests of the effect of a real estate downturn appeared to be conducted by a team from the PBOC and CBRC. A 30% decline in property prices, the regulators found, would have only a "minimal impact" on banks' capital buffer. The report estimated that banks' nonperforming loans were just 1.1% at the end of 2010.

Since the IMF conducted its review of the financial sector, some of the issues it discussed are coming to fruition. Property prices in major cities are headed downward, with some analysts forecasting that they may drop 30%. The spree of lending following the 2008 financial crisis to bolster economic growth is widely expected to boost the level of nonperforming loans, especially by local governments. Off-balance-sheet lending, which is harder to track, is growing.

To deal with such problems, the IMF recommended "deepening the commercial orientation of banks and other financial firms," and boosting China's ability to deal with crises. "A designated government entity should be vested with resolution powers" to deal with firms that are judged to be beyond saving, the IMF said.

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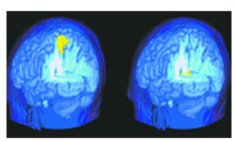
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