CHINA NEWS

China's Moment of Truth: Financial Reform or Growth?

With Economy Faring Worse Than Thought, Efforts to Reform Are Colliding With the Need to Boost Growth

By LINGLING WEI, BOB DAVIS and MARK MAGNIER

Sept. 15, 2014 5:17 p.m. ET

BEIJING—China's long push toward financial reform is bumping up against a more pressing national goal: boosting growth.

The world's second-largest economy is faring worse than previously thought, with government stimulus measures proving too short-lived to counter a real-estate downturn and flagging factory output. Over the weekend, China reported a sharp drop-off in industrial production during August to 6.9%, year-over-year, the slowest pace of growth since the 2008 global financial crisis.
Beijing has sought to avoid large-scale stimulus programs that would spur short-term growth at the expense of longer-term reform efforts, with banks, companies and local governments still carrying a mountain of debt from the massive lending used to bounce back from the crisis.

The government tried a limited stimulus this year, steering loans to public housing and railways. But for the first time since 1998, China may fall short of meeting its annual growth target, set at 7.5% this year. Beijing now must decide whether to employ more dramatic measures, such as cutting interest rates, or simply accept slower growth and fewer new jobs, economists say.

“There’s a bottom level they won’t tolerate,” said Julian Evans-Pritchard, an economist with Capital Economics. “But we haven’t hit it yet.”

A recent showdown illustrates how easily financial reform can lose out to the demands of political leaders struggling to meet GDP growth targets.

China's central bank has long pushed for reforms intended to spur competition among state-owned banks and put more money in consumers' pockets, two long-term goals embraced by top government leaders.

Toward that end, the People's Bank of China put together a plan to offer banks discounted loans, along with the freedom to decide how to lend the money. The idea was to encourage banks to make more loans to commercial enterprises instead of relying on low-risk government-directed projects. The program also would give banks a financial cushion when China lifts the interest-rate cap on bank deposits in the next two years, another reform goal.

But the program's debut loan instead followed a familiar script, The Wall Street Journal found, sending 1 trillion yuan, about $162 billion, to the China Development Bank: The politically connected institution had lobbied top government leaders to lower its funding costs for slum clearance, Chinese officials and economists with knowledge of the matter said. China's State Council, the government's top decision-making body, directed the central bank to make the loan—at 4.5%, far lower than current rates—to stimulate the economy, the officials said.

Unlike the U.S. Federal Reserve, China's central bank, known informally as yang ma or "Big Mama," doesn't operate independently and for decades directed banks to make politically approved loans.

Media officials at China's central bank and the China Development Bank didn't respond to requests for comment.
With economic growth stalled, China's leaders have made clear the central bank's priority is stimulating the economy—even at the risk of delaying or reversing efforts at financial reform.

"The PBOC is making a heroic but schizophrenic effort to maintain momentum on financial market reforms while alleviating political pressure to support growth by using targeted interventions," said Cornell University economist Eswar Prasad, who tracked China's economy for the International Monetary Fund.

The new lending facility—called Pledged Supplemental Lending—allows banks to bid for central bank loans of a year or longer. Interest rates for the loans are intended to eventually serve as a medium-term benchmark rate, according to Zhang Xiaohui, head of the central bank's monetary policy department, during remarks to economists in May.

China's central bank hasn't publicly confirmed the new bank lending program, but government and banking officials described it to the Journal. The central bank hopes that by keeping quiet about the lending facility it can revamp the program when pressure from leaders ease, officials said, and turn it into an instrument of financial liberalization.

The central bank also feared that word of the trillion-yuan loan—made in April—would signal to the market that it backs a broad stimulus plan to pick up the sagging Chinese economy, which could trigger further investment in Chinese real estate, despite a glut of unfinished apartments.

The new lending facility dovetails with the central bank's goal of removing government limits on bank deposit rates. China's central banker, Zhou Xiaochuan, has pledged to liberalize deposit rates by the spring of 2016—seen as a crucial reform. The move would push banks to compete for customers by offering the best terms.

Bank-deposit rates are now capped at 3.3%, providing a cheap source of bank funds. Higher rates would likely force banks to better analyze risks and, economists say, make banks more likely to lend to private borrowers—who would pay higher rates—than to state-owned firms that have been their mainstay customers. Economists say the shift could hurt short-term growth.

Chinese banks that oppose the reforms worry about shrinking profit margins, according to Chinese and Western officials, including Nicholas Lardy, a China scholar at the Peterson Institute for International Economics. "Those benefiting from [economic] distortions lobby against change," he said.

Ms. Zhang, of the central bank, mapped out a plan at the May session to stick to the goal of gradually relaxing rates on deposits. The new lending program, she said, was central to the plan, according to a transcript of her remarks viewed by the Journal.

"The central bank's ability to influence market rates...may be the most crucial success-or-failure factor for interest-rate liberalization," she said, according to a transcript of her remarks viewed by the Journal.

Since Communist Party leader Xi Jinping took office in 2012, the central bank has seen its influence on monetary policy grow. Mr. Xi returned for a third term the central bank's governor, Mr. Zhou—a longtime reform advocate—even though Mr. Zhou had reached the bank's retirement age of 65.
So far, Mr. Zhou has fended off calls to cut interest rates and broadly stimulate the economy, fearing such moves would add to China's debt load. But his ability to fight off such demands may diminish over the coming months as the leaders worry more about spurring growth.

The influence of China's central bank still has sharp limits. At the moment, its orders are to help prop up the economy. UBS China economist Tao Wang said, "That was the command."

The economy slowed sharply after a decent second quarter as China's heady, high-growth era, which lasted 30 years, gives way to diminished expectations.

"No one expects GDP of 10% growth anymore, but there is also much uncertainty about how the transition away from the investment-led model will play out," said research firm Gavekal Dragonomics in a note.

In recent weeks, the economic horizon has darkened. The property market, which has struggled all year with a glut in residential construction, contracted further. The August data suggest that the effect of China's real-estate slump is starting to spread. Economists estimate about a quarter of the economy is tied to real estate, adding in everything from building materials to appliances. Conditions weakened in August for such related industries as steel, glass, cement, furniture and washing machines, according to the statistics bureau.

Any more bad news will test the government's pledge not to open wide the stimulus taps. "We believe the priority of the policy makers now is to prevent the property market from evolving into an economywide crisis," said Mizuho economist Shen Jianguang. "We're reaching a moment of truth."

At a dingy, cluttered courtyard in southern Beijing, 40-year-old Sun Suqiong said business was the worst he had seen in a decade selling doors, windows, railings and pipes. Sitting at his shop with four napping employees and no customers, he echoed investors world-wide: "I'm not sure about the future."

—Liyan Qi, Richard Silk and Daniel Inman contributed to this article.