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When soaking up liquidity takes more than a mop BUSINESS ASIA by Bloomberg

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The receding tide of global liquidity has left many emerging markets high and dry in the past month, but not China. The challenge facing the People's Bank of China is the opposite. It has to prevent its monetary policy from being swept away by a deluge of surplus cash, which has created a property bubble and is fanning credit growth that's too rapid and risky.

The monetary authority's strategy will be what the deputy governor of the People's Bank, Wu Xiaoling, has evocatively described as "removing the firewood from under the cauldron."

If only it were that simple.

Take, for example, the recently announced 50 basis-point increase in the reserve requirement, or the amount of cash that lenders have to keep with the central bank, to 8 percent of deposits. This increase, which will come into force July 5, has been anticipated by the market for at least a couple of months, giving banks ample time to build excess reserves.

In fact, it is precisely because of this reason that central banks around the world have largely given up using cash reserves for active monetary management and moved on to targeting short-term interest rates.

"The new policy," as a Credit Suisse economist, Dong Tao, puts it, "merely moves part of excessive reserves into required reserves." People's Bank of China holds 2.3 trillion yuan, or $290 billion, of required and excess reserves, of which only 150 billion yuan will be frozen by the central bank's action.

The effectiveness of tweaking reserve requirements is further blunted in China by the fact that it doesn't hurt Chinese banks as much as it should to set aside excess money. And that's because they receive interest income from the central bank even on their extra reserves.

The interest rate on excess reserves was first reduced in December 2003 to 1.62 percent per annum from 1.89 percent. It was cut again last year to 0.99 percent. With the inter-bank overnight rate this year averaging about 1.52 percent, a lender that maintains excess reserves is not bearing too high an opportunity cost on "idle" money.

"The People's Bank of China ought to discontinue the payment of interest on excess reserves," the economists Marvin Goodfriend at Carnegie Mellon University and **Eswar Prasad** at the International Monetary Fund wrote in an April paper.

"Experience has shown that discontinuing interest on excess reserves in order to raise the opportunity cost would lower the elasticity of excess reserve demand and greatly reduce its volatility."

The other weapon in its arsenal that the Chinese central bank won't hesitate to use is "administrative measures," or giving banks firm directives to rein in credit growth.

This strategy, when it was tried in 2004, ended up as an across- the-board denial of credit to businesses, something that can't and indeed didn't go on for too long.

Besides, diktat-based monetary controls "vitiate the process of banking reform by keeping lending growth under the administrative guidance of the People's Bank of China rather than letting it be guided by market signals," said Goodfriend and Prasad.

The root of the problem with the Chinese monetary policy is well known: It is compromised by the authorities' desire to keep the exchange rate under tight control.

And while it may appear that the central bank's bond sales are quite well able to mop up the excess liquidity that's released in the banking system by its foreign-exchange purchases, the authorities are now getting "fundamentally worried" about the rising stock of the so-called "sterilization debt," says the UBS economist Jonathan Anderson in Hong Kong.

As the Chinese central bank buys dollars to keep the yuan stable at about 8-to-1 against the U.S. currency, it ties itself to a low interest-rate regime because an even bigger deluge of capital inflows into China may happen from a closing of the rate differential with the U.S. Federal Reserve.

The one-year benchmark deposit rate in China is 2.25 percent, as much as three percentage points lower than in the United States. It was last raised by 27 basis points in October 2004.

Tao, of Credit Suisse, estimates that Chinese deposit rates must rise by 200 basis points and lending rates by 300 points to reach the neutral zone. And yet, he expects the central bank will only raise the rates by a maximum of 54 basis points this summer. That may take the lending rate, which was increased by 27 basis points in April, to 6.39 percent.

The net result of all the tightening may be a big zero: Analysts almost unanimously expect the Chinese economy to expand 9.5 percent or more in 2006, not much slower than 9.9 percent last year.

Every year of "no landing" is increasing the risk of an eventual "hard landing." People's Bank of China badly needs to raise the cost of money significantly. And that necessitates a move on exchange rates, sooner rather than later.