

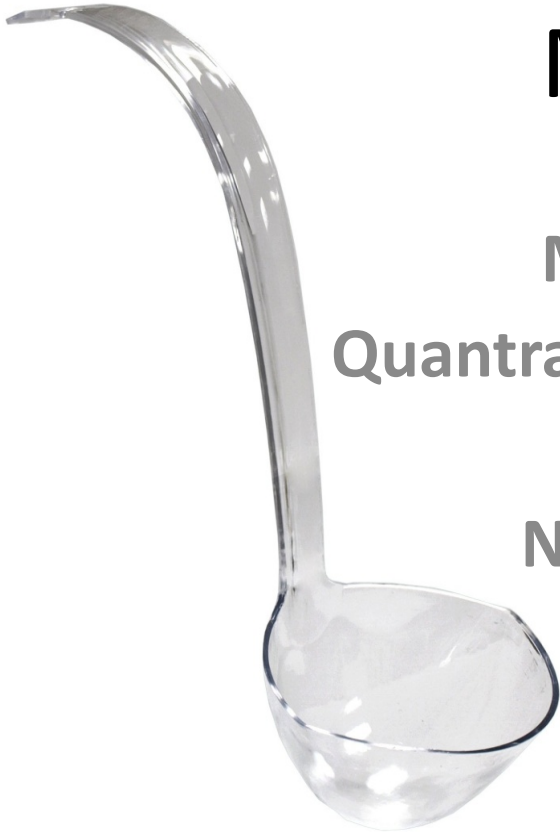
Taking Away the Ladle: China's 'Exit Strategy' for Monetary Policy

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From “rational” to “appropriate” credit growth



Changes in the People's Bank of China Monetary Policy Committee March 31 statement:

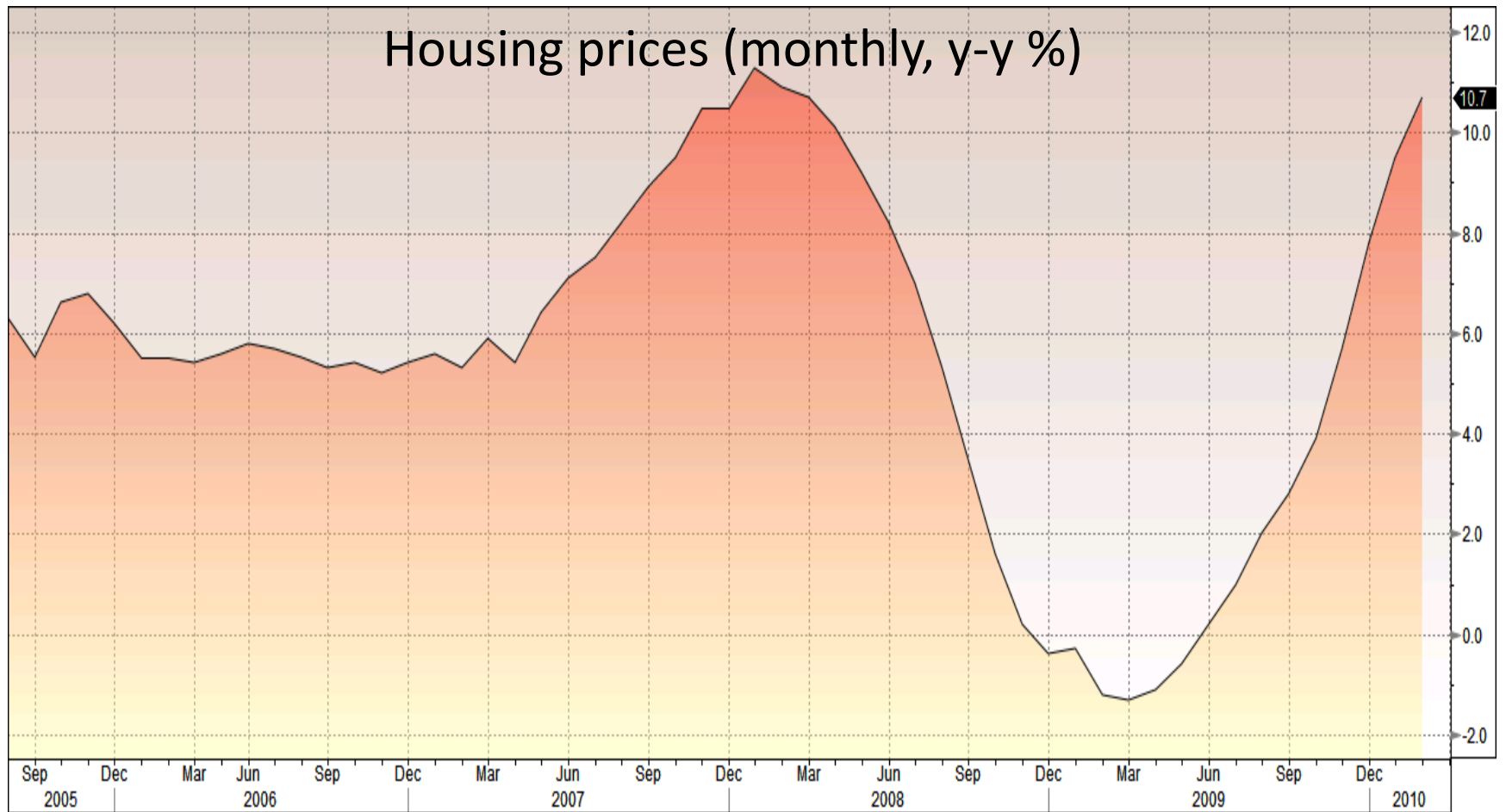
- 1.) “Guide **rational** expansion in the quantity of monetary credit” changed to “**appropriate** expansion.”
- 2.) New language on the need for banks to strengthen internal controls and not exceed this year's CNY 7.5 tr aggregate lending target.

Source: Jingji Cankao Bao, 2010

2009 credit growth was 29% of GDP; the official fiscal deficit only 2%



25% of '09 new lending may have gone into the property market



Local financing platforms have become a major source of systemic risk

Entities set up by local governments to raise money for investment projects

Primarily backed by local government land holdings

3,800 platforms have borrowed over 240% of total local government annual revenue

Many have investments in sectors with excess capacity or in redundant infrastructure projects

70% of local financing platforms are believed to be unprofitable

*Sources: Caixin Online, 2/5/10;
Century Weekly, 2010;
21st Century Business Herald, 3/3/10*

Investment platforms accounted for 40% of new lending in 2009

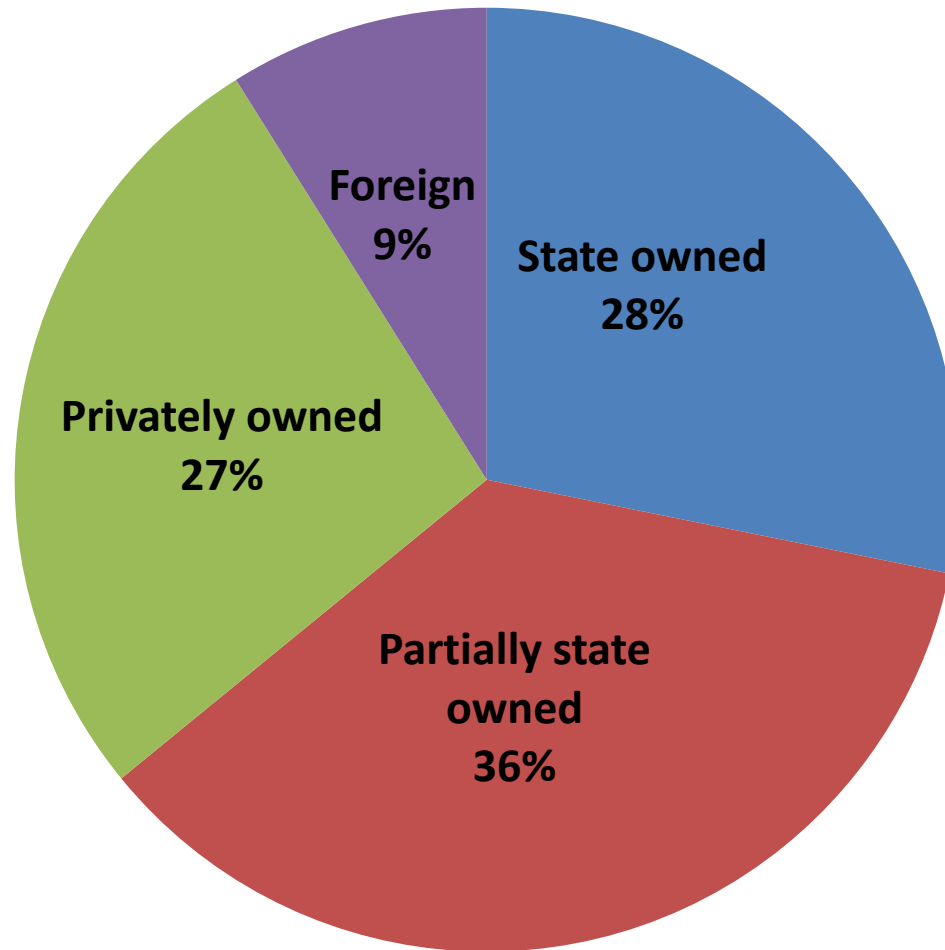
	12/2009
2009 year-end total CNY loans at all financial institutions (tr)	40.0
<i>of which investment platforms (tr)</i>	6.0
	<i>share of total</i> 15%
	<i>growth rate</i> 273%
2009 increase in total CNY loans (tr)	9.6
<i>increase in investment platform loans (tr)</i>	3.8
	<i>share of total new lending</i> 40%

Source: Meiri Jingji Xinwen, 2010

The monetary policy “toolbox”

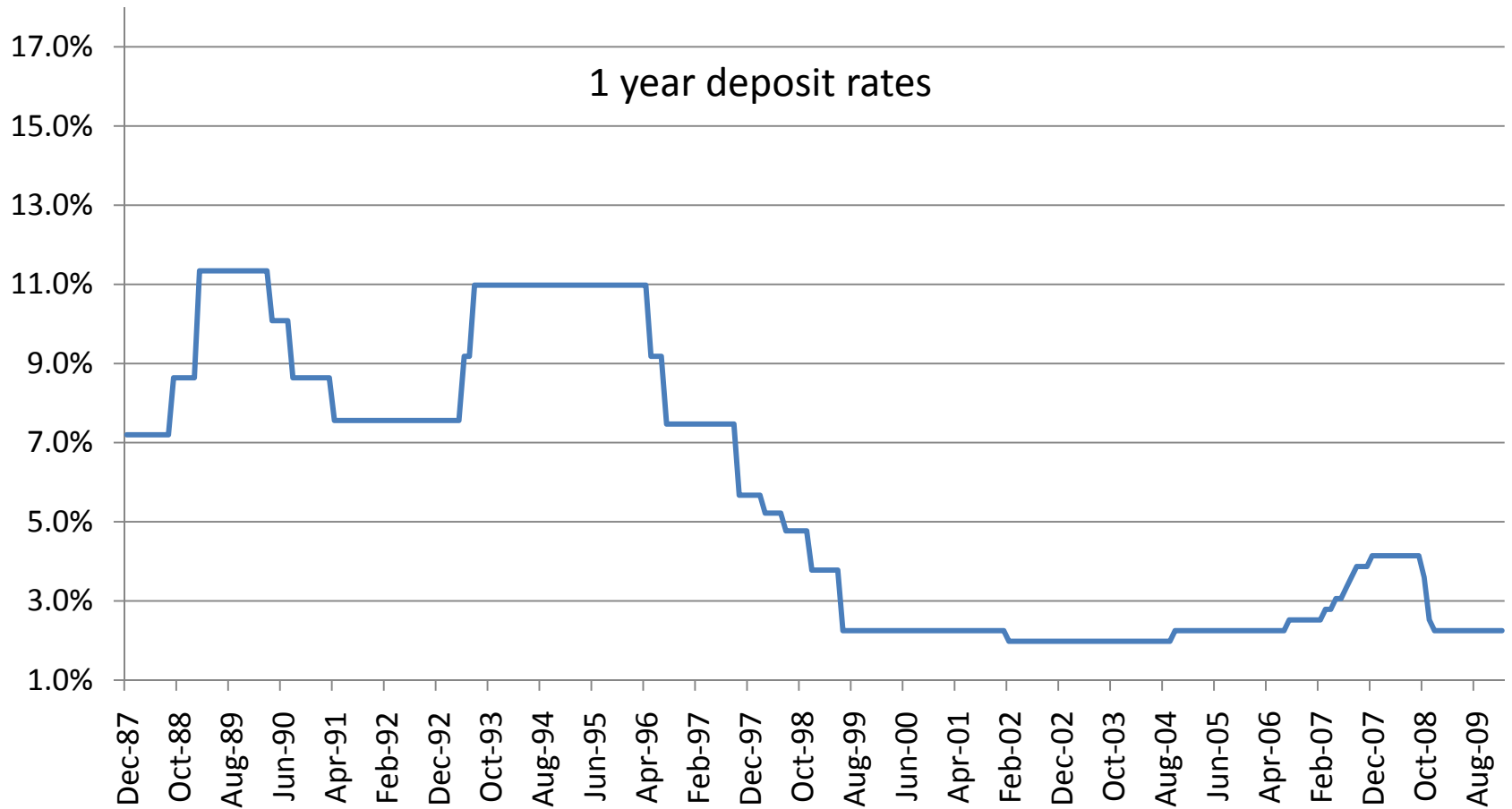
Base rates for deposits and loans	The PBoC sets maximum rates for commercial bank deposits and base rates for loans. Banks may lend at no less than 90% and no more than 170% of the base loan rate.
Required reserve rates	A percentage of deposits that commercial banks are required to hold as reserves with the central bank.
Open market operations (OMO's)	Sales of central bank paper (CBP) and repurchase agreements with commercial banks.
“Window guidance” and administrative measures	<i>Via</i> verbal directives, periodic circulars, and regulatory changes.

Soft credit constraints: 2008 fixed asset investment by ownership type



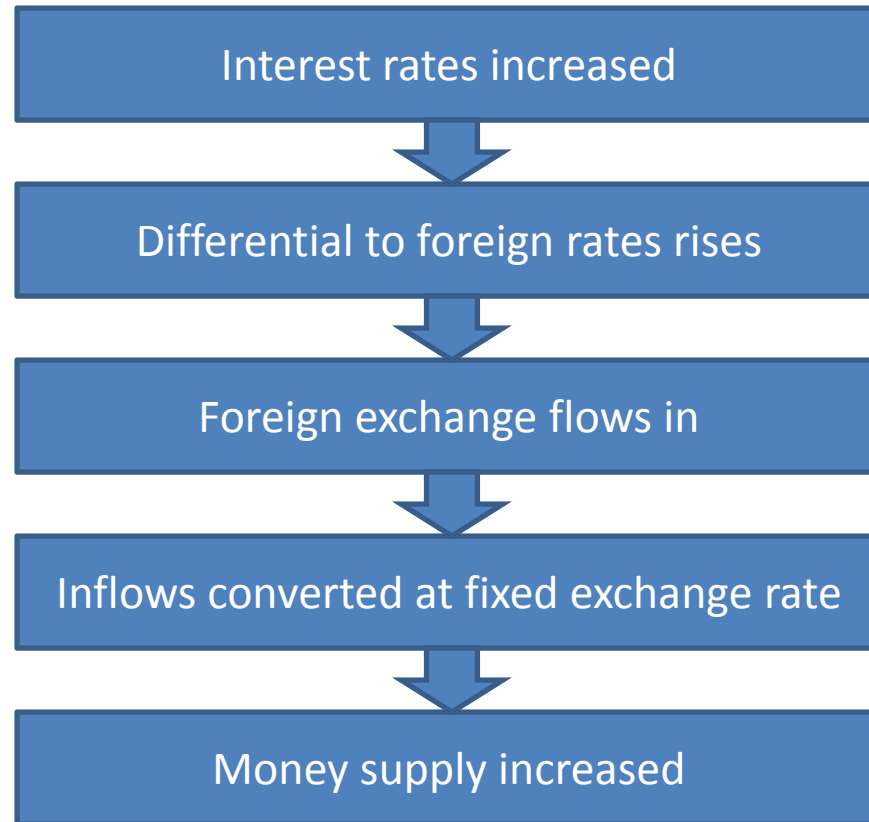
Source: China Statistical Yearbook 2009

Draconian credit controls were the real story



Source: Bloomberg

Monetary tightening with a fixed exchange rate

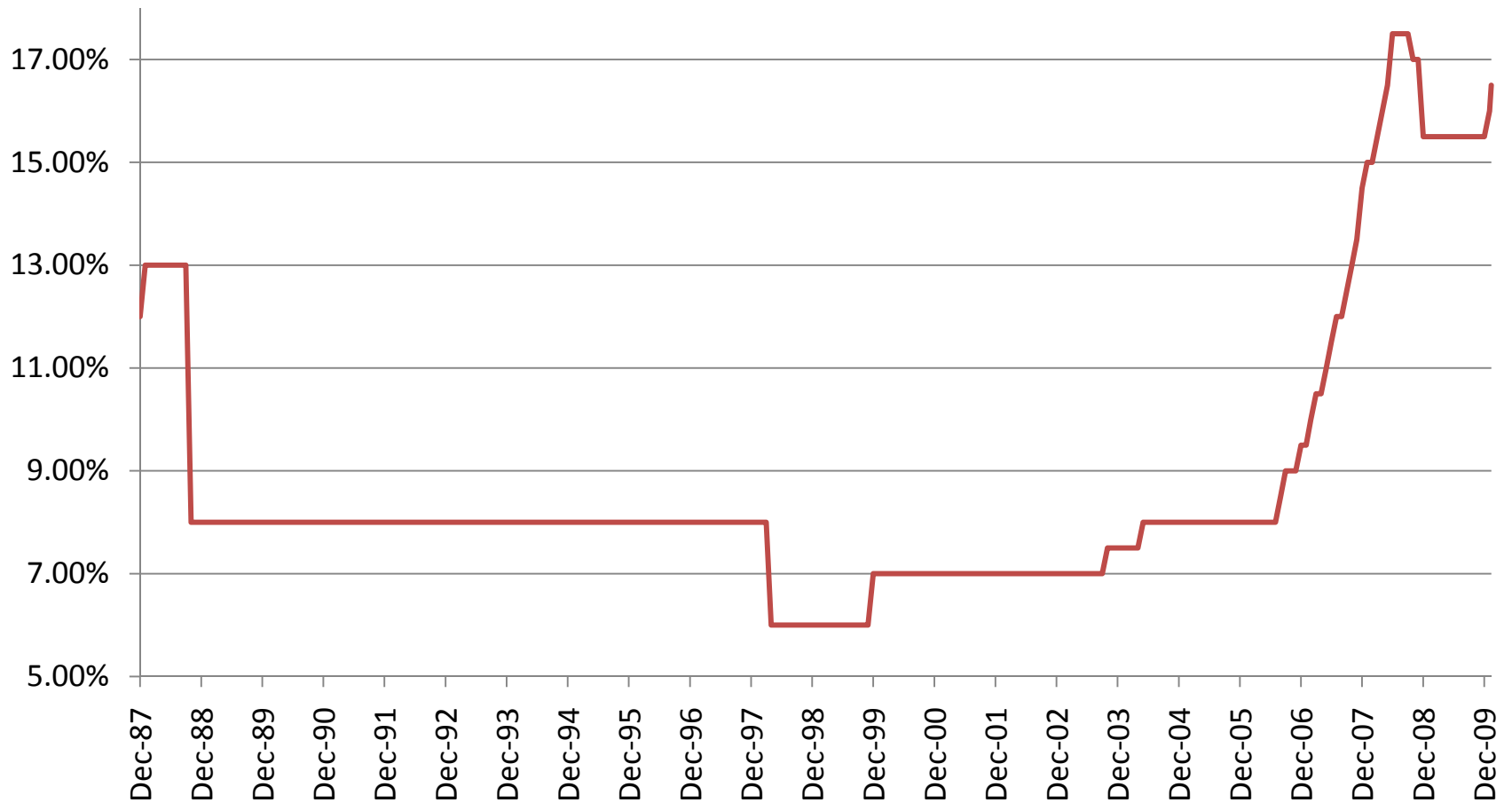


Chinese net exports of goods and services (CNY bn): 1994 - 2008



Source: Bloomberg

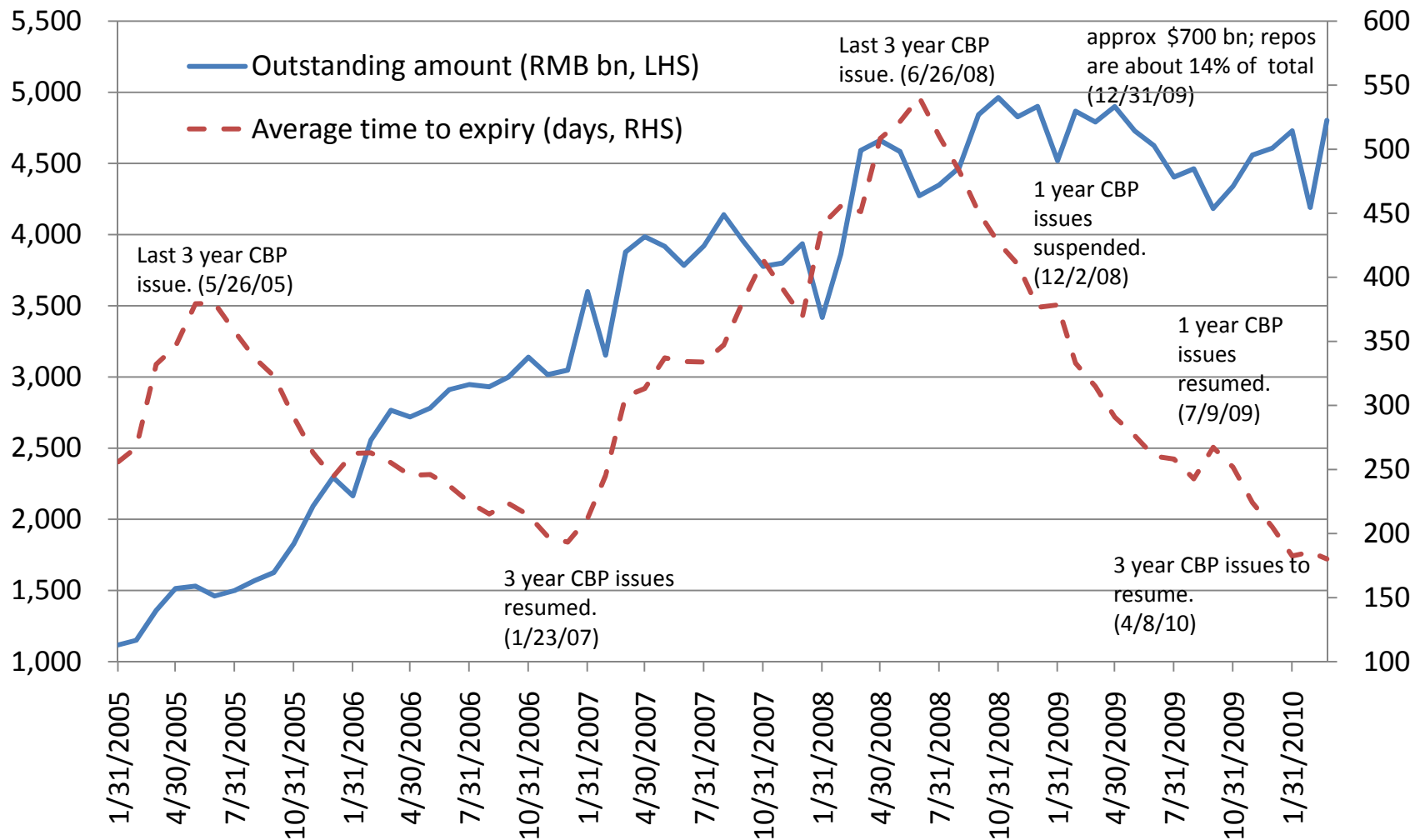
Sterilizing forex inflows with required reserve rate increases



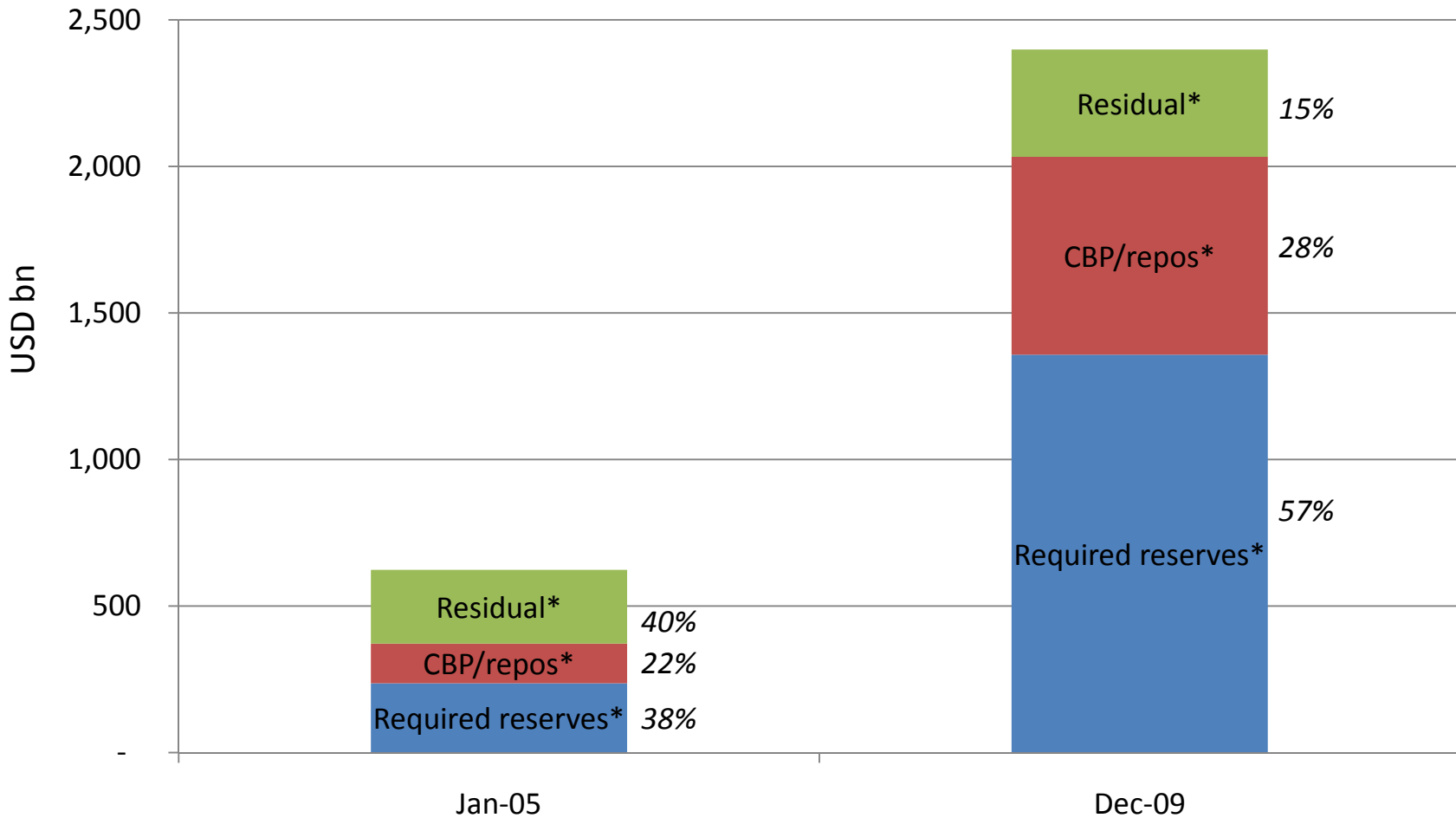
Open market operations

Central bank paper	An interest-bearing obligation of the central bank. The PBoC issues CBP with maturities of 3 months, 6 month, 1 year, and 3 years at regular weekly auctions normally held on Tuesdays and Thursdays.
Repurchase agreements	In a repurchase operation, the central bank sells government bonds to a commercial bank under an agreement to repurchase the bonds on a fixed date, thereby temporarily reducing the money supply by the amount of the sale. PBoC repos are for periods of 7 days, 14 days, 28 days, and 3 months and are also done at the Tuesday and Thursday auctions.

PBoC CBP and repos outstanding



Total PBoC forex reserves and matching liabilities



**USD equivalent at current exchange rates*

Source: Bloomberg, PBoC

Main targets of administrative tightening

- 1.) Local financing platforms
Window guidance from the China Bank Regulatory Commission has led to the suspension of most new lending for financing platforms. Existing lines of credit are also being cancelled, particularly on projects that violate regulations. (*21st Century Business Herald*, 3/3/10)
- 2.) Mortgage financing
Minimum down payments in Shanghai, Chengdu, and other cities raised from 20% to 30% on primary residences and 40% on second homes. Some banks have temporarily suspending mortgage lending altogether. (*Economic Observer*, 3/7/10)
- 3.) Property development
Suspension of lending to over-leveraged projects. (*Economic Observer*, 3/7/10)
- 4.) Personal loans
Investigations into flows of personal loans into the stock market. In Shenzhen, an investigation of 900 loans totaling CNY 1.6 bn found that CNY 130 mn had been used to purchase shares. Some of the bank branches involved ordered to halt personal lending for the next six months. (*21st Century Business Herald*, 3/2/10)

Controlling credit growth

Measures on working capital, personal, and fixed asset loans and guidelines on project lending	Require due diligence on the purposes for which loans are made and careful monitoring of payments. In some cases, the bank must pay the borrower's creditors directly. (CBRC, 2/20/10)
Differential required reserve rates	50 bp higher reserve rates for banks that lent "too much" were applied in January. (<i>Caixin Online</i> , 1/25/10)
Strict enforcement of bank capital adequacy requirements	CBRC to conduct inspections and intervene in cases where banks are undercapitalized. (CBRC, 1/13/10) Required capital adequacy ratios raised from 8% to 11% for larger banks, 10% for smaller banks. (<i>China Times</i> , 3/26/10)
Strict enforcement of the Loan Guarantee Law	Local governments may be prohibited from issuing letters of comfort for their financing platforms. (Deutsche Bank, 3/9/10)
Quarterly lending targets	Quarterly lending may not exceed 30% of each bank's annual target; monthly lending may not exceed 40% of the quarterly target. (<i>Caixin Online</i> , 3/3/10)

Déjà vu all over again

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- | | |
|-------------|--|
| 1972 - 1973 | centralized economic management reintroduced, use of bank loans and enterprise working capital to finance infrastructure construction prohibited (Wang, 441) |
| 1985 - 1986 | restrictions on projects outside the state plan, minimum capital requirements for borrowing by township enterprises |
| 1993 - 1994 | mortgage lending suspended, financing for property projects withdrawn, investigations into the misappropriation of state funds |
| 2004 | reduction in new project approvals and financing curbs for sectors with excess capacity, restrictions on land supply |
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Conclusion

In China, conventional monetary policy is relatively ineffective because of soft budget constraints and the fixed exchange rate...

which means that counter-cyclical enforcement of prudential bank sector supervision must serve as a substitute for normal central bank tightening and easing cycles.

While conventional interest rate policy allows market forces to determine which projects are halted...

“taking away the ladle” with administrative measures cuts off entire classes of borrowers regardless of their individual merits.



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