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Inside China's Bank-Rate Missteps

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Struggling to reform China's monetary policy, the country's leaders blame the problems on speculation and aggressive media coverage. WSJ Reporter Lingling Wei explains the Bank of China's role in the cash crunch.

BEIJING—A rare peek into the actions of China's leaders in a month when a Chinese cash crunch spooked global investors shows a leadership falling short in its struggle to redirect China's economy and also faltering in its efforts to communicate its intentions to markets.

The People's Bank of China instigated the cash shortages that catapulted Chinese interest rates to nosebleed highs during the past two weeks because the central bank felt it had no alternative amid what it saw as out-of-control credit growth, according to an internal document reviewed by The Wall Street Journal.

But by failing to make that clear—at a time when worries about slowing Chinese demand had already scared away some foreign capital, and as signals from the U.S. Federal Reserve also were redirecting global cash flows—the Chinese central bank inadvertently contributed to a surge in global market anxiety.

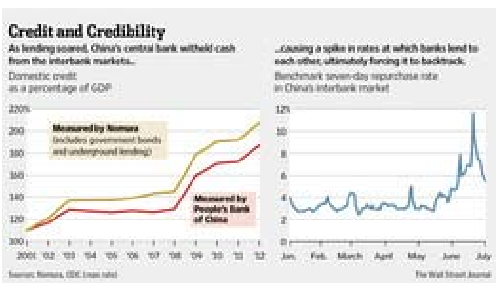
Xinhua/Zuma Press

PBOC Governor Zhou Xiaochuan said last week the central bank will use 'a variety of tools to adjust market liquidity at appropriate times.

After the chaos that ensued, including rumors that a major Chinese bank had defaulted on a payment, Chinese leaders are blaming market speculation and what the authorities view as overly aggressive media coverage for the problems. Some critics, however, say the fault lies partly with clumsy maneuvering by the central bank and the senior officials who oversee it, saying it exposed their inexperience in anticipating how markets—domestic and foreign—would interpret their actions.

"The very best of policy intentions can create turmoil in markets if the central bank lacks transparency and clear communications," says Cornell University China expert Eswar Prasad.

China is far from alone in stumbling when trying to signal changes in monetary policy. Managing expectations is tough even for the much-more-experienced U.S. Fed, whose policy makers have been trying for a week to calm markets after Fed Chairman Ben Bernanke's remarks about possibly reducing monetary stimulus helped send global markets tumbling.



But such concerns are new territory for a government and party steeped in secrecy. A look behind the scenes at the events of the past two weeks highlights leaders unsure of how to tackle the credit surge, and ultimately blaming part of the reaction to the problem they had helped create on a news leak.

A top Chinese leader, Vice Premier Ma Kai, has ordered an investigation into a market rumor of insolvency at Bank of China Ltd., one of China's top four state-owned banks, said people with direct knowledge of the probe, which could be a signal leaders are looking for clues about the sources of the market turmoil that came to a head on June 20.

Since early June, the PBOC has sought to force Chinese banks to redirect their lending away from shadow bankers—a mélange of trust companies, pawnbrokers, leasing companies and others—whose lending is putting further stress on an economy already slowing, economists say.

To achieve this, the central bank withheld cash from the interbank market, essentially twisting the arms of traditional bankers to force them to change their lending practices.

On June 20, China's leaders feared the credit squeeze was getting out of hand. Overnight interest rates at which banks borrow from each other spiked to as high as 30% that day. A rumor circulating in Shanghai that Bank of China had defaulted on an interbank payment was given more credence when a Chinese newspaper, the 21st Century Business Herald, reported the alleged default on its website around 6 p.m. According to the newspaper, Bank of China defaulted during that afternoon, "deferring transactions for half an hour due to a fund shortage."

Around 8 p.m., Bank of China issued a denial, saying it hadn't defaulted and had completed all outbound payments "in a timely fashion" that day.

The bank also said it reserved its right to pursue legal action against "the institutions and individuals who created and spread the rumor."

In Zhongnanhai, China's leadership compound, that wasn't sufficient. Vice Premier Ma, a 67-year-old veteran economic official, who oversees the central bank and is also a member of the ruling Politburo, ordered China's security agency to start an investigation, said people familiar with the decision. "The focus [of the probe] is how the rumor got started," one of the people said. It is unclear what action, if any, might result.

At the same time, the Communist Party's Central Propaganda Department ordered Chinese media not to use terms such as "cash crunch" and "inadequate liquidity" in their coverage, according to several Chinese media officials.

Spokespeople at the Public Security Ministry, the State Council, Bank of China and the 21st Century Business Herald, and the Propaganda Department didn't respond to repeated requests for comment.

Since 2009, Chinese domestic debt has been growing so rapidly it approximates credit bubbles in the U.S., Europe, Japan and Korea that precipitated recessions. In the spring of 2013, the central bank and banking regulators tightened regulations but to little avail. For the first five months of 2013, domestic credit, called total social financing in China, rose 52% from 2012.

According to a previously undisclosed summary of a PBOC internal meeting on June 19, the central bank was especially concerned that in the first 10 days of June, Chinese banks increased lending by 1 trillion yuan ($163 billion)—an amount the central bank said "had never been seen in history." About 70% of that amount consisted of short-term notes that mostly don't show up on banks' balance sheets—making it easier for the banks to get around regulatory lending restrictions—rather than lending the money to promising companies or projects.

The PBOC interpreted banks' actions to mean that "some banks thought the government would launch stimulus policies as the economy slows, and positioned themselves in advance," according to the summary. A number of banks including, Postal Savings Bank of China, China Citic Bank Co., China Minsheng Bank Corp. and Ping An Bank Co. were singled out for criticism.

The banks declined to comment, as did an official at the PBOC's press department.

The meeting was chaired by Zhang Xiaohui, head of the PBOC's monetary-policy department, who indicated that banks shouldn't count on the PBOC for cash any time they ran into trouble and that the central bank wouldn't ease monetary policy despite slower growth. "There won't be any easing, nor tightening," Ms. Zhang said.

Later that day, the PBOC's decision was ratified by the State Council, the government's top body. After that session, the State Council said in a statement it would keep money supply at a "reasonable" level, but that it wanted more of the banks' cash to be lent to favored borrowers including "strategic emerging industries." The message from the State Council meeting was significant, in part, because it didn't say the government's goal was to steady markets. "That was a sign the government will stick to the adjustments it was making" and not cave in to expectation for stimulus, said Lu Feng, deputy director of Peking University's National School of Development, a prominent think tank.

Concerned that the banks wouldn't get the message, the PBOC called some of them in, while deciding to give them more funds. The central bank's message was: "Now here are more funds, but use it wisely," according to one of the banking executives with knowledge of the conversation.

By then, the PBOC was widely being criticized for letting its campaign get out of hand and it moved to ease fears that the credit squeeze would continue unabated. For three days in a row early last week, the central bank said the overall liquidity in China's financial system remains ample and that it had injected funds into some financial institutions and would continue to do so when needed.

Still, the central bank's actions took days and didn't quickly calm investors. Chinese stocks posted their worst one-day loss in nearly four years on June 24, contributing to a broad regional decline in equities and commodity markets.

At the State Council's next session on June 26, it issued a statement including the words that were missing a week earlier, saying the authorities must "stabilize" market expectations.

The actions by the central bank and State Council have helped lower benchmark borrowing costs in China's interbank market, with the seven-day repurchase agreement rate dropping to 5.45% on Monday from 11.62% at the close on June 20. Still, the rate remains far above its 3%-4% range prior to June, and analysts expect it to remain higher as a continuing warning to banks to revamp their lending practices.

"On one hand, we'll guide financial institutions to keep reasonable credit growth," PBOC Governor Zhou Xiaochuan said at a financial forum in Shanghai last week. "On the other hand, we'll also give a full play to a variety of tools to adjust market liquidity at appropriate times to keep markets generally stable."

Whether Beijing will stick to that plan, analysts say, may depend on how the Chinese economy fares. In the first quarter of 2013, China grew at 7.7%, year over year, one of its weakest performances since the global financial crisis, and a number of analysts now forecast that China may miss its full-year growth target of 7.5% after 15 consecutive years of exceeding the annual target.

Barclays recently has been especially wary. "Based on an increasingly likely downside scenario," GDP growth in China could drop to 3% or less within the next three years, Barclay's said, though the Chinese economy would bounce back "dramatically" from any such "hard landing" because it would approve economic reforms.

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