Business/Financial Desk; SECTA
China's Bank, In Transition, Raises Rates

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29 October 2004
The New York Times

HONG KONG, Oct. 28 -- China's central bank raised official borrowing costs for the first time in nine years Thursday night, a step aimed at slowing breakneck economic growth and inflation but one that could risk social unrest if heavily indebted state companies respond by laying off more workers.

Beijing also removed the ceiling on what banks could charge for loans, a measure that paradoxically could make more loans available to risky private enterprises and ultimately enhance China's long-term growth prospects and give its economy much greater stability.

The two moves shift China further toward a Western-style financial system in which markets determine the allocation of credit, not government officials.

The interest rate increase, a little more than a quarter of a percentage point, is not big enough by itself to change the direction of the Chinese economy. But it is widely expected by economists to be the first in a series of increases that could lift rates by as much as two percentage points in the coming year, which could seriously curtail economic growth.

That would damp demand for products offered by the United States and other countries rushing to take advantage of the Chinese market. But the effect on American consumers is likely to be quite small, as Chinese companies are expected to take the steps needed to keep prices low and maintain their exports.

For Beijing, the interest rate increase is a historic embrace of free-market tools of economic management despite possible internal political repercussions, said Tao Dong, the China economist at Credit Suisse First Boston's office here.

"This probably will anger a lot of people, but I give the government high marks," he said. Indebted property developers and laid-off workers are likely to be among the angriest.

By seeking to control inflation with higher interest rates, Beijing may limit some profit opportunities for a long list of companies and countries involved in the roaring Chinese market -- from luxury automakers in Europe, to iron ore producers in Brazil and Australia, to oil exporters in the Middle East.

Higher interest rates could also cause some hiccups for American companies with large beachheads in China, like General Motors. Indeed, prices of oil, copper, cotton and other commodities declined Thursday, underscoring concerns among investors that demand is easing in China for many raw goods used in manufacturing, everything from clothes to washing machines.

After concluding last spring that the economy was expanding at an unsustainable pace and fueling inflation, Chinese leaders initially chose mostly administrative methods to try to limit excessive growth, like the denial of approvals for construction projects.

But these methods have failed to rein in rising prices. Consumer goods, on average, cost 5.2 percent more last month than a year earlier despite price controls on many products. Price increases are running at nearly twice that pace for goods traded between companies, which are subject to fewer price controls.

In making its move, the Peoples Bank of China, the central bank, raised the benchmark rates that the state-owned banking system offers for one-year loans and one-year deposits by a little more than a quarter of a percentage point: 27-hundredths of a percentage point, to be exact. The lending rate rose to 5.58 percent and the deposit rate climbed to 2.25 percent.

The Peoples Bank also ended years of regulations tightly limiting the maximum interest rates that banks could charge on loans. The limits, which the Peoples Bank started to loosen last December, had discouraged the country's banks, almost all state-owned, from taking the risk of lending to small and medium-size private companies. Similar businesses in other countries can attract loans by agreeing to pay higher rates of interest.

Most state-owned enterprises already have the political connections to borrow at no more than the benchmark rate, and sometimes pay an even lower rate. Raising the benchmark rate will hit them especially hard at a time when many of them are struggling to repay previous loans and avoid laying off workers.

In the United States, John W. Snow, the Treasury secretary, praised the Chinese moves. "It indicates to me they're moving more and more in the direction of more sophisticated market-based management of their economy, and I think that's a good thing," Mr. Snow said during a trip to Wilkes-Barre, Pa.

But some analysts said they feared that the raise in rates was calculated to mute international demands that China revalue its currency. Washington has been pressing China to raise the value of its currency, which is pegged to the dollar, as a way to help reduce the United States' trade deficit with China and make American exports more competitive.

"China's decision to raise interest rates by for the first time in nine years only delays a revaluation of its currency instead of making it more probable," said Ashraf Laidi, the chief currency analyst at MG Financial Group in New York.

The Peoples Bank said in a statement that its moves were partly aimed at keeping money in the banking system. Economists at the International Monetary Fund and elsewhere have watched with concern in recent months the slowing growth of deposits at Chinese banks.

Affluent urban Chinese families in particular are turning away from depositing money in banks at the extremely low interest rates offered, choosing instead to lend money directly to struggling businesses at double-digit interest rates.

Steeply rising prices and low, government-mandated interest rates have prompted companies across China to borrow heavily over the last two years, feeding an extraordinary economic boom. The borrowers have erected forests of apartment buildings and many new factories, expecting that prices will go up fast enough to ease the cost of repaying the loans.

"On the borrowing side, if the interest rate is 5.3 percent, then take as much as you can get, because the real rate is minus 4 percent," said Nicholas Lardy, a Chinese banking expert at the Institute for International Economics in Washington, in a telephone interview a few hours before the official announcement.

Many of the most fashionable boulevards in China's urban centers are lined with new luxury apartment buildings with long rows of empty windows, because few buyers can afford them. Yet new apartment buildings continue to be built nearby, construction often proceeding around the clock, as is common in China.

Chinese leaders have expressed growing concern in recent months that many bank-financed projects cannot support themselves and will result in another wave of nonperforming loans at state banks.

Economic data released last Friday showed that the tempo of economic growth in China barely slowed in the third quarter despite these measures, and suggested that the Chinese economy may have started to accelerate again in September as the effects of the initial controls began to wear off.

The frenzy has driven up prices of a wide range of commodities, from iron ore for the steel in building girders to copper for household plumbing, enriching many countries that export them.

By raising the interest rate now but leaving the exchange rate unchanged, Beijing runs the risk that speculators will pour even more money into China **--** possibly stoking inflation further **--** in the hope that Beijing will eventually have to allow the currency to appreciate.

Partly for that reason, the International Monetary Fund considers greater flexibility in the exchange rate a more urgent issue for China than an interest rate increase, **Eswar Prasad**, the I.M.F.'s China division director, said on Monday.

If China were to follow the I.M.F.'s recommendation, by either letting the yuan trade in a wider range against the dollar or fixing the yuan to more currencies than just the dollar, then the short-term effect may be appreciation of the yuan.