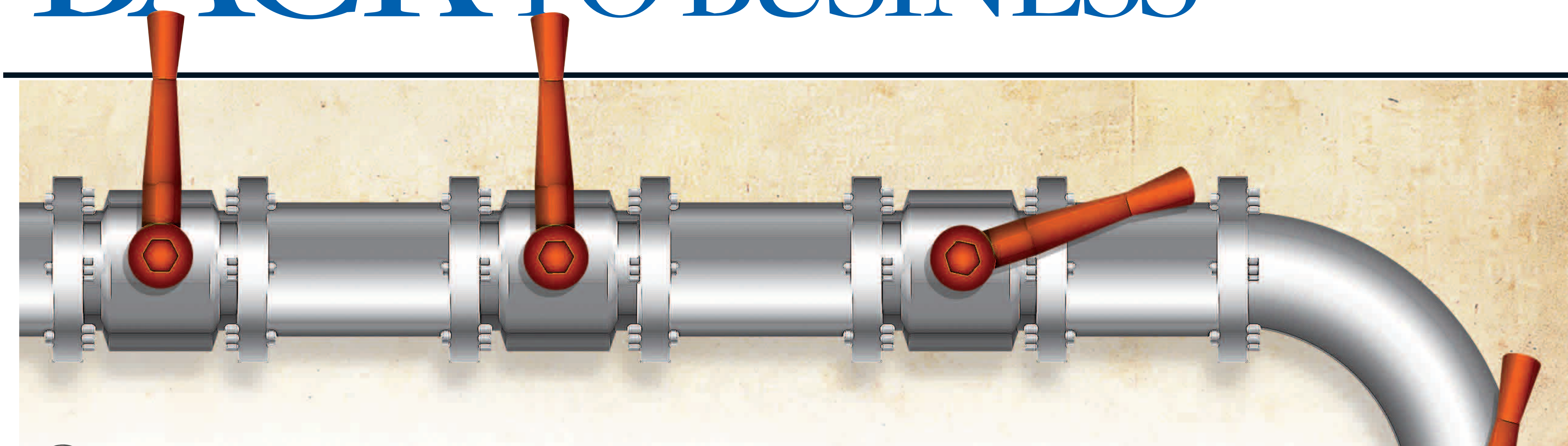
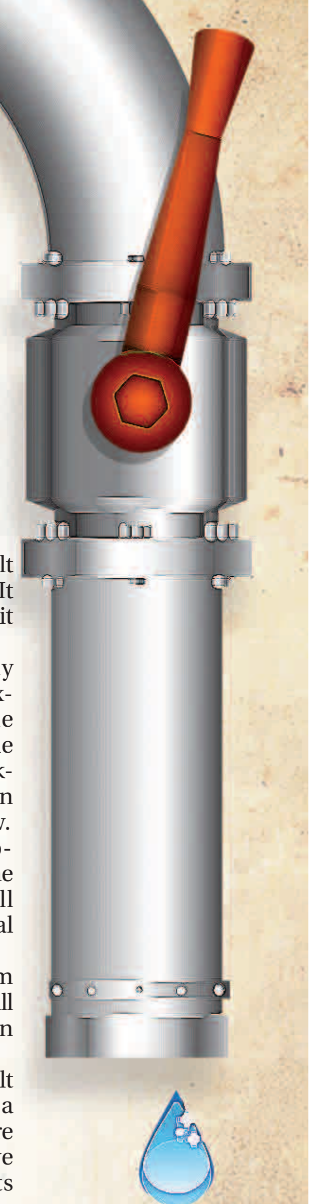
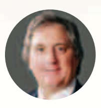
BACK TO BUSINESS







THE VIEW
RICHARD HARRIS

Pulling the right levers

Cutting rates won't help economy unless Beijing takes other steps needed to liberalise economy

Never let it be said that Chinese economic reforms proceed quickly. Last week, Beijing ended its monopoly on the salt industry, which had provided Chinese administrations with as much as half their revenues for 13 centuries.

Salt taxation has been a fiscal money-spinner, but it created discontent, smuggling and rebellion not only in China, but also in imperial Russia and colonial India. It also helped inspire the French Revolution.

Last week's more important shift, though, was communicated by the People's Bank of China – the decision to cut interest rates to help the flagging economy.

Economists in the past century discovered that interest rates could be a very good lever for economic activity, as the price of money affects every part of the economy, including that of future investment.

The PBOC pulled the lever on rates last Friday. Photo: Bloomberg

China's debt levels are now estimated by some economists to be a staggering 250 per cent of gross domestic product – so cutting the benchmark lending rate by 40 basis points to 5.6 per cent and the deposit rate by 25 basis points to 2.75 per cent surely comes at a good time.

But can such miniscule changes really make an impact on the economy?

We know that putting up interest rates can dampen runaway economic growth, but economists use the phrase "pushing on a string" to illustrate the effectiveness of lowering rates.

Low rates in the West for the past six years have not meant instant growth, nor in Japan for the past 20 years. Economies require structural reform as well.

Most governments would love to have the apparent control Beijing has on its highly regulated, post-communist economy.

In reality, there are just too many controls – and too many different people pulling them – so simply moving interest rates is not very effective.

To pull one lever means that you have to pull them all. Or they end up pulling themselves.

In other countries, a cut in interest rates would mean a fall in the currency, which would stimulate exports. The yuan, however, is not market-driven, but the decision by the authorities to pull that lever is almost as big a headache as allowing market forces to run free.

Until recently, banks had essentially operated with fixed deposit and lending rates.

Having largely fixed, excessively low lending rates stimulated the rapid development of the big – that is state-owned – economy to gear up for exports.

However, that led to overcapacity in many industries, as policymakers and planners in a command economy like to invest for the last crisis, not the next one.

Today, a bank can lend at whatever rate it likes, but deposit rates are still low, encouraging savers to chase returns in property and the unregulated shadow banking industry.

As with all rigged markets, pent-up demand and supply find other, often unsuitable, outlets.

Banks are also regulated by the loan-deposit ratio and the reserve requirement ratio.

As one would expect in a highly regulated economy, if you adjust the first ratio (or lever) to make it easier to make loans, the latter ratio changes, making it harder for banks to lend.

To relax one regulation means you have to relax others, otherwise unintended effects counteract the good work done before.

The obvious solution to this problem is to relax all the regulations and move to a full market economy before any single move does damage.

But in a country the size of China, governing takes a long time to get right. The administration inherited an economy built for the challenges of the 1990s. It doesn't have 13 centuries to put it right.

> **To pull one lever means that you have to pull them all. Or they [pull] themselves**

Adjusting the economy doesn't only include rate relaxation, but also reforms in the banking sector – including the shadow one – taxation and bankruptcy codes and in regulation like securities and corporate law.

An acceleration of the upgrading and development of the bond and equity markets will help provide long-term capital for industry.

The drive against cronyism and corruption, if continued, will encourage the market allocation of resources.

The ability to remove the salt monopoly after 1,300 years is a powerful illustration of the desire of this administration to drive economic reform, and of its power base.

At the current levels of the Shanghai stock market, share prices might well taste the constant drip, drip, drip of good news of change – and like it.

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Illustration: Henry Wong