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China’s monetary tightening will be felt around the globe

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Jung An Credit Co provides funds to small businesses both around its Shenzhen headquarters and elsewhere in China — but only when it can receive money from the Chinese banks since it itself doesn’t have deposits to recycle. In recent months, it has had to turn away as many as half its potential borrowers for lack of funds.

Meanwhile, 1,300 kilometres and a world away, in Shanghai, International Far Eastern Leasing, one of the biggest non-banks in China, has commitments from banks that amount to twice its balance sheet and has no problem helping its customers finance purchases of everything from MRI scanning machines to printing presses.

China has been veering away from the easy money policies that it embraced in the wake of the global financial crisis for months. With inflation more than 5 per cent, especially for politically sensitive foodstuffs and property, dealing with rising prices has become top priority in Beijing.

So far, the effects have been uneven as the varying circumstances of Jung An and Far Eastern suggest.

Meanwhile, parsing lending data and other indicators of monetary policy has become a global pastime. The extent to which China will embrace tightening in earnest today has consequences that resonate far beyond China itself, influencing growth and the price of commodities everywhere.

If lending growth continues at a rapid pace, it could reinforce fears of overheating, wasteful investment and a new round of non-performing loans. But if growth slows down too sharply, all over the world prices for everything from gold to pork could drop and factories and ports fall silent as orders from previously voracious customers in China fall.

Banking regulators have recently said that they won’t adopt explicit lending targets for the year. The central bank, the People’s Bank of China, has already raised interest rates twice recently and hiked the amount of money Chinese banks have to leave on deposit with it six times in 2010. But real interest rates remain negative.

Last year, the Chinese banks lent a total of about Rmb7,500bn.

In December, Fitch came out with a report that suggested credit flows in China are as high this year as last — they are just less visible. “Lending has not moderated, it has merely found other channels,” the Fitch report states. Fitch said banks were evading stricter lending quotas by securitising loans, selling them to trust companies and then going out and booking more loans.

The timing of the Fitch report is particularly sensitive since the market is already spooked by the inflation numbers and the prospect of further monetary tightening.

For the first 11 months of 2010, official new loan creation amounted to some Rmb7,460bn, according to figures from JPMorgan, confirming the Fitch report. Yet, at the same time, the real economy is showing signs of cooling, suggesting that there has been some effect of the regulators' efforts to move to at least a more neutral money policy.

For example, the favorite indicator of Morgan Stanley's China strategist Jerry Lou is airline bookings, which he says points to a drastic slowing. Others see signs that the property market and areas of heavy investment, such as steel, are cooling as well. Moreover, interbank rates have jumped.

So today China faces two challenges. It must drain excess liquidity which has fuelled unacceptably speedy rises in property prices and overinvestment in sectors such as steel.

But it must also try to change the allocation of capital. In the past, the large state-owned enterprises could always count on their bankers to channel funds to them. But today, the structure of the economy is changing. Small and medium-sized enterprises account for more than 60 per cent of economic activity. Yet in the good times when money flows generously, they still get only 30 per cent of the financing. And when times are bad, they are the first to get cut off — with the smallest being the most vulnerable. That means the modest clients of Jung An can't get money to support their small business operations, providing bottled water to small chain stores, or operating small spas or printing operations.

Chinese officials are constantly calling on the United States to act responsibly as printers of the world's reserve currency. At the same time, the world might say to China that what it does will increasingly have global consequences as well.

For years, capital in China has arguably been too cheap because of imposed limits on rates and a high savings rate. Indeed, the world has become hooked on cheap capital on both sides of the Pacific.

In recent years, China has done an impressive job in supporting growth without generating excessive inflation. And China is immeasurably stronger than in the mid-nineties when inflation was in double digits and there was far less quality to its economic growth. Back then, it hardly mattered beyond China's borders. This time, it is a different matter.

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