**Transcription: The Implementation of Central Bank Policy in China: The Roles of Commercial Bank Ownership and CEO Faction Membership**

**Tim Phillips:**

Today on VoxTalks economics Central Bank Policy in China.

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Like all Central Banks, the People's Bank of China guides the economy by giving informal guidance to Commercial Banks. Now, how much does this channel influence bank lending and what are the real world economic consequences of it? Bank reaction to recent guidance that was designed to cool off mortgage lending in China offers a fascinating insight into this question. Michel Habib of the University of Zurich is one of the authors of a discussion paper that's got a lot to teach us about how guidance works in China and maybe beyond, and he joins me now. Michel, welcome to VoxTalks Economics.

**Michel Habib:**

Hello Tim.

**Tim Phillips:**

Michel, first of all, the People's Bank of China, does it have a financial stability remit that's similar to other Central Banks that perhaps we're more familiar with?

**Michel Habib:**

It most certainly does have. I mean, how similar, I'm not entirely certain, but I am sure basically all Central Banks have to worry about financial stability.

**Tim Phillips:**

And this paper deals with real estate markets. There has been a lot of turmoil in those markets in China recently. What's gone wrong there? How big a problem is it for China's economy?

**Michel Habib:**

I mean, it's certainly a huge problem. Now, that doesn't mean that China will not be able to solve the problem, but it's certainly a huge problem because the amounts involved, as illustrated, for example, by the bankruptcy of Evergrande, the amounts involved are simply mind boggling. So what happened, of course, is that there was a huge movement of the population from the countryside to the cities in China over the last 40, 50 years. And so that means, of course, that a lot of new construction had to be done and it was done, but to some extent there was actually oversupply. Now there's simply too much construction, too many empty apartments. This is why people sometimes speak of ghost towns in China. And so the developers are unable to sell the apartments that they have finished and to finish the apartments that they have started, in many cases.

**Tim Phillips:**

Is this just a problem for China? Or if there is a crash in these property markets, does it affect other world economies as well?

**Michel Habib:**

Most certainly. I mean, China is the world's second largest economy and it's certainly not a closed economy. So you can certainly imagine that things that happen in China, especially on such a scale, potentially would have impact elsewhere. To some extent, some of these companies have actually borrowed from foreign banks, so that's going to have an impact as well. But it's also the fact that if demand decreases in China because of the collapse, then you can expect imports into China to decrease and you can expect some reallocation of resources from servicing local demand to exports. So that too will obviously have an impact on the rest of the world.

**Tim Phillips:**

Now, turning to Central Bank guidance, which is our topic today, why is it important? Well, I suppose anywhere in the world, not just in China, to look not just at the guidance that the Central Bank gives, but how the Commercial Banks interpret it.

**Michel Habib:**

Because to a large extent, the policies of the Central Bank are implemented through the policies or the conditions that are set by the Commercial Banks. So it's not enough for the Central Bank to say, well, raise mortgage interest rates. The Commercial Banks actually have to do it. And of course, if it's something that is required by regulation, then the Commercial Banks don't really have much of a choice. But in this case, what was used was something called Window Guidance, which is somewhat more informal, and therefore that leaves some degree of discretion to the banks. And not surprisingly, the banks and the CEOs of the banks have exploited the discretions that was afforded to them, within limits.

**Tim Phillips:**

Okay, well, let's have a look at what that guidance was then.

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**Tim Phillips:**

So, Michel, in this case, what was the People's Bank of China's guidance? You called it the Window Guidance in, what was it 2016, 2017?

**Michel Habib:**

Yes, it started in late 2016, and the revised stricter guidelines were issued in March 2017. And basically, the banks were told that they needed to decrease their mortgage lending because the government was worried about the incredibly fast increase in the price of housing and they wanted to moderate that. And so there was a statement that was made at a conference. I read somewhere that it was the chairman, so she who made it. The population of China and the banks were reminded that something along the lines of houses are built to be lived in, they're not built for speculation.

**Tim Phillips:**

For the interpretation of that, you have identified in this paper two different types of bank. What are they?

**Michel Habib:**

So actually, three. But you're right, I mean, it's mainly two. So the thing to remember is that in China, the government plays a very big role in the economy, especially in the financial sector. So we look at 38 very large banks, only two of which are private. So the rest are actually owned by the government. Actually, I should say, by the governments pural because one needs to bear in mind the fact that you've got many levels of government in China. So you've got the Central Government, which is extremely powerful. But you've also got Provincial Governments, which are not powerless. And you also have got Local Governments which in the case of some cities like Shanghai which in a way could be viewed as some kind of province in and of itself. But in any case, you've got three levels of governments and okay, I'll combine both Provincial and City into under the heading of Local Government. And they've got different incentives to some extent. So the Central Government owned banks will reflect to a large extent the remits, the priorities of the Central Government. Similarly, the Local Government owned banks will reflect the priority or behave according to the wishes and reflect the priority of the Local Governments.

And these are not the same, right? So the same government, obviously everyone is concerned about economic growth, but the Central Government is also much more concerned about inflation and financial stability than our Local Governments. And because of that you can expect that when there's a directive that asks different banks to cool it down in terms of mortgage lending and therefore decrease the rate of real estate development. So the economic growth that is attributable to real estate, you can expect Central Government owned banks to react differently from Local Government owned banks, which is what we found.

**Tim Phillips:**

And going deeper than this as well, which is the bit that really surprised me. You managed to identify two different types of CEO for these banks. Now what are these two types and what difference in priorities do they have?

**Michel Habib:**

So again, three, because you've got kind of neutral or nonfactional and actually there are quite a few of them, unlike the banks. But of course, to answer your question, a bank is I mean it's not a person, right? So it's a collection of person and in particular it has a CEO. And the CEOs themselves, of course, have their own priorities. Now there's very interesting work that has been done on factions within the Communist Party in China. So it turns out a lot of the CEOs are actually members of the Communist Party. And within the Communist Party you've got a number of factions, which is not surprising. You've got factions within all parties. But in any case, in the case of China, the factions that are of interest to us, are on the one hand the specialist finance faction, people who previously worked at the People's Bank of China. So the Central Bank or at the Ministry of Finance or some financial regulator. And you've got members of many generalist factions. And again, here the incentives are not the same. So members of finance faction are very concerned about financial stability, inflation and so on. Members of the generalist faction obviously cannot afford not to be concerned about these. But when it comes to a trade off between economic growth on the one hand and financial stability, inflation on the other hand, they're certainly going to put a lot less stress on inflation and financial stability than will the member of the finance faction. And so in the same way that the banks by virtue of their ownership, so Central Government owned, Local Government owned, privately owned as well, will behave differently to the revised guidelines, okay, to the Window Guidance. So will the CEOs to the extent of course that they have some discretion, I mean no one has full discretion, but to the extent that CEOs have discretion, they will exploit the discretion in line with the interest of their faction as well.

**Tim Phillips:**

But to do anything useful with this analytically, you have to be able to distinguish these two factions ex-ante. How do you do that?

**Michel Habib:**

So we simply looked at the employment record of the CEOs. So one thing to bear in mind is that in China, as in many other places, you've got a little bit of a revolving door between the government and state owned corporations. And so often the CEOs of the banks that we were looking at had prior experience in government. If it was a Minister of Finance or the People's Bank of China, then we classify them as members of the specialist finance faction. Otherwise, if they did have government experience, then we classify them as members of a generalist faction. There are many generalist factions, there are also many specialist faction like the foreign affairs faction and so on. But you will not find those people at the head of commercial banks. And so if looking at the Cert case, if the CEO has had no government experience at all then they're considered to be nonfactional CEOs.

**Tim Phillips:**

Right. You then have to attribute the influence of bank ownership and the CEO's faction in how guidance is interpreted. What method do you use to do that?

**Michel Habib:**

So we use a very well established by now method called differences in differences. We actually use triple differences. We use both double and triple differences. Essentially what we look at is the extent to which a Commercial Bank will raise its mortgage interest rate, will raise the down payment requirement following the issuance of the revised guideline. We try to relate the extent to which it does so to the ownership of the bank. So private Local Government, Central Government and the faction membership or not of the CEO. So generally specialist non factional. First, what you find is that one needs to account for both ownership and faction membership. Otherwise, we're only looking at half of the problem and some things are not entirely clear. But we find that the Central Government owned banks that are headed by CEOs who are member of the specialist financial faction, so you can see we've got coinciding incentives, respond most quickly to the guidance of the PBOC. In other words, they raise mortgage interest rate and down payment requirements the most. Conversely, Local Government owned banks that are headed by generalist CEOs do so the least. Okay? Because again, here the incentive is to try to delay the implementation of the new policy because as long as they haven't been yet fully implemented or as long as they're being implemented more weakly somewhat, then one can continue counting on economic growth driven by real estate development.

**Tim Phillips:**

It's intriguing, isn't it, to find out that what intuitively you might think would happen is there in the data for you. Can you isolate these two factors and say which one matters more? Is it the ownership or the CEO faction?

**Michel Habib:**

We try to do that by looking at the case not of coinciding incentive, as I mentioned before, where you've got, for example, a Central Government owned bank headed by a specialist CEO or a Local Government owned bank headed by a generalist CEO, but where we have kind of the cross effect. So we may have, or we do have actually a Central Government owned bank headed by a generalist CEO or a Local Government owned bank headed by a specialist CEO. There's weak evidence. What we find is that to some extent, bank ownership dominates faction membership. So in other words, if you look at a Central Government owned bank headed by a generalist CEO, well, the Central Government would like to implement the policy more thoroughly. The generalist CEO would like to do so less. What you find is that the first effect dominates. So the Central Government kind of overrules in a way or the effect of the ownership dominates that of the membership, and therefore you do have a slightly more thorough implementation of the new policy.

**Tim Phillips:**

Of course, for this to matter, then the interpretation has to have some real world effects. Did you find that this difference in interpretation, you can see it in the economic effect of the guidance?

**Michel Habib:**

Absolutely. By the way, I should say it's not just interpretation, right? I mean, it does have an impact on the extent to which they raise mortgage interest rates and down payment requirements. Yes, absolutely. So the way we do that is that we look at different cities in China and we look at the extent of the presence of the different kinds of banks. So Central Government owned banks with specialist CEOs and so on and so forth, which, by the way, are the ones that dominate. And what we find is that the greater the presence of Central Government owned banks with specialist CEOs which, remember, are the ones that raise interest rates and down payment requirements the most. The greater will be either the decline in the price of real estate or the greatest will be the slowdown in the rise of the prices of real estate. And conversely, when you look at a greater presence of Local Government owned banks with generalist CEOs, this is where the impact is least.

**Tim Phillips:**

There are many people who spend a lot of time looking at bankers and working out which places they worked in in the past. So can we extend this analysis to how guidance is implemented in other countries as well, where perhaps these patterns of ownership and CEO type are less obvious? And if so, what does this mean about how Central Banks could maybe give their guidance so that it's followed in a way that they would consider to be optimal.

**Michel Habib:**

We're certainly not the first ones to, I mean, okay, we're the first one to do exactly what we do, but the idea of looking at the impact of connections and background and so on. So, for example, in the paper we mentioned a very nice monograph by a person called Adolf who looks at a Central Bank anti-inflationary policy and he looks at for a long period of time in very many countries. And he finds, of course, that the background of the central bankers, the members of the policy board certainly has an impact on the kind of policies that are followed. So in a way, we're in the line of a well established and existing line of research. And basically the point is that you can't just order people around, right? That's basically the idea. I mean, however much one would like to do this, right, people have some discretion because decisions are not always easy to implement. It's not obvious exactly what has to be done. And so to the extent that they have some discretion, it would be naive to expect them not to exploit the discretion that they have in line with their own interest, to some extent at least. And that, I think, is something that one expects to find to a greater or lesser extent everywhere. And that, of course, is something that needs to be taken into account. I mean, if you don't take into account people's incentives, you're likely to get results that are not quite the one you were hoping to get.

**Tim Phillips:**

Michel, it's a very interesting piece of research and quite surprising as well. Thank you very much for talking about it.

**Michel Habib:**

Thank you. Thank you very much.

**Tim Phillips:**

The paper is called The Implementation of Central Bank Policy in China. The roles of commercial bank ownership and CEO faction membership. And the authors are Michel Habib, Yushi Peng, Yanjie Wang and Zexi Wang. It is discussion paper 17918 at CEPR.

**Outro:**

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