

Bring On The Credit

Too much lending is bad, right? Maybe in the West—but China has the opposite problem.

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If there is a single lesson to have emerged from the current financial crisis, it is that lending got out of control. The West needs less of it—not less compared with today's levels, of course, because right now virtually no one is lending, but less than was sloshing around over the past decade, when banks borrowed \$26 for every \$1 they owned, and the average American family owed \$121,000 on their house.

The stereotype of the gentleman banker who makes plain-vanilla loans and retires to the golf course at 3 p.m. is no longer a source of scorn but, in some quarters at least, an ideal. Yet while this new conventional wisdom makes sense for the West, it ought to be flat-out ignored in China. As New York and London learn to embrace the new ethos of thrift, China's banks need to borrow a page from the Citigroup and JPMorgan of old (while avoiding their worst excesses, of course). What this means is they need to start handing out cash, and lots of it. More loans for more people will help China navigate the current economic crisis. It might even benefit the West.

The problem with China's banks isn't their size—the Industrial and Commercial Bank of China is the world's sixth largest corporation, with a market value greater than Microsoft. It's that, despite their wealth, they don't lend enough. And what loans they do make go mostly to large companies and state-owned businesses. According to research by Morgan Stanley, just 7 percent of the loans made last December went to households.

This isn't an accident, but the fruit of a deliberate government policy, a war on lending that Beijing has waged to help keep inflation in check. To keep prices stable during China's years of torrid growth, Beijing set quotas on how many loans could be issued. Now that the global economy is cooling (some might say freezing), inflation is no longer a worry, according to Brad Setser, an economist at the Council on Foreign Relations, Beijing's policymakers ought to "unshackle the banks."

Setser and other experts think this shift is essential because the Chinese government's war on lending has had a lot of unintended consequences. For one, banks offer pretty terrible interest rates to savers, since the government bars them from relending much of their deposits (a bank's chief way of making money). As a result, though Chinese businesses were "raking in fairly significant profits while the economy was doing well," says Eswar Prasad, an economist at Cornell University, they chose not to bank them, and instead spent them quickly, sometimes on frivolous investments. "Any rate of return [on a new investment] is better than something near zero," says Prasad.

The war on lending has had an equally negative effect at the household level. Chinese families save a lot—about a quarter of their income, according to estimates. A major reason for this is the lack of a social safety net; families keep a healthy nest egg on hand to pay out-of-pocket expenses. If China had its own Citibank to issue loans and credit cards to all, some of the need for this nest egg would be reduced, because families in a tight spot would have access to credit when it was most needed. The result would be more money to spend on consumer goods,

providing a boost to the deflating economy.

Increased lending in China could also have an impact in the West. China has long kept its currency artificially depressed in order to make its exports cheaper for Western buyers. That policy also made Western goods too expensive for most Chinese to afford, however, and led to U.S. complaints of currency manipulation. If more lending in the Middle Kingdom increased consumer spending there, which has historically accounted for just a third of GDP, it would allow China's famously productive exporters to rely more heavily on the home market, and potentially allow Beijing to let its currency appreciate, boosting imports and removing a sticking point in Chinese-American relations.

Ordinary Chinese are well aware of the needs for more loans, which is why they've created a shadow banking system of their own. Underground banks can be as informal as an extended network of friends and family, or something more concrete, such as a pawnshop or an agricultural cooperative. Analysts agree that the underground banking system serves a desperately needed function. "These guys are very flexible," says Stephen Green, head of China research at Standard Chartered bank in Shanghai. One study estimates that informal lending countrywide reached \$290 billion in 2007. Yet underground banks are less efficient and can charge usurious rates of 60 percent or more, compared with a legal maximum of 26 percent at formal banks, and the court system is ill-equipped to deal with disputes.

Fortunately, there are signs that Beijing has started to take the hint. To combat the deepening slowdown, Chinese officials have taken steps to let cash flow a bit more freely by abolishing credit quotas, cutting interest rates and lowering deposit ratios. According to Morgan Stanley, Chinese banks made more than \$110 billion in new loans in December—a 14-fold increase over the previous year's level.

Still, more than half of this lending went to short-term uses like paying bills and almost none of it went to households, so the shadow banking system remains popular. And thus Beijing must come to grips with it. Legitimizing the underground banks would be one possible solution. Beijing has taken tepid steps in this direction, which, according to Green, have been greeted with little enthusiasm. Going legit means abiding by government restrictions, including caps on interest rates, which underground moneymen have resisted. They steer clear of the formal sector "because the regulation is still quite limiting," says Green.

Beijing should heed those concerns, and take the proper steps to legitimize the informal banks, regulating a practice that often amounts to loan-sharking. Persuading the large, formal banks to transmogrify into something more like Citibank—a people's bank for the People's Republic—is another option. Whatever the particulars, the general fix remains clear. The West may need to rein in its borrowing right now. But China needs all it can get.

With Lauren Hilgers in Shanghai

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