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Economic stimulus a mixed blessing for China

BEIJING

Lending helps Beijing weather global storm, but it may yet prove costly

BY TED PLAFKER

Despite U.S. government prodding and wheedling and unprecedented taxpayer-financed bailouts, American banks have stuck to anemic lending policies over the past year, seeming more concerned with replenishing their bonus pools and reserves than helping to rekindle the economy.

As is often the case, things have played out differently in China.

Like other besieged governments, Beijing responded to the financial crisis in late 2008 with a major fiscal stimulus of 4 trillion renminbi, or $586 billion, over two years. Unlike many other governments, Beijing could also order — not just ask — Chinese banks to mount a parallel stimulus offensive in the form of a huge lending drive.

Fresh lending by Chinese banks in 2009 rose to nearly 10 trillion renminbi, about double the volume of the previous year.

While this has helped China to weather the economic storm in flamboyant style so far, it may yet prove costly. Not only does the government fear the inflationary potential of its stimulus measures, but there are also risks of destabilizing asset bubbles, industrial overcapacity and waste from duplicative investment projects.

For the banks themselves, the lending splurge threatens to undo significant progress made in recent years in reducing ratios of problem loans to total lending.

A decade ago, Chinese banks staggered under a load of bad debt, reported by the Bank of China at nearly 40 percent of their total lending in 1999. In 2000, the nonperforming loan rate for the major commercial banks in China stood at 29 percent, according to official statistics and in the view of many Western analysts who questioned Chinese accounting standards, it was probably far higher. Nonperforming loans are defined as those on which repayments are more than three months in arrears.

The government vowed to bring the rate down to 15 percent by 2005, and by the end of 2007 it had dropped below 7 percent. One factor behind this reduction was the need for Chinese banks to attract investment from private and foreign sources.

This steep decline to single-digit levels would seem to tell a heroic tale of a banking system that solved its problems, but not all analysts take it at face value. Skeptics say the cleanup was largely based on sleight of hand, involving specially established asset management companies, speculative bonds and fuzzy government guarantees that together did little more than kick the problem down the road.

Even the least cynical analysts acknowledged that lower ratios partially reflected the dilution of bad loans in a vast sea of new lending, some of which would go bad but was still too recent to register as nonperforming.

Yet such doubts and qualifications notwithstanding, few deny that some degree of bad debt reduction was genuine and that overall loan quality among Chinese banks has improved from the worst of times.

Now, however, new concerns are emerging over the state of Chinese banks and their balance sheets. Zhou Xiaochuan, governor of the People's Bank of China, the country's central bank, spoke publicly of such worries in early January, and hinted at a lending slowdown.

Large credit flows, "will not only go against the objective of economic structural adjustment, but will also pose bank lending quality risks," Mr. Zhou said in a magazine interview.

As recently as November, senior Chinese bankers spoke confidently of their ability to avoid loan quality problems. Jiang Jianqing, chairman of the Industrial & Commercial Bank of China, China's largest lender, explicitly predicted that record-high lending in 2009 would not lead to any increase in the country's overall bad-debt ratio.

About the same time, the Banking Regulatory Commission reported that during the first 10 months of 2009, the nonperforming loan ratio for commercial banks had fallen by 0.76 percentage point from the end of 2008, to a mere 1.66 percent.

In his remarks this month, the central bank governor, Mr. Zhou, promised that Chinese policy makers would seek "to improve the focus and flexibility of policy" and "keep a good handle on the pace of monetary and credit growth, guiding financial institutions toward balanced release of credit and avoiding excessive turbulence."

Mr. Zhou's comments also included a mention of bank reserve ratio requirements as a policy tool, and on Jan. 12, the central bank duly announced an increase of 0.5 percentage point, to 16 percent, in the proportion of their deposits that Chinese banks must keep on reserve.

The increase was the first reserve ratio adjustment in China in about 14 months. Many analysts predict that total Chinese bank lending may pull back by about 20 percent, to no more than 8 trillion renminbi, this year.

According to Jing Ulrich, managing director of China equities in Hong Kong for JPMorgan, the first half of 2010 will experience continued but gradual policy tightening, with more emphasis on further administrative measures, rather than interest rate adjustments. In a Jan. 12 research note, Ms. Ulrich predicted a 20 percent to 30 percent cut in bank lending growth for this year, compared with 2009.

Ms. Ulrich also warned that the longstanding Chinese aim of lifting domestic consumption "has gained new urgency in the face of last year's collapse in external demand." She said that she expected the authorities to continue the consumption stimulus policies they adopted in 2009. These included encouragement for consumer finance companies, subsidies for private car owners who sell old vehicles to buy newer ones, and similar aid for large household appliances.

China, meanwhile, seems determined to keep the renminbi pegged to the dollar, despite protests from the United States and other trading partners who say that this leaves the currency artificially undervalued, giving Chinese exports an unfair advantage. While this may lead to political tension, especially as the United States heads into congressional elections this year, it should succeed in helping to expand the exports on which so many Chinese companies — and jobs — depend.

But according to Michael Pettis, a professor of finance at Guanghua School of Management at Peking University, any added stress on Chinese banks will hamper progress toward China's objective of raising domestic consumption.

It is "almost inevitable" Mr. Pettis said, that the recent credit splurge would lead to more nonperforming loans, or NPLs, and the burden of recapitalizing banks might ultimately fall on households. Because substantial stakes in many Chinese banks are now held by private and foreign investors, the government may be reluctant either to give cash directly to banks or to buy their bad loans above true value. That, he said, left the option of giving banks a de facto subsidy by setting a wide spread between the rates they pay on deposits and the rates they charge for lending.

"Households are effectively being taxed with low interest rates on their deposits," Mr Pettis said.

"If you see NPL rise, will this subsidy be increased? You can't increase the effective tax on household income and also expect them to increase consumption."

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Anger on pay clouding complex issues
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