Paulson Policy Memorandum

Financing the Next Stage of China's Development with Consumer Credit

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Introduction

China's government faces two linked economic challenges: first, how to sustain growth, and second, how to rebalance the economy with a larger role for domestic consumption. Consumer credit holds the alluring prospect of solving both problems at the same time.

China is already making rapid strides in the development of its consumer credit market. Still, the lesson from international experience is that higher consumer lending does not always drive rebalancing and sometimes poses risks to financial stability. A more diverse consumer finance system, providing greater access to credit for low- and middle-income households, would maximize the benefits for China.

This policy memorandum surveys the state of China's consumer credit markets and explains why a better system could yield opportunities, both for households and for China's overall economy. The memo makes topline policy recommendations to Chinese regulators and policymakers concerned with financial sector reform. These aim to maximize the growth potential of consumer credit while tamping down financial risks.

Growth and Rebalancing

China's economy has registered a marked slowdown (see Figure 1). In 2007, GDP growth touched a high of 14.2 percent. In 2014, it may struggle to reach the government's 7.5 percent target. That near halving of the growth rate reflects a combination of weaker global demand, diminishing returns to investment, and failure of consumption spending to pick up the slack (see Figure 2).

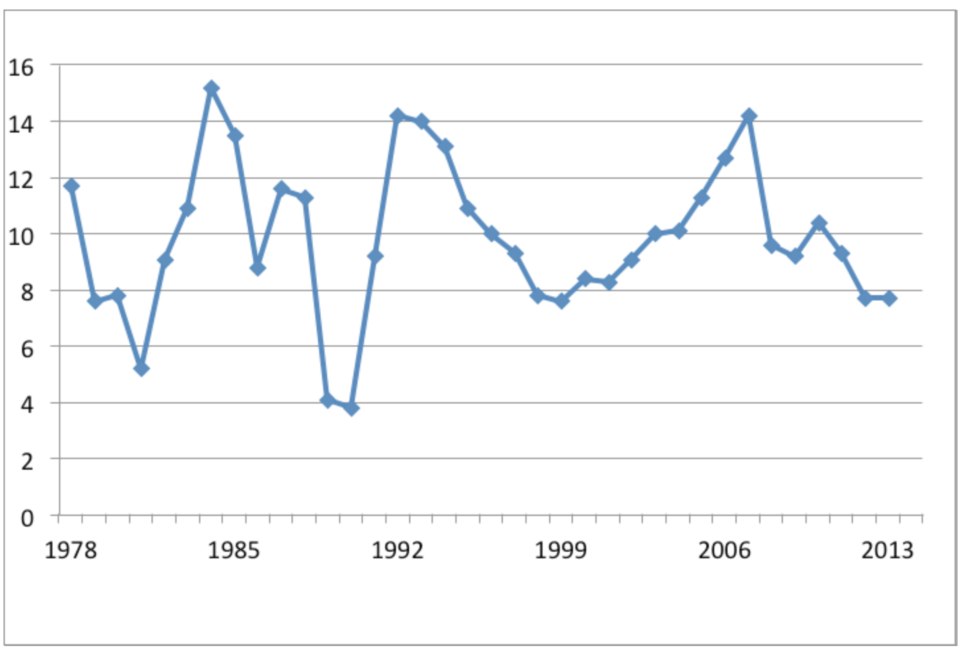
There could be worse to come. The share of investment in China's GDP is close to 50 percent—a nose-bleed inducing height that raises fears of overcapacity in industry and has yielded ghost towns of unsold property.

The Challenge

In 2014, exports and new property under construction both contracted in some months. That underlines the risks of continuing to rely on foreign consumers and domestic construction to drive growth, as well as the importance of tilting the Chinese economy toward a larger role for domestic consumption.

That process is already underway. The services sector, which is more labor intensive, is now a larger part of the economy than manufacturing. Growth in household disposable income has outpaced GDP since mid-2013.[1] Progressive improvements in social

Figure 1. China's GDP Growth Slows



Source: *Bloomberg*

services and welfare are freeing up household resources for consumption.

Progress, however, is painfully slow. At the current rate of change it would take 140 years for private consumption to play the same role in China that it does in Japan, and 193 years for it to hit the same level as in the United States. Accelerating growth in consumer credit offers the opportunity to kick start the process.

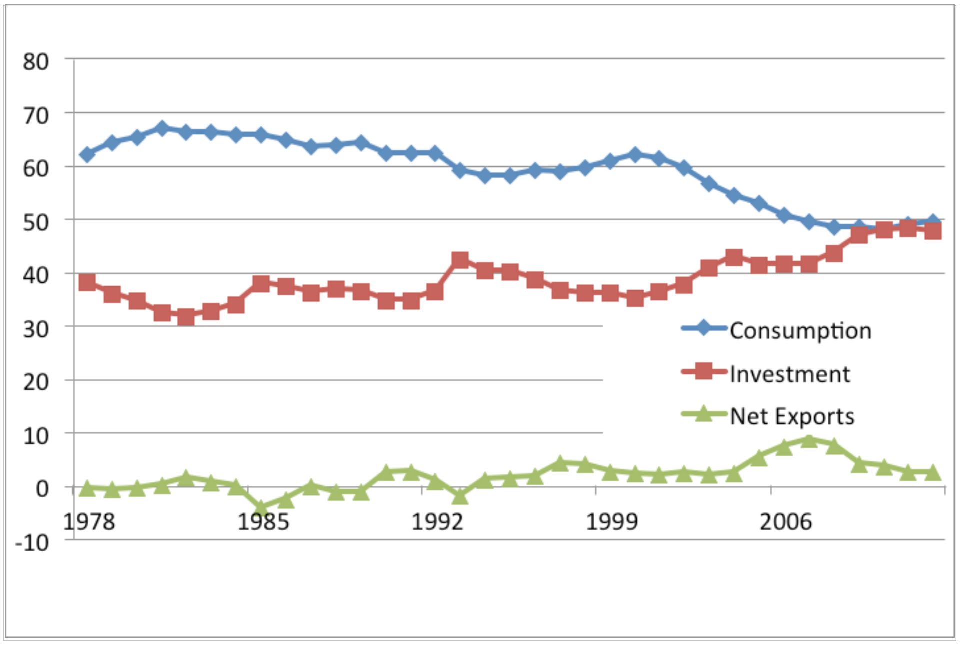
The Opportunity: Consumer Credit

Consumer credit provides an immediate means to supplement household income, and could thus provide a boost to growth while also increasing the contribution of consumption to overall demand. In a narrow sense, borrowing always has to be paid back, so higher consumer loan growth can provide only a temporary boost to household spending and the economy. In a broader sense, however, easier access to credit for households also has the potential to shift behavior and incentives in a way that has a more permanent impact.

Figure 3 illustrates historical changes in US savings behavior from the 1960s through the recent past. This is instructive for China because, in contrast to the United States, China's household savings rate is extremely high.

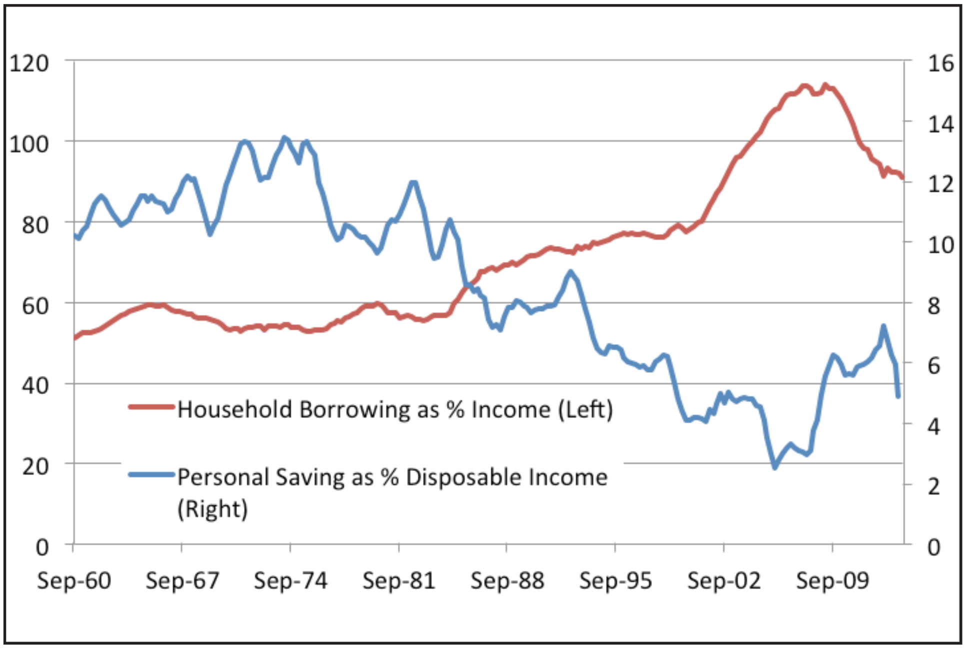
Based on flow of funds data, Chinese households save more than 40 percent of their income.[2] That reflects, in part, the need to squirrel away funds to pay for education, the purchase of a home, or

Figure 2. Share of Consumption in GDP Dwindles



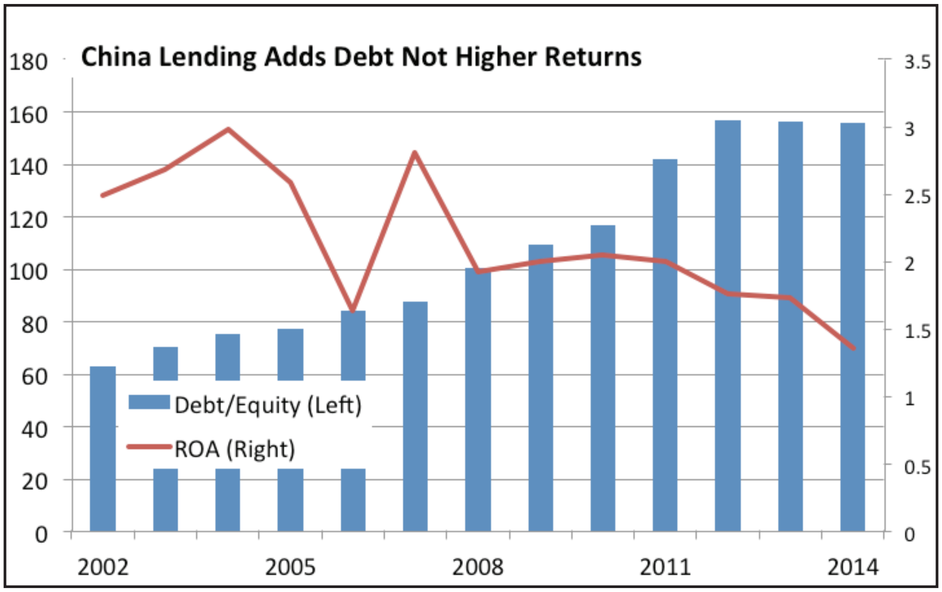
Source: *Bloomberg*

Figure 3. US Household Savings Fell as Borrowing Rose



Source: *Bloomberg*

Figure 4. China Lending Adds Debt Not Higher Returns



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medical costs that would be incurred in the event of illness. By providing households with a resource upon which they can draw in times of need, easier access to credit could reduce the need for precautionary savings. In the United States, the rise in consumer credit and the decline in household savings occurred in parallel.

Increasing the resources available to households for consumption could also empower consumers to drive a change on the supply side of China's economy. By extending ever-increasing loans to China's firms, banks have financed a build-out of industrial capacity and luxury property that may never be used. Empty shopping malls in the center of Beijing testify to the inability of loan officers to identify what China's growing consumer class want. Data on China's listed companies shows that rising debt has been accompanied by falling return on assets (see Figure 4).

By encouraging a greater flow of credit to consumers, Chinese policy makers would effectively employ them as agents to decide which firms are providing the goods and services they actually want.

With the consumer-facing side of the economy more labor intensive, boosting funds for consumption would also be a more effective means to bolster employment than channeling funds to industry and fixed assets. Stronger employment would start a virtuous cycle, with a boost to wages providing more funds for consumption.

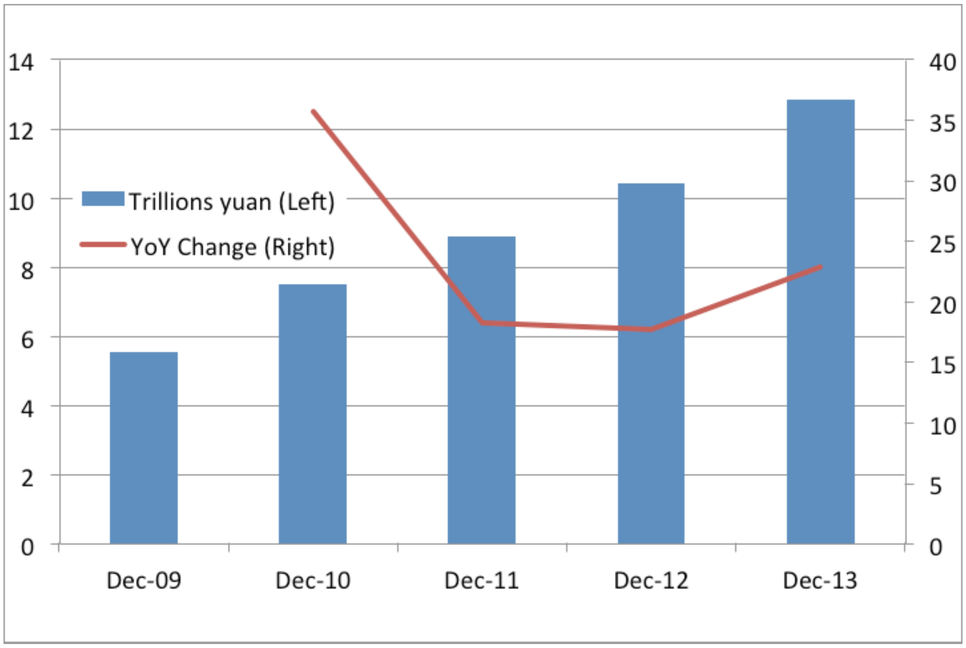
Generational and Policy Shifts: Enablers of Rapid Credit Growth

China's stock of consumer credit is growing fast from a low base (see Figures 5 and 6). As of November 2014, outstanding consumer loans from China's banks totaled 15.1 trillion yuan ($2.4 trillion), up from 5.5 trillion yuan ($900 billion) at the end of 2009. Average year-on-year growth of more than 27 percent in the years since the financial crisis has outpaced even the rapid growth in lending to firms.

What is more, all of the categories of consumer finance have grown rapidly. Mortgage loans expanded to 10.2 trillion yuan ($1.6 trillion) in the third quarter of 2014 from 4.8 trillion yuan ($800 billion) at the end of 2009.[3] Short-term consumer loans expanded to 3.2 trillion yuan ($500 billion) from 600 billion yuan ($100 billion).[4] Credit card balances also expanded briskly.

That shift has been facilitated by the arrival of a younger generation of Chinese consumers with a greater willingness to borrow to pay for current consumption. Ford Motor Company's China auto finance arm, for example, makes 44.2 percent of its loans to customers aged 21 to 30. Customers aged 41 to 50 make up just 13.2 percent of the portfolio.[5]

Figure 5. Bank Loans to Households Grow Fast From a Low Base



Source: *Bloomberg*

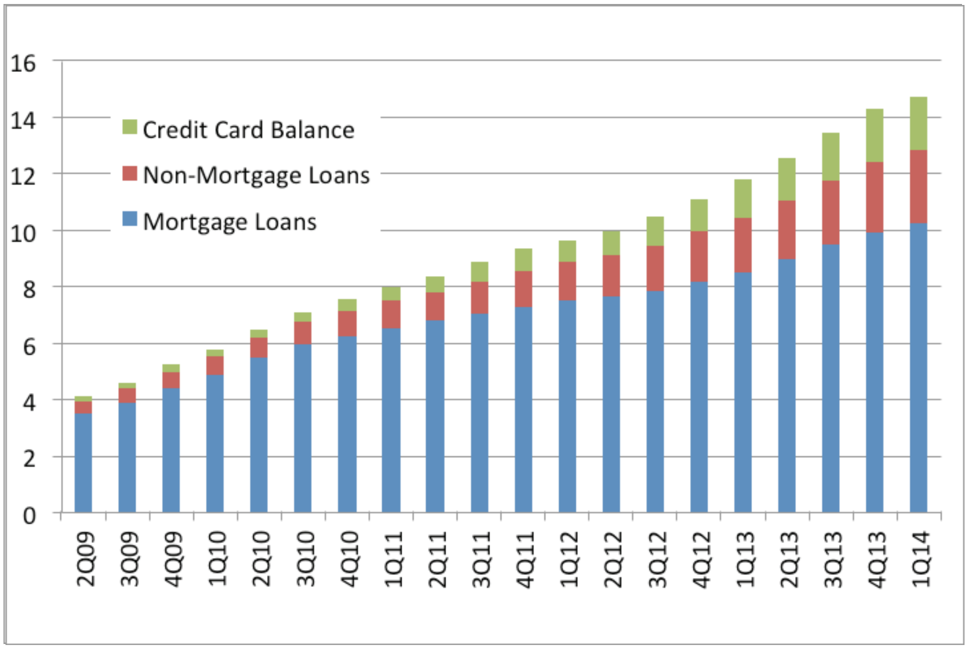
But this shift has also been driven by changes in the rules governing the allocation of credit. Four consumer finance companies were launched in 2009, part of China's response to the global financial crisis. In 2014, licenses were granted to private banks run by consumer-facing firms Alibaba, Tencent, and Suning.[6] The launch of asset-backed securities has allowed auto finance firms to expand their business at a rapid pace.

China's central bank, the People's Bank of China (PBOC), has promised to accelerate the development of the credit information market—an important building block of the consumer credit market more broadly. In the payment market, Unionpay's monopoly position has been the subject of a challenge in the World Trade Organization.[7] But even there, regulated caps on fees mean consumers and merchants have not been gouged.

International Comparison: Scope to Grow

But in spite of rapid growth, China's consumer credit remains underdeveloped. Based on PBOC data, outstanding consumer loans at the end of 2013 equaled 22.8 percent of GDP. That is less than half the level in Taiwan and a third of the level in South Korea, where household credit equals 46 percent and 71.5 percent of GDP, respectively. In the United States, households owe debts equal to 68 percent of GDP, down from 86 percent in 2008 as the financial crisis prompted massive deleveraging.[8]

Figure 6. All Categories of Household Credit Growing Fast (Trillions Yuan)



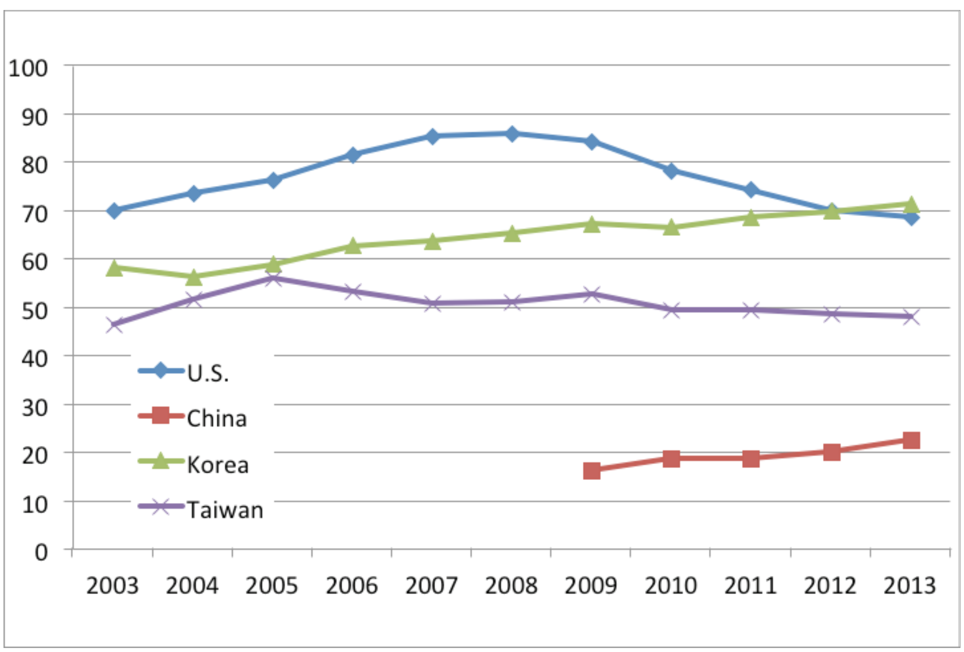
Source: *Bloomberg*

In China, that low baseline is evident across the spectrum of household borrowing (see Figure 7). In the United States, mortgage debt is equal to about 50 percent of GDP. In China that figure is just 17 percent. Non-mortgage borrowing by US households is 17.5 percent of GDP but just 4.4 percent of GDP in China. The average Chinese consumer has less than a single credit card, compared to wallets stuffed with them for many American consumers. In China, around 20 percent of cars are purchased using autofinancing compared to 75 percent in the United States.[9]

Viewed in terms of household income, the situation is slightly less positive, reflecting the relatively low share of total income enjoyed by China's households. In China, the share of household income in GDP is difficult to calculate because of the absence of income-side GDP data. However, based on flow of funds data from 2012—the latest available—that share is 60 percent of the total. That is substantially lower than in the United States, where household income is 84 percent of GDP. China's household borrowing is 32 percent of household income, substantially higher than when measured as a share of GDP. In the United States, outstanding household borrowing is equal to about 81 percent of income.[10]

China's official data do not present a complete picture on either household

Figure 7. China Household Borrowing Low as Percentage of GDP



Source: *Bloomberg*

income or borrowing. On the income side, that is because the National Bureau of Statistics survey is skewed toward lower and middle-income households, and participants are unwilling to disclose their informal earnings. On the borrowing side it is because PBOC data do not capture borrowing from friends, family and loan sharks.

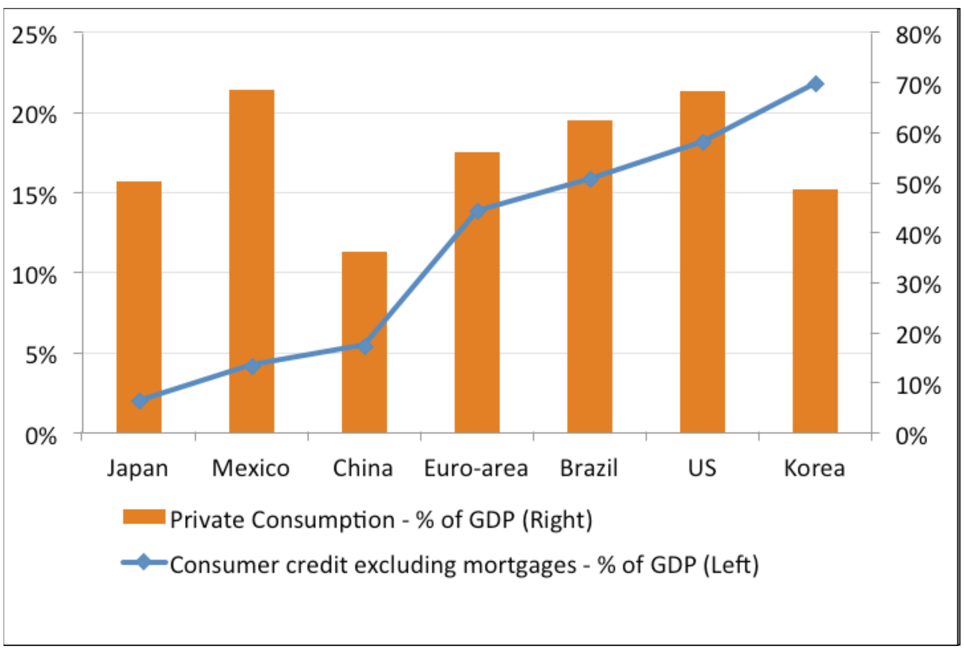
But data from the China Household Finance Survey fills the gap. It suggests that informal borrowing is slightly larger than informal income. Taking account of both, household borrowing in 2013 was about 37 percent of household income—higher than the result based on the official data although still substantially below the level seen in the United States.[11]

A Caution from International Experience

The logic behind fostering a consumption-driven economy with greater consumer lending appears clear. China's scope for expanding credit to households is also substantial. Still, the lesson from international experience is that expanding consumer credit does not always bring the desired results and can sometimes trigger financial instability (see Figure 8).

In theory, consumer credit should improve resource allocation for households and thus support consumption. In practice the international evidence is mixed. Consider these examples: Japan and Mexico have low consumer credit

Figure 8. Consumer Credit and Consumption as % GDP Not Well Correlated



Source: *Bloomberg*

but consumption plays a major part in driving demand. South Korea's households, by contrast, are highly indebted without playing a major part in supporting growth. China, the United States, the Euro-area, and Brazil show a more intuitive pattern, with rising consumer credit correlated with stronger household spending. That is a reminder that how consumer credit is allocated matters as much as the amount that is lent.

One lesson from the United States in the financial crisis is that highly indebted households can be a major risk to stability. In Hong Kong, weak corporate loan demand in the wake of the 1997 Asian Financial Crisis pushed banks into rapid expansion of their credit card business.

The growth rate of household borrowing in China is extremely rapid, with outstanding lending more than doubling in the last four years.

Outstanding credit card receivables rose to HK$62 billion ($8 billion) in 2001 from HK$40 billion ($5.2 billion) in 1999. When growth slowed and unemployment rose, the number of personal bankruptcies registered a sharp increase, according to the Hong Kong Monetary Authority. South Korea saw GDP growth fall sharply in 2003 as past expansion in household borrowing triggered a wave of delinquencies. The Korean government was forced to step in to rescue the country's largest credit card company.[12] High household debt remains a drag on growth.

In the United States in 2007, household debt was 86 percent of GDP. In Hong Kong in 2001 the level was 61.7 percent. Korean borrowing in 2002 was 64.2 percent of GDP. China is clearly still some way from those danger lines, and at the early stage of market development it is relatively easy for banks to cherry pick the lowest risk borrowers while still growing their loan books at a rapid pace. A tough approach by Chinese regulators is an additional reason for confidence that risks can be managed. Down payment ratios in auto finance and mortgages are set at high levels. Loan to income ratios are typically low. Indeed, China is a far cry from the "No Income, No Job, No Assets" NINJA loans that were part of the origin of the US housing crisis. A household debt crisis, therefore, seems like a distant prospect.

Still, there are reasons for caution. For one, household borrowing in China is growing rapidly, with outstanding lending more than doubling in the last four years. That is not as rapid as the rate of growth seen in South Korea leading up to 2003, but it is faster than growth in Hong Kong in the years before its 2001 problems and in the United States in the run up to the 2008 crisis. Limited experience of a down cycle in either the real economy or consumer finance also calls into question the capacity of Chinese lenders to accurately assess risks.

Slowing Income Growth and Overstretched Banks Pose Risks

China's economy is heading into a period of lower growth, slower rise in wages, and flat or even falling real estate prices. Urban disposable income slowed to below 10 percent annual growth in the first half of 2014 from close to 20 percent in the first half of 2008.[13] Real estate prices in the overwhelming majority of Chinese cities tracked by the National Bureau of Statistics are falling.[14] Loans made on the assumption of continued rapid increases in income and gains in property prices might not be robust to a period of slowing wage growth and greater volatility in the real estate market.

The scope for increasing household borrowing also has to be understood in the broader context of rapid increases in leverage elsewhere in China's economy. The period since the 2008 financial crisis has seen super-charged expansion in lending to state-owned enterprises (SOEs), local governments, and real estate developers. In the period from 2008 to 2014, outstanding credit swelled from about 125 percent of GDP to more than 200 percent of GDP.

Such a rapid increase in lending has raised fears of frailty in the financial system. The result: households might be able to borrow more, but banks could be hard pressed to lend more without a trade off in slower growth of lending to firms.

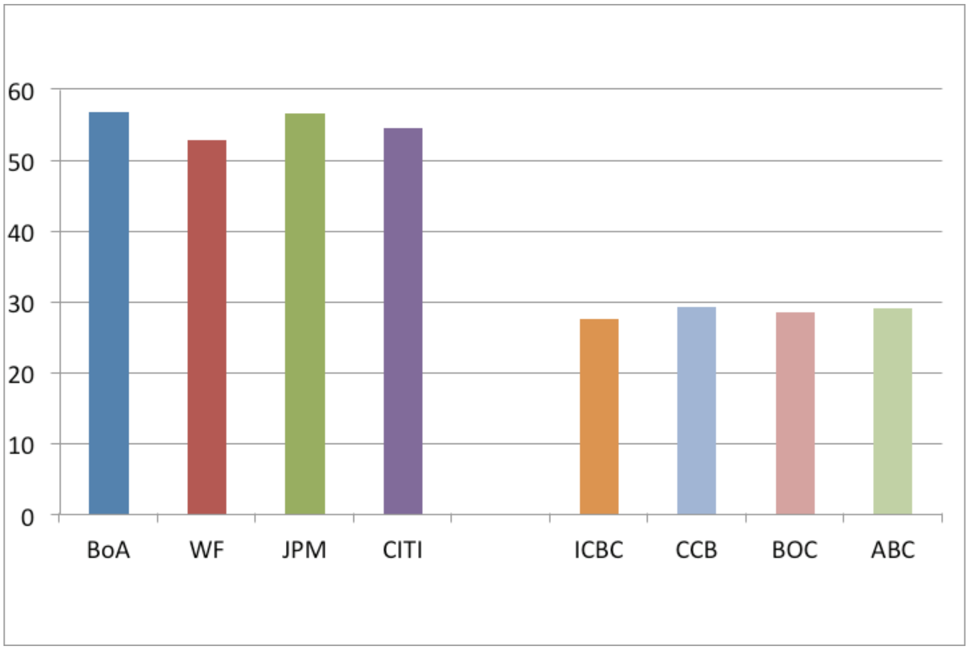
A longer-term concern is that the rapid expansion of banks' loan books is based on the high saving rate of Chinese households, which contributes to a steady flow of deposits. An increase in consumer credit, which triggers a move away from savings, would also dent banks' capacity to lend.

Bank Incentives and Skewed Distribution of Credit

For China's banks, consumer credit is already an unattractive proposition. Households have less collateral than corporate borrowers and less transparency on sources of income. China's Credit Reference Center has records on 837 million individuals. But as of November 2013, just 317 million had loan histories, making it difficult to assess credit quality for the majority of would-be borrowers.[15]

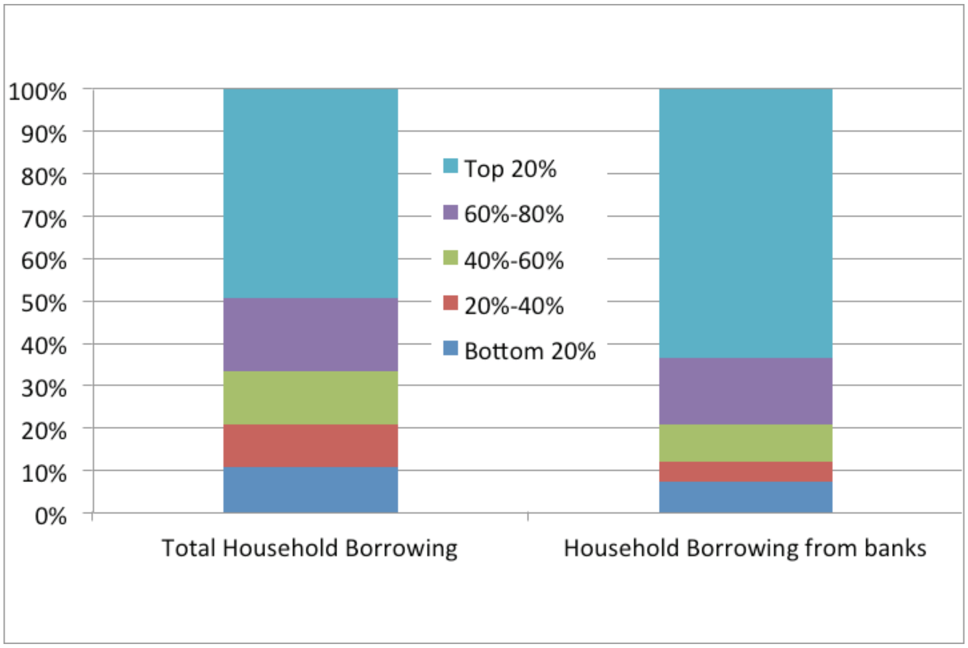
Chinese households typically borrow smaller amounts, which increases transaction costs. Unlike SOEs and local government financing vehicles, they have no rich parent to guarantee the loans. Corporate loans are typically made with the understanding that funds will be placed on deposit at the same bank. Consumer loans are not. That

Figure 9. Consumer Loans as % of Total Lower For Chinese than US Banks



Source: *Bloomberg*

Figure 10. Share of Chinese Household Borrowing By Income Level



Source: *Bloomberg*

means consumer loans come at a higher cost to the banks, worsening their loan-to-deposit ratio and constraining their future capacity to lend.

In the United States, consumer loans for Bank of America, Wells Fargo, and other major banks, account for more than 50 percent of their loan book. For China's top banks, by contrast, the share is less than 30 percent (see Figure 9). That reflects, in part, a different financial system, with US firms borrowing less from banks and relying more on direct finance from bond and equity markets. Still, part of the difference comes from a greater sophistication and willingness of US banks to extend credit to households.

For China's poorest 40 percent of households, close to two-thirds of their total borrowing comes from the informal sector.

The disadvantages of consumer lending from the banks' point of view are compounded when it comes to lending to China's low and middle-income households (see Figure 10). According to China Household Finance Survey data, the richest 20 percent of households account for 63 percent of total borrowing from the formal financial sector. China's low and middle-income households, by contrast, present a higher risk for the banks. The bottom 60 percent of households receive just 21 percent of the loans. And that, in turn, leaves many Chinese households reliant on loans from the informal financial sector.

For China's poorest 40 percent of households, close to two-thirds of their total borrowing comes from the informal sector. The result is that poor households have to pay higher curb market rates for their funds. According to the China Household Finance Survey, rates from informal lenders are around 10.3 percent, almost double the 5.9 percent charged by banks. Of course, this partly reflects higher risks in lending to low-income households. Still, inefficiency in small informal lenders and—in some cases—predatory pricing, are also part of the picture.[16]

At an aggregate level, it is saving by China's rich—unable to spend all of their incomes—that is most significant in determining the national savings rate. At a household level, it is China's low and middle-income households that carry the greatest burden of precautionary saving to pay for education, healthcare, and old age. So it is by improving access to credit for this group that the Chinese financial system can generate the most widespread gains in shifting savings behavior and freeing up funds for consumption. By channeling the majority of funds to high-income households, current arrangements risk increasing the gap between China's haves and have-nots without generating any positive impact on household savings behavior or aiding the country's larger objective of economic rebalancing.

It is, of course, possible that China's newly licensed private banks—including consumer-focused firms such as Alibaba, Tencent, and Suning—will have a greater focus on the consumer end of the business. Alibaba is already the major player in China's payments market through its arm Alipay and is experimenting with credit payments.[17] Access to households' transaction data thanks to their purchases on Taobao and TMall—the firm's e-commerce platforms—might help Alibaba overcome the problem of limited credit histories and reduce the risk in consumer lending. In early 2015, a visit by Premier Li Keqiang to Tencent's private bank signals top level government support for the new ventures.

How Policy Can Help to Expand Consumer Credit

Taken together, the data and trend lines suggest that the expansion of consumer credit present an opportunity to drive growth and rebalancing. And China has already started to tap this. Lending to households is growing rapidly from a low base, making a positive contribution to bolstering demand and tilting the economy toward a greater role for household spending.

Against that background, three policy changes would be especially beneficial:

First, Chinese regulators should aim to head off financial risks by balancing support for rapid growth of consumer credit with maintenance of tough standards on down payment requirements for mortgages, loan-to-value, and loan-to-income ratios.

Second, China's financial policymakers can help to shift incentives for banks toward a greater focus on consumer lending through the use of policy tools. Use of targeted reserve requirement cuts for banks with a strong commitment to household lending, or differential treatment of household loans in the calculation of loan deposit ratios, could both be beneficial. This would offset banks' concern that household loans do not come back in the form of deposits.

Third, Beijing should leverage financial sector reform to accelerate the creation of private banks and specialized consumer finance and mortgage firms. These would be banks and firms with access to wholesale funding markets. The expansion of the number and quality of such firms would help to increase the diversity of product offerings and impose competitive pressure on established banks to raise their game in serving household borrowers.

Endnotes

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