China Moves on Banking Reforms

By THE EDITORIAL BOARD  MARCH 12, 2014

In November, China’s leaders announced their intention to enact sweeping reforms in economic and social policies. This week, they said they were ready to carry out some important financial changes that could strengthen the country’s banking system and benefit savers and small businesses.

Chinese banking regulators said on Tuesday that the country would remove government limits on the interest rates banks pay on deposits sometime in the next two years. They also said that private businesses would be allowed to open five banks in two major cities and two provinces. Depending on how these changes are carried out (many details are not public), they could significantly shake up the financial system, which is dominated by state-owned banks that primarily lend to inefficient government enterprises and a fast-growing shadow banking system that operates with little regulatory oversight.

Interest rates on customer deposits are currently set at 0.35 percent. Those artificially low rates have benefited banks by keeping their costs of doing business low. But they have also encouraged Chinese families to put their money into more risky investments like real estate, stocks and lightly regulated wealth management products, which invest in projects that cannot get loans from banks. Letting those rates rise and creating a deposit insurance system, which Chinese officials have said they intend to do, should make it easier for ordinary people to save money without taking outsize risks. Higher rates should also make it harder for politically connected businesses and government-owned enterprises to get loans.

Allowing the establishment of the first privately operated banks in the country in Shanghai and Tianjin and in the provinces of Guangdong and Zhejiang could help increase lending to privately run small and medium-size businesses.
These steps are only a start. Since 2008, the total debt in the Chinese economy has surged to about 210 percent of the country’s gross domestic product — a very high level for a developing country. What’s most troubling is that a lot of the growth has taken place in the shadow banking system, which is made up of lightly regulated trust companies and unregulated money lenders. A few businesses that took high-interest loans from shadow banks have recently defaulted on their debts and analysts fear many more will default as the economy slows.

Chinese officials have to strike a careful balance. If they hit the brakes too hard to curb lending by state-owned banks and shadow lenders, they could precipitate a crisis. But if they are slow to act, the financial system will become even more vulnerable.

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