EC2374

Economy of Modern China

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Topic 8 Financial Sector: Reform & Development

key points/questions:

- China's financial sector is dominated by a large, fast growing, yet still relatively inefficient banking system
- China's financial market is small and has not been effective in allocating resources
- the state continues to dominant in China's formal financial sector
- private equity and bond market are developing are relatively unimportant
- informal financing is important in allocating financial resources

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toward a functioning modern financial sector

- financial sector important for economic development
- financial sector development in China
  - an overview
  - banking sector
  - securities market
- impact of the current crisis and remaining issues

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important for allocating financial resources

- to evaluate the overall development
  - financial deepening (size)

    increase in financial assets as a % of GDP

    more deposits and loans

    more stocks issued
  - financial broadening (variety)

    increase in number/variety of participants/instruments

    more banks & insurance companies

    more stocks listed

    more instruments including bonds, trusts, mutual funds

financial development in China: an overview

- financial system deep but very narrow
  - dominated by banks

    dominated by state banks

    limited number of non-banking institutions

    rapid increase in new credit
  - equity markets beginning to play a role

    Shanhai Stock Exchange (SHSE)

    Sengzhen Stock Exchange (SZSE)

    Institutional investors introduced

banking sector reforms

- under central planning
  - a totally government-run institution
  - played a very limited & supporting role
  - acted as an accountant to accommodate the flow of physical goods
  - funding decisions were made according to government policy preferences, not financial considerations

banking sector reforms

- under central planning
  - 1950-1978, a mono-bank

    the People's Bank of China (PBOC)

    owned/controlled by the central government, under Ministry of Finance

    both a central bank and a commercial bank

    controlling about 93% of the total financial assets

    handling almost all financial transactions.
  - its main role is to finance the physical production plans

banking sector reforms

- restructuring of the banking sector before 1993
  - establish independent central bank

    PBOC departed MOF (1979) to become the central bank in 1984

    stopped handling credit and savings

    macro control and supervision
  - transform the four state-run banks into commercial banks

    Agriculture Bank of China (ABC): 1979

    China Construction Bank (CCB): 1979

    Bank of China (BOC): 1979

    Industrial and Commercial Bank (ICBC): 1984

banking sector reforms

- restructuring of the banking sector before 1993
  - Some development of other financial intermediaries

    Regional banks (partially owned by local governments): in coastal SEZs;

    Rural credit cooperatives (RCCs): under the supervision of the ABC

    Urban Credit Cooperatives (UCCs):

    Non-bank financial intermediaries, such as the Trust & Investment Corporations

banking sector reforms

- restructuring of the banking sector before 1993
  - the role is changed from providing credit to lending, but
  - lending is still dominated by government policies

    PBOC lacks central bank independence

    banks lack standardized criteria to assess risks

    Increasing NPL problems: 40% of loans to SOEs is estimated to be NPL

    local government influence local lending for SOEs and speculative investment in real estate construction

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banking sector reforms

- new reforms since 1994
  - provide legal protection for PBOC & commercial banks' decision-making
  - policy banks created for policy-lending activities

    The State Development Bank

    The Export-Import Bank

    The Agricultural Development Bank
  - re-organizing banks into a regional system

    nine regional central-bank branches
  - credit plan abandoned
  - reserve requirement lowered

banking sector reforms

- new reforms since 1994
  - four state-run commercial banks still dominate

    70% of the total bank deposits and loans
  - foreign banks allowed to serve foreign-invested enterprises
  - allow entry of semi-government banks

    There are about 20 share-holding state controlled banks.

    There are also hundreds of city banks in different cities.
  - private banks also emerged

banking sector reforms

- new reforms since 1994
  - Privatization of state commercial banks

    Introduce foreign strategic investors

    IPO
  - allow entry of semi-government banks
  - private banks also emerged

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banking sector reforms

- problems and challenges with NPLs
  - non-performing loans problem remains serious
  - the stock of NPLs
    - over-lending in the past
    - official estimates around 20-25% in early 2000s
    - independent estimates up to more than 50%
  - the flow of NPLs
  - low efficiency of the banking sector
    - ownerships and incentives
    - weak oversight
    - lack of necessary skills and ineffective reporting system

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banking sector reforms

- problems and challenges with NPLs
  - Problems and challenges: bank recapitalization
  - Bank recapitalization needed to reduce burden & have more autonomy
  - Set up 4 asset management companies (AMCs) in 1999

    Huarong (for ICBC), Cinda (for CCB), China Orient (for BOC), and Great Wall (ABC)

    transfer part of the NPLs to AMCs

    attempts been made to convert debt into equity stakes

    loan recovery rate was relatively low

      19.85% for Huarong; 10.41% for Great Wall; 22.82% for China Orient;

      and 33.64% for Cinda, by the end of March 2005

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banking sector reforms

- Key characteristic: a mild financial repression
  - continued monopoly of the four largest state banks

    through them, the state maintains close control of the financial sector

    low return on assets
  - cost:

    slowing down development of the financial sector and poor lending decisions.
  - benefit:

    avoiding financial crisis

    help finance government spending

    high profits of state banks

    low costs of state borrowing

security market

- objectives to establish security market
  - to further reform the SOEs

    improving corporate governance
  - to raise capital for enterprises, especially the SOEs

    a major objective for the enterprises
  - to diversify China's financial sector

    away from the monopoly of state banks

    a policy-makers' concern

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security market

- A survey
  - different kinds of security exchanges

    the Shanghai stock exchange and the Shenzhen stock exchange

    A-share vs. B share

    Chinese companies also listed shares in NY, HK, and Singapore stock exchanges
  - Stock market still dominated by (former) SOEs

    Almost all listed firms are (former) state-owned enterprises

    Almost all of the very largest SOEs are listed

    Some, including non-state companies are listed on overseas markets
  - majority of the equity not circulated

    mainly governments and government agencies

    even the circulated shares are traded in fragmented markets

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security market

- problems with China's stock markets
  - supply is very limited due to regulations
  - prices are relatively high and volatile

    P/E ratio: around 40 (A shares) until recently (compared to 25 for S&P 500)

    prices very sensitive to government policies

    rapid turnover
  - regulations still relatively poor:

    disclosure standards low

    transparency very limited
  - manipulation and fraud not un-usual

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security market

- Recent changes:
  - sell state shares

    first attempted in 2001, later in 2006
  - improve regulatory standards and transparency

    new rules and regulations

    publicize and strengthen training

    reinforce the implementation of new rules
  - improve market liquidity

    increase supply of shares

    diversify sources of demand
  - introduce investors with stable, long-term interests

    insurance companies, pension funds, mutual funds

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Impact of the recent crisis:

- direct impact is small
  - The capital control is still in place

    Foreign capital can't invest in the domestic stock
  - QFII is a small portion of institution investors in China
  - Chinese government is still the largest shareholders of the big-Four
  - Chinese banks' direct holding of US troubled assets is minimal
  - However, stock market was shaken hard

    Domestic market bubble burst
- indirect impact is significant

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Impact of the recent crisis:

- Policy lessons
  - From the 1997 Asian financial crisis

    NPLs & Poor cooperate governance
  - Regulatory dilemma

    Needs to bail out troubled banks

    Moral hazard problem: too-big-to-fail
  - Governance of financial institutions

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Remaining issues:

- Government-related NPL problems
- Banking vs. market for funding new industries
- Investor protection
- Developing more financial products and markets
- Risk management