China's Financial System: Growth and Risk

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Contents

Abstract

We provide an updated and comprehensive review of China's financial system and explore the possible challenges in the future. First, China's financial system has been dominated by a large banking sector, which has played an important role in financing the real economy in the past decades. With the interest rate liberalization, the profitability of banks will go down and the competition in the banking sector will become stronger in the future. Moreover, this sector still needs to meet the challenge to reduce the amount of nonperforming loans. Second, the role of the stock market in allocating resources in the economy has been limited and ineffective. However, with the rapid growth of the markets and the introduction of more financial products, financial markets are expected to play a more important role in the economy going forward. Third, a nonstandard sector that consists of alternative financing channels is the most successful part of the financial system in terms of supporting the growth in the past decades. The co-existence of this sector with banks and markets can continue to support the growth of private and local government firms. Finally, in order to sustain the economic growth in China, policies need to reduce the likelihood of damaging financial crises, including a banking sector crisis, a real estate or stock market crash, and a "twin crisis" in the currency market and banking sector.

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1

Introduction

One of the enduring puzzles surrounding China's rapid economic growth during the recent decades is how it was achieved with an underdeveloped financial system. Despite more than 30 years of successful reforms, the development of the financial sector is still lagging. Based on a large number of previous studies of financial systems, the relationship between the structure of financial systems and economic growth in the real economy differs significantly across countries. In this monograph, we first give a brief review on the finance-growth nexus. After that, we provide an updated and comprehensive review of China's financial system and compare it with financial systems in other countries. We discuss what has worked and what has not within the markets and intermediaries in China, and further consider the effects of the recent development of China's financial system on the real economy. We also examine a nonstandard financial sector, which operates beyond the markets and banking sectors and consists of alternative financing channels, governance mechanisms, and institutions. Finally, we provide prospects for future research on several unresolved issues, including how China's financial system can integrate into the world's markets and economy without being interrupted by damaging financial crises. There is no doubt that China's financial system has experienced dramatic development in recent years and the economic growth rate remains high relative to other countries after the global financial crisis.[1]

We draw four main conclusions about China's financial system and its future development. First, compared with other developed and emerging economies, China's financial system has been dominated by a large banking system. Although in recent years, the banking system saw the entrance and growth of many domestic and foreign banks and financial institutions, the whole banking system is still dominated by the five largest state-owned banks. All of the "Big Five" banks have already been publicly listed in recent years, with the government still being the largest shareholder and remaining in control. This ownership structure has served these banks well in terms of avoiding major problems encountered by major financial institutions in developed countries that were at the center of the 2007–2009 global financial crisis. Moreover, the level of nonperforming loans (NPLs) over GDP was steadily decreasing after reaching its peak during 2000–2001 but it is increasing again after the 2008 global financial crisis. This rise is due to the large number of investment projects in infrastructure that were undertaken in order to boost the economy after the crisis, making the high NPL ratio one of the main risks in the banking system again. Given the uncertainties of the global economy and the ongoing financial reforms and economic structural reforms in China, the country's financial development and economic growth may meet challenges in the near future.

Our second conclusion concerns China's financial markets. In recent years, both China's stock market and bond market have witnessed significant development. However, their current scale and importance are not comparable to those of the banking sector and they may not be effective in allocating resources in the economy, because they remain speculative and driven by insider trading in the equity market. Nevertheless, markets are likely to play an increasingly significant role in the

[1]Based on the report of the World Bank in the International Comparison Program released in 2014, China overtook the United States in terms of GDP PPP (Purchasing Power Parities) during that year.

economy, based on the direction of the ongoing reforms in the financial sector. We discuss several issues and potential problems related to increasing the size and scope and improving the efficiency of the stock and other financial markets.

Third, the alternative financial sector has played an important role in satisfying the financing demand and maintaining the high growth rate in the real economy. In an earlier paper, Allen et al. (2005, AQQ hereafter) argue that the most successful part of the financial system, in terms of supporting the growth of the overall economy, is not the banking sector or financial markets, but rather a sector of alternative financing channels, such as informal financial intermediaries, internal financing and trade credits, and coalitions of various forms among firms, investors, and local governments. In recent times this sector is often referred to as the "shadow banking system." This financial sector has supported the growth of a "Hybrid Sector" with various types of ownership structures. Our definition of the Hybrid Sector includes all non-state, non-listed firms, including privately or individually owned firms, and firms that are partially owned by local governments (for example, Township Village Enterprises or TVEs).[2]

Finally, a significant challenge for China's financial system is to avoid damaging financial crises that can severely disrupt economic stability. These crises include traditional financial crises: a banking sector crisis stemming from an accumulation of NPLs and a sudden drop in banks' profits; or a crisis/crash resulting from speculative asset bubbles in the real estate market or stock market. There are also other types of financial crises, such as a "twin crisis" (simultaneous foreign exchange and banking/stock market crises) that struck many Asian economies in the late 1990s. Since its entrance to the World Trade Organization (WTO) in 2001, the integration of China's financial system and overall

[2] We include firms partially owned by local governments in the Hybrid Sector for two reasons. First, despite the ownership stake of local governments and the sometimes ambiguous ownership structure and property rights, the operation of these firms resembles more closely that of a for-profit, privately owned firm than that of a state-owned firm. Second, the ownership stake of local governments in many of these firms has been privatized.

economy with the rest of the world has significantly sped up, but on the other hand, large scale and sudden capital flows and foreign speculation increase the likelihood of a twin crisis. Given the rapid growth in China's foreign exchange reserves,[3] there has been a large amount of speculative, "hot" money flowing into China in anticipation of a continuing appreciation of the RMB, China's currency, relative to all other major currencies, especially the US dollar. Depending on how the government and the central bank handle the process of opening up the capital account, there could be a classic currency crisis as the government and central bank try to defend the partial currency peg, which in turn may trigger a banking crisis if there are large withdrawals from banks.

The remaining sections are organized as follows. In Section 2, we briefly review the history of China's financial system development, present aggregate evidence on China's financial system, and compare them to those of developed and other developing countries. In Section 3, we examine China's banking and non-banking financial intermediaries over time, and the recent development in the shadow banking system. In Section 4, we briefly examine the growth and irregularities of financial markets, including the stock market, bond market, real estate market, and listed firms, and consider the effects of several initiatives to develop new markets and further develop existing markets, as well as changes in corporate governance among listed firms. In Section 5, we examine the non-standard financial sector, including alternative financial channels and governance mechanisms. In Section 6, we examine different types of financial crises and their potential effects on China's financial system in the near future. Finally, Section 7 concludes the monograph.

[3] At the end of 2007, China's foreign currency reserves surpassed US$1.5 trillion, overtaking Japan to become the largest in the world; they increased to about US$4.0 trillion as of June 2014 with a large fraction invested in U.S. dollar denominated assets such as T-bills and notes but fell back to about US$3.7 trillion by June 2015. Morrison and Labonte [2008] estimate that around 70% of China's foreign reserves are invested in dollar denominated assets.

In terms of converting RMB into US dollar, we use the exchange rate of US$1 = RMB 8.28 (yuan) for transactions and events occurring before 2005, and the spot rate at the end of each year for those activities during and after 2005 (Figure 6.1B provides a graph of the exchange rates between the US dollar and the RMB).

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