

## Remapping the Financial System in a Transition Economy - The Case of China

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### Abstract

China's economic transition began at the end of 1978. The traditional planned economic system resulting artificial low interest rates, price, and overvalued exchange rates still heavily govern the financial system. The government now faces the challenge of ensuring their effective implementation in financial system where inherited structural constrain is the main problem. Ultimately, the financial sector need to be mobilized by which the resources could be allocated in a more effective and prudent manner, to support stable and sustainable growth, improved quality of life and better employment opportunity. This case study describes the nature of China financial market and offers a big picture of its current performance. It focuses on Chinese capital market and examines the appropriate role for an efficient capital market. The paper also analyzes the structure and behavior of the banking industry and critically discusses the central bank, the effectiveness of fiscal and monetary instruments, and it's implication on exchange rate system. Finally, it illustrates the design of emerging banking regulation in transaction process and the future challenges and policy recommendations.

**Keywords:** Capital market; Transition economy; Financial system reforms; Banking structure; Monetary policy; Fiscal policy; SOEs; China

### Introduction

The financial market in China is consisting of interbank money markets, foreign exchange markets and capital markets. During the past five years, it has been substantial improved the central bank has increased the independence in monetary policy implementation, the state owned banks has enhanced the autonomy in credit management, bank regulation has been improved, and the managed foreign exchange system has further stabilized China's economy. But the Chinese financial system is still inefficient despite a series of important financial reforms have been undertaken. Broadman [1] suggest that the banking sector is heavily influenced by the government interventions in allocating credit to the state owned enterprises (SOEs); the commercial banks are considered insolvent with huge non-performing loans (NPLs); the managed exchange rate is inadequate in transaction economy; the lack of competition in the financial and capital market; the excess investment result in overheated economy and the irregular combination of inflation and deflation are the issues contradicting rapid growth economy [2].

China's interbank money market dominates the financial market, and in the money market, 75% of the country's deposits and commercial loans are controlled by the big four state-owned commercial banks, 90% of the loans have been allocated to state-owned enterprises (SOEs) consisting huge non-performing loans [3]. China has the highest annual savings in the world; however, the majority of financial resources have been inefficiently allocated into SOEs and run poorly. Bond market compromises mainly government or treasury bonds and less than 2% of corporate bonds. Two stock markets of Shanghai and Shenzhen are initially created for providing SOEs additional funding. Although the liberalization of financial

markets is becoming the vital task for Chinese Government, they are still closed in nature [4] State-owned Enterprises (SOEs), credit plan controlled financial reform, restricted investment and pegged exchange rate are the main economic features. China has experiencing an overheated economy for at least ten decades. The economic bubbles rose in the real estate and stock market as a result of over credit allocation, large fund has been shift from the banking sector to unregulated sectors. When China exhibits a continuous economic booming, the banking liquidity has been squeezed [5]. Many economists also worry that China's economy is just a bubble since 43% of economic growth was from investments, mainly financed by high saving rate of over 40% of GDP [6]. As such, the behavior of financial system becomes increasingly uncertain. Whether to raise the interest rate or appreciate yuan, the government controlled financial system has been struggling for some years. Raise the interest rate could slow down economic growth; however, it may attract speculative inflows of hot money into China. Furthermore, the government worries those state-owned firms will lose money, since the increased interest rate will result in an increased cost of capital, and therefore will require more subsidies from an already shrinking budget. Another option is to appreciate yuan. But the government is reluctant because this will erode the competitive advantage of China in international trading activities. The trade-off between two possible government policies further raises the financial market uncertainty and fluctuation.

### The Role of Capital Market and Banking Structure

The capital market in China includes government securities, financial bonds, enterprise bonds and equity. The total amount of all instruments issued from 1990-2000 was about 400 billion yuan, with 150 billion yuan was government securities and 250 billion yuan was other instruments [7]. In an efficient S, the primary role of the capital market is as Fama [8] suggested, "allocation of ownership of the economy's capital in which firms can make production-investment decision, and investors can choose among the securities that represent

ownership of firms” [8]. The characteristic of China capital markets is fast growing but still in the nascent stages [9]. For example, the issue of equity has to subject to the credit plan quotas and the development of capital market is determined by administrative decree rather than market forces. These constrain limits the efficiency of capital market as a role of allocating financial resource to business. Huang [10] suggested that the Chinese government’s allocating funds strong bias in planned economy — more favorable in SOEs and less favorable in private sector. The funding policy treatment diagram provides the evidence that SOEs are unable to compete because of internal constraints including political control, poor governance, regulation weakness and poor incentives. Private sectors also become less competitive as internally shortage of funding. Interestingly, neither

SOEs nor private sectors are able to generate substantial high income. The banking sector dominates the financial sector. China banking structure is one central bank based namely the People’s Bank of China (PBC), three policy banks, among 104 commercial banks four are state owned commercial banks and one hundred are shareholding commercial banks, 3,000 urban credit cooperatives, 42,000 rural credit cooperatives, and about 190 foreign banks. The policy banks comprise the State Development Bank of China (SDBC), Agricultural Development Bank of China (ADBC) and the Export Import Bank of China (EIBC). Four state owned commercial banks are Industrial and Commercial Bank of China (ICBC), Bank of China (BOC), Agricultural Bank of China (ABC) and China Construction Bank (CCB) [5] (Figure 1).

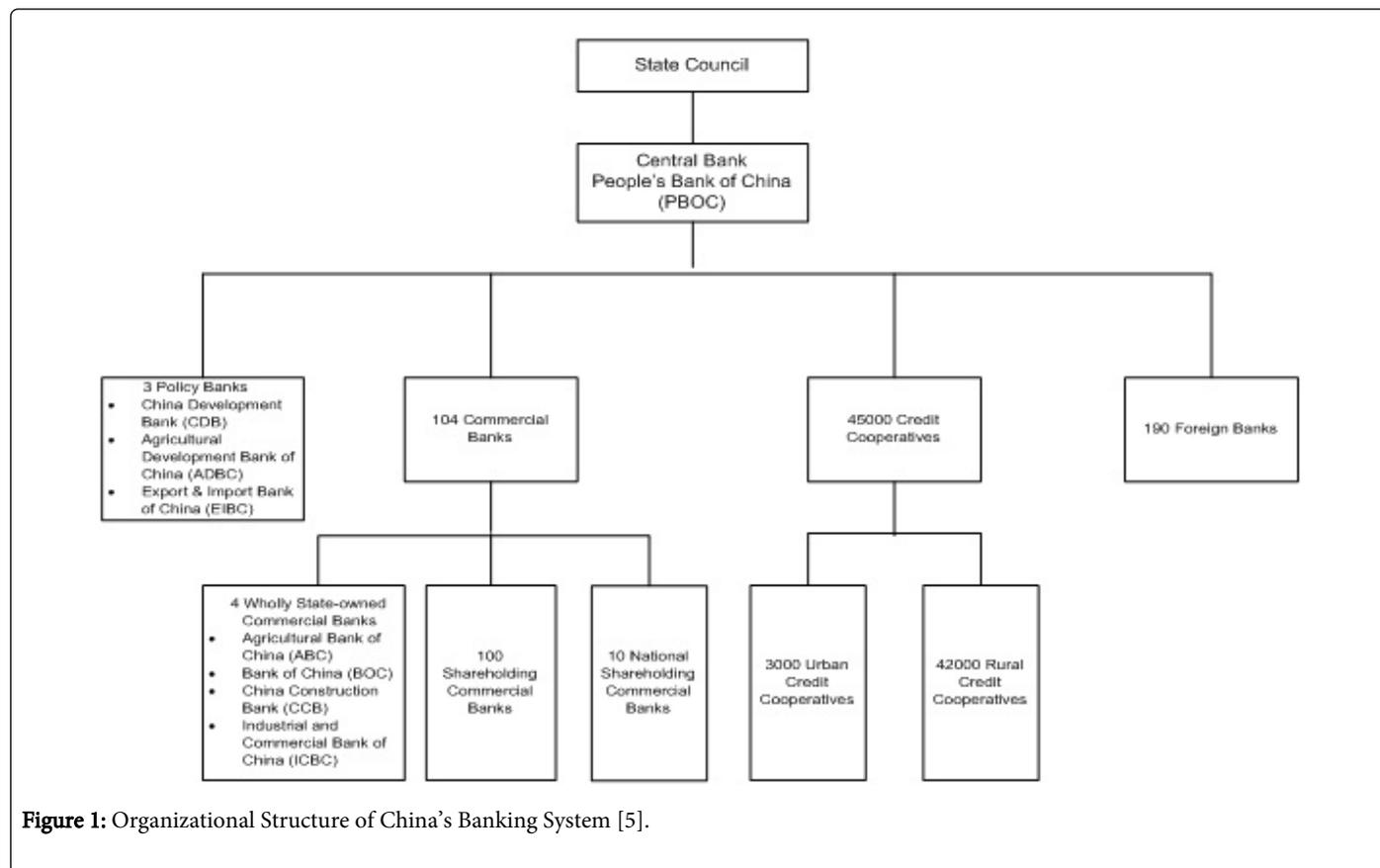


Figure 1: Organizational Structure of China’s Banking System [5].

Bank loans are the primary means for most business founding investment, which is twelve times of the capital that can be obtained from stock market. The big 4 state-owned banks accounts for 70% and 1/3rd of the total banking sector assets and the financial system assets respectively [5]. The banking system is still, very much centralized. The central bank and the State Planning Commission is the main channel through which the government control is exercised and the credit plan is mainly how the government influences the investment in the economy and maintains control over the direction of industrial development. Although recent efforts to enhance the independence of the central bank in implementing the monetary policy, the autonomy of the state owned banks in credit management, the banking sector is still heavily influenced by the government interventions in credit allocation and interest rates determination. Competition is still at lower the end. The objective of policy banks is to ensure that state-directed lending does not interfere with commercial banking activity. However, the current practices of policy banks are not likely to achieve

the goal; it may take a few years before policy banks have their own resources to shoulder all policy lending. As a result, the commercial banks profitability has remained poor from 1994-2000, with ROAA (return on average assets) at lower than 0.2% which was remarkably small. The Agricultural Bank of China (ABC) was the worst among them. Nevertheless, the banks are unable to reduce the costs from obtaining banking activities economics of scale, as the limited lending is unable to spread the cost of collecting and evaluating information regarding the creditworthiness of borrowers. These outcomes suggest that a comprehensive transition process is urgent in China’s banking industry.

Since 1998, the central bank has gradually shifted from direct control to indirect control of the macroeconomic with instruments of central bank loans, interest rate, exchange rate, rediscounting and open market operations. During the past five years, a sound monetary has been introduced as to increase domestic demand and reduce

consumer price index. The PBOC has decreased the interest rate by 8 times since 1996. Although the nominal interest rate is continuously decreasing, the real interest rate is not constantly decreasing due to the deflation [11]. M2 grew by 20.8% with total new loans RMB1.8 trillion in 2003. When the monetary policy successfully coordinated with RMB660 billion government bonds issued to finance infrastructure as a means of fiscal policy, the GDP has achieved 8% annual growth rate between 1997 and 2004 [4] (Figure 2).

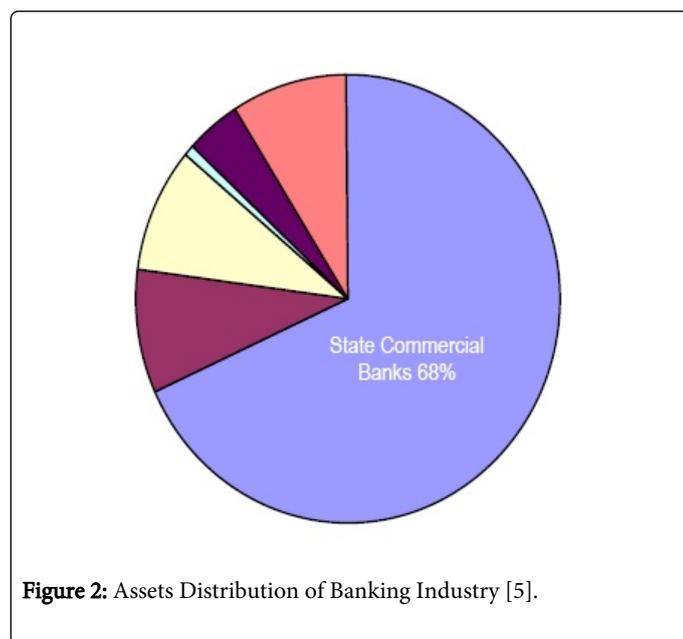


Figure 2: Assets Distribution of Banking Industry [5].

However, the government controlled central banking system remains immature. Artificially low interest rate to facilitate the SOEs is the case. The PBOC put effort in shift government determined interest rate to market-based interest rate reform. In 2000, market-based interest rate reform was experimented in eight country and rural credit cooperatives, with lending rate range widened from 50% to 100%. In 2002, the upper limit for lending rates at rural credit cooperatives and country financial institutions increased by 10% and 30% respectively. In 2000, PBOC loosened controls over rates for the pound, Swiss franc and Canadian dollar, leaving only US dollar, euro, yen and Hong Kong dollar currently are regulated by the PBOC [12].

Traditional money supply and demand theory suggests that the growth of money supply equals the sum of economic growth and inflation. The situation in China is far more complicated, representing a picture of mixing inflation and deflation. On the one hand, when the money supply growth rate exceeds the economic growth rate, the inflation occurs. The period before 1998, year 2000, 2001 and 2003 all experienced inflation. When fast monetary expansion is on the way, inflation is becoming a serious concern for the central bank. On the other hand, China has also experienced mild deflation between 1998 and 2000, and year 2002 with consumer price index between -1% and 1%. Xie [12] reported that the rapid growth of China economy and deflation is coexistence. The rapid growth economy should establish on the growth of aggregate demand, while in China, the rapid economy growth is result from the proactive fiscal policy such as investment and exports. In 2002, total investment was RMB1.4462 trillion, total exports was US\$142.1 billion with annual growth rate 21.5% and 5.4% respectively. However, the consumption growth rate has slowed down in the same period, RMB1.9959 trillion in retail sales

of consumption goods which was 8.6% lower than the previous year, indicates conservativeness in consumption rather than current economic growth. Deflation thus occurred when actual consumer demand is insufficient. The mixture of inflation and deflation is an unusual economic phenomenon. The role of central bank therefore, is not only fight inflation, but also need to prevent deflation through a stable currency and monetary policies [13].

## Reform of Banking Sector

Rapid expansion of money supply in China not only contributes to investment boom but also results in US\$500 billion in non-performing loans. Four major Chinese banks have been in serious financial trouble for some time with higher than 10% bad-debt ratio which is over the international warning level [12]. The main task for the banking regulators is to balance the increased need of lending and the risk associated with bad debt [14]. The government is considering forming a new banking regulatory commission as a rescue package, including disposition of nonperforming loans, improve loan quality, prudent accounting standards, and strengthen risk management. In 1999, China established four asset management corporations (AMCs) specializing in disposing, restructuring, contracting-out those nonperforming loans.

As a result, RMB361.84 billion of nonperforming loans had been disposed in 2003. Implement loan classification system to ensure loan quality statistics. In 2002, the five-category loan classification system has been introduced to the entire banking industry in order to reflect loan quality accurately. Prudent accounting standards have been further emphasized in the banking regulation. Clean up NPLs and collect interest are clearly regulated according to related rules, The new banking regulatory commission also increased bad-debt reserve ratio as a means to prevent NPLs. The new regulation has set several commercial banks loan authorization and examination mechanisms, separating the supervision and loan-granting systems, strengthen credit risk evaluation, examine loan repayment, and improve the accountability of loan clerks. The objective of this new regulation rescue package is target at 2-3% drop in the ratio of NPLs to total loans and 15% decrease in bad-debt ratio every year start from 2005. However, in a long run, this paper views the problem of NPLs won't be drastically improved unless the problems of loss-making SOEs are tackled because most of the funds are allocated to SOEs of which 40% are loss making. Nevertheless, the banking regulation should be designed upon a close relationship between the PBOC and the Banking Regulatory Commission. As such, they can integrate the risk management of financial market and together maintain the safety of the banking industry [12].

## Reform of Exchange Rate

The pressure of deflation was emerged since 1998 Asian Financial Crisis. All the macroeconomic policies that were adopted during this time in China aimed at overcoming the economic slowdown and the threat of deflation. The major measures that the government employed was fiscal spending on infrastructure, interest rate lowering, export by tax rebate encouragement, and increasing money supply [15]. In April 1998, the government announced a huge investment program, involving annual expenditure of RMB 2 trillion (\$ 240 billion), amounting to 2.5 percent of GDP. The focus of spending was transport and telecommunications, water conservation, environmental protection and residential housing. In addition to increased lending by Chinese banks, funding was provided through the capital market,

increased investment, and low- interest overseas loans and bond issues. Meanwhile, money supply increased year by year. The amount of M2 in 2000 was almost 15,000 billion, compared with 5,000 billion in 1995. Monetary conditions were progressively eased via cuts in interest rates and a reduction in reserve requirements [11].

According to the IS-LM Model by Godley and Cripps [16], when the government increases its expenditure, the IS curve shifts to the right, which leads to income and interest rate increasing. When the government increases its money supply, the LM curve shifts to the right, which leads to income increasing, but interest rate is decreasing. This model seems to fit the Chinese economy very well. Because of the fiscal expansion and increasing money supply, the Chinese real GDP annual growth rate was more than 7%, despite the unpleasant international business environment. This growth rate is largely due to fiscal expansion. Therefore the real interest rate was raised slightly, although the nominal interest rate was cut several times. The effect of monetary policy in China seems far less than that of fiscal policy. In reality, the government took the fiscal policy, rather than monetary policy, as the major method to stimulate economic growth (Figure 3).

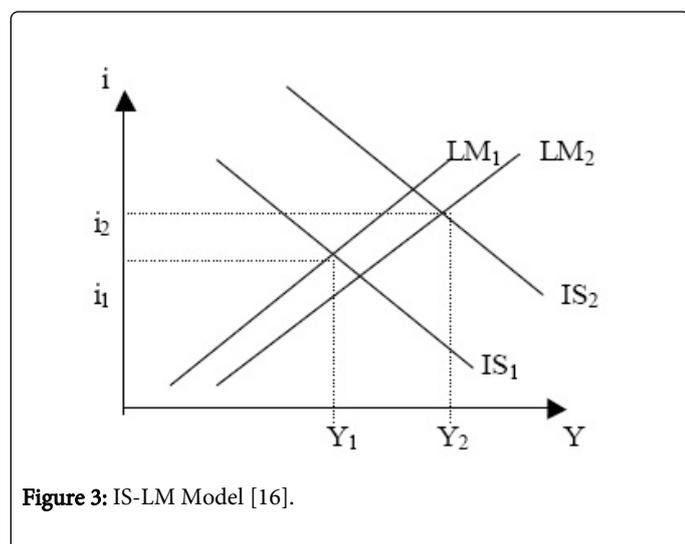


Figure 3: IS-LM Model [16].

Despite China internal financial sector weakness, its external financial strength is obvious—strong balance of payments, large foreign exchange reserves, a stable currency and modest foreign debt. This external strength helped to stabilize the China’s economy, most importantly, helped China to sail through the 1997 Asian Financial Crisis. Its exchange rate namely “managed float” exchange rate system, in particular, has served as a key anchor for monetary policy for many years with Renminbi/Dollar exchange rate has been tightly fixed between 8.2RMB and 8.3RMB to 1 US\$ for 6 years [13]. In fact, the “managed float” exchange rate essentially is fixed exchange rate. The fixed exchange rate is one of the factors contributing to current overheated economy. Under fixed exchange rate system, an expansionary fiscal policy such as the reduction in export tax become increasingly powerful, shifting the IS curve to the right [16]. Coordinated the monetary effect of the change in the balance of payments will reinforce the fiscal policy and lead to a bigger rise in national income. For instance, in 2000, the government decreased the export tax by 2%, this actions were accompanied by PBOC mandated increases in commercial bank credit of 420 billion yuan. The effect was total fiscal revenue reached US\$161.6 billion, and the increased in fiscal revenue was attributable to rapid economic growth [17].

Under the present circumstance, floating the yuan would lead to repetitive appreciation. That is evident from the Japanese experience. From the 1970s to the mid 1990s, a series of appreciations in the yen sent the Japanese economy into a deflationary and zero interest rate trap. In China, once the exchange rate begins to fluctuate, the dollar assets will look riskier and private holders will reduce to hold them, forcing an appreciation in the value of the yuan. This appreciation will repeat itself as China’s balance of payments surplus — large inflows of FDI plus small current account surplus — continues to produce liquid dollar assets that China’s private sector will be less and less willing to hold. As the appreciation continues, domestic price levels which were fluctuating between inflation and deflation — will begin to fall. As a result, interest rates will be pushed down to zero, making it impossible to stop the deflation — very much like the trap in which occurred in Japan. China has had a trade surplus since 1995; however, if an appreciation in the yuan is applied, Chinese exports will become more expensive in dollar terms, economists believe that China’s trade surplus could be reduced [11] (Figure 4).

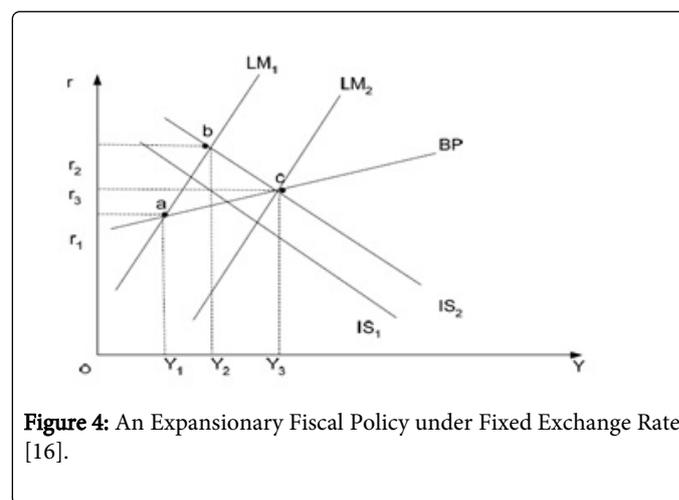


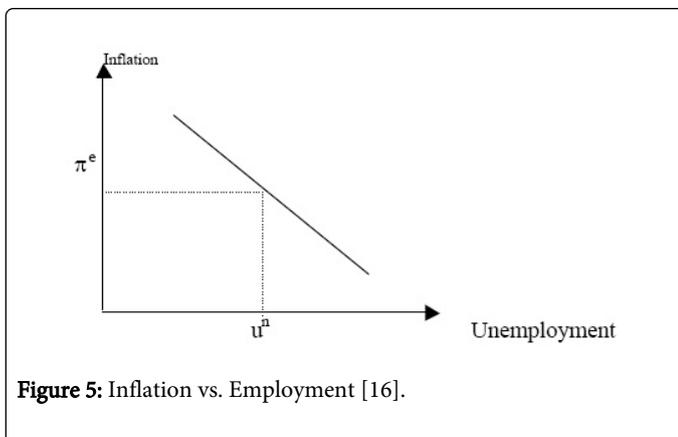
Figure 4: An Expansionary Fiscal Policy under Fixed Exchange Rate [16].

### Financial System Reform and its Challenges

In the past few years, China seemed to rely overly on fiscal policy. Indeed, in the last five years, the fiscal stimulus program was the main engine of GDP expansion in the Chinese economy. Although fiscal and monetary policies are effective policy instruments to deal with fluctuation in the short run, in the long run, the income level of a country is settled by capital and labor, among which human capital and technology progress are the most important [18]. This report recommends that China have a view to the future and pay attention to education and technology progress, in which it has not invested much.

From the aspect of short-run economic policies, recommend that China reduce its use of fiscal policy. Although official figures show domestic debt at only 15 per cent of GDP, many economists believe that if contingent liabilities in the form of bad debts in state banks, unfunded state pension and social welfare liabilities are counted, domestic debt levels quickly climb to near 100 per cent of GDP, which is very dangerous [11]. On the other hand, fiscal expansion tends to crowd out private investment, which is harmful to China’s ability to get out of the current downturn. China may increase the use of monetary policy. Generally, the increasing of money supply tends to cause higher inflation, which governments try their best to avoid. As for the case in current China, inflation may be the first enemy since its CPI has been going up for a couple of years and its unemployment rate

has been high. So, appropriate increase of its money supply will not cause much pressure of inflation, but will be helpful to lower its high employment as predicted by the Phillips Curve [16] (Figure 5).



Although the credit plan is the main government policy and historically governed each bank's credit volume by different types of lending, and translated the government's investment plans into reality, it is becoming an increasingly ineffective monetary mechanism. In the economic transaction, the government unusual important role in determining the allocation of credit by commercial banks is direct contrast to the market forces in allocating resources [19].

The weakness of the central bank in monetary management mainly from the key instrument for allocating resources—the credit plan, the means by which the People's Bank of China influences aggregate demand and controls the money supply. Although effort has been made towards open market operation, this monetary instrument is still inflexible and not fit in the economic transition [19]. The power of the central bank should be increased to enhance its ability at macroeconomic management to achieve monetary and price stability. To increase the central bank's ability in managing monetary policy, the rule of the thumb is to shrinking the coverage of the credit plan. This paper also suggests the central bank enhance the use of reserve ratios, asset-liability ratios and the rediscount facility, more actively inject liquidity into the financial system. Furthermore, the central bank needs to permit greater flexibility of interest rates in the money market. Without such flexibility, open market operations would not be able to manage. Nevertheless, a good supervision ensures safety, soundness and stability in the banking systems. The central bank's efforts to manage monetary policy in a more effective manner will be difficult if its bank supervisors fail to ensure that banks follow its prudential and regulations. Finally, a two-tier banking system which popular in most transition countries is strongly recommended to facilitate the transaction of the "monobank" system into a real banking system structure with one based central bank and a large of competitive commercial banks [20]. Before successfully completing the transaction process, the commercial banks are actually functioned as agents of the state rather than banks as they are not yet entirely free to lend according to commercial criteria [21]. Another feature of commercial banks is the mixing of policy-oriented loans and profit-oriented loans, which is one of the reasons for moral hazard problems. When the commercial banks are responsible for both policy lending and commercial lending, it is difficult to monitor the funds from a less profitable allocation to a more profitable allocation of financial resource. As such, information asymmetry problem arise which direct result in moral hazard problems. To assisting the transformation, state

commercial banks may have to decentralize branch systems, manage high operating costing and oversized workforce, more importantly, deal with nonperforming assets. Suggests reduce in scope and detail of the credit plan and the steady deregulation of interest rates. The government should also increase the level of competition within the financial sector. Under WTO membership, state owned commercial banks are facing intense foreign competition. These is increasingly emerging to resolve state owned commercial banks financial problems and reinforce financial reform, avoiding the loss of international credibility and WTO rulings against it [21].

Comparing with bank financing, capital markets in China just plays a marginal role. The value of bank loans in the year 2000 was ten times the value of bond and equity issues. It also suffers from distortions in pricing, access, and market development because it is subject to the same constraints and controls as the rest of the financial sector [22]. This paper suggests to increase the efficiency, stability, and transparency of capital markets and reduce systemic risk by shrinking of the credit plan in controlling share and bond issues, using equity markets to encourage enterprise to improve their operational efficiency, international financing standards of the New York Stock Exchange and Stock Exchange of Hong Kong could be a source of enterprise governance discipline. The capital markets should provide a greater diversity of financial instruments to enhance open market operations including derivative securities (futures and options), forward contracts in currencies, and more enterprise bonds and shares. Under this circumstance, the banks could quote forward rates and hedge forward transactions across a broad range of maturate. Forward operations will speed up integration between the banks' foreign exchange and domestic operations. However, the liberalization of capital market must with control to stabilize the domestic economy. If there is potential of high inflation, the government should slow down the capital market reform process and cope with rising prices. The biggest constraint in China that deterring successful financial reforms is actually the poor performance of SOEs. The SOEs absorbed more than 75% of bank loans; however, they have experienced a substantial decline in profits regardless the overall economy is fast growing. Dorn [23] argued that there is no real capital market in China where SOEs dominant the stock exchanges with 70% shares are non-tradable. Schroeder [24] also argued that the China financial market would only serve as a secondary role unless the ownership of industry could be changed and bankruptcy would allowed. Maintaining the dominance of SOEs will reduce China's potential wealth, privatization or some called "marketization" is the only way to create new wealth as inefficient SOEs disappear. For instance, the precondition of privatizing SOEs leave the room for free investment, the value of capital thus will be maximized for the benefit of both shareholders and consumers. The privatization of the SOEs therefore is a key to successful financial reforms. Only by this way, all the other problems that discussed in this paper are likely to be solved. However, the challenge is how to make economic liberalization to be consistent with political liberalization.

The financial system in China has made considerable progress during the past decades; however, it has not yet been transformed to a market-oriented system. While development of the stock market is clearly important, in the next 10 years, it is unlikely for the stock market to dominate banking industry in the means of allocating financial resources because China's stock market is still at a low stage of development. Corrigan [25] argued that the highest priority should be placed on the reform of the banking-oriented financial system. From asymmetric information point of view, banking-oriented

financial system is more suitable for China. As a relative information-poor environment, most of Chinese firms find it difficult to build reputation; the lack of managerial talent and experience suggest that investors monitoring will be critical. Despite the fact that the banking-oriented system is more suitable for China in short run, further decentralization of banking sector is still crucial. Where the four main state-owned commercial banks are the core of the commercial banking system in China, there are plenty of room for regional banks and urban and rural credit cooperatives. The possibility of further decentralization could be achieved by establishing second-tier banking, namely regional banks together with urban and rural credit cooperatives. The two-tier banking system is considerable because it not only can contribute funds, but also create a competitive environment by promoting decentralization.

## Conclusions

The major financial reforms of China during the past decades were focused on reducing government intervention by removing of credits plans, interest rate deregulation, tightening financial prudential practice and financial sector restructuring. Although a remarkable progress has been achieved, China's current constrains within financial system deter the country's development in a long run, and the government-determined financial reform and state-owned enterprises are the bottleneck. Strong efforts should be made to speed the privatization of the SOEs, fostering competition among commercial banks, liberalizing interest rates, increasing autonomy of the central bank, promoting capital market mobility and floating exchange rate. Nevertheless, unlike Eastern Europe and Russia where mass privatization is imperative, China should adopt an incremental, "bottom-up" and gradual approach, aiming the efficiency of the transition process and stabilization of the society. By the next stage of China's financial designing, the proposed institutional changes should intended to represent a significant step in the transition towards market-oriented financial system.

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