China’s Financial Sector: Contributions to Growth and Downside Risks  
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Any evaluation of China’s financial system and its prospects must concentrate on its contribution to China’s economic growth and to related solutions to a range of domestic economic goals. The evolution of China’s financial system, in all its various dimensions, is in midstream, with its many market and non-market aspects reforming simultaneously. Its hybrid nature, with aspects considered by foreign observers to be not only unconventional but inefficient, in fact appears to serve China’s current needs relatively well. The requirements for continued reform include maintenance and improvement of non-market, policy directed, components at the same time that immature market-based components struggle to overcome the considerable handicaps imposed by the human resource and institutional shortcomings of a country with GDP per capita below US 2,000 dollars.

China has faced and continues to face a range of domestic economic challenges directly associated with its rapid growth and market system reforms. The most important challenges are (1) job creation to restructure China’s labor force away from low-productivity rural interior activities, (2) accelerating construction of urban infrastructure, and (3) countering the weakness of China’s tax base and other public financial resources. China, starting as it has from very low levels of GDP per capita, is attempting to leap ahead into middle-income-country status in the span of only several decades. Its economic, social and political foundations are all changing and expanding at once.

A cornerstone of Chinese economic and financial policy, therefore, is the requirement for China to continue to support rapid economic growth and job creation at the same time that it modernizes its financial system. In this setting, it is useful to emphasize the two-part nature of China’s financial system—a market-based competitive component and a government-directed public component.


China’s market-based financial system was essentially non-existent in 1978, at the outset of the post-Mao reform period. Today, it has most of the institutional forms of a traditional modern financial system, even though the functionality of those institutions is immature and even though the financial role of other non-traditional institutions, especially China’s planning commission, is especially strong. The system’s evolution from 1978 to today has been relatively rapid, and change continues at an impressive pace. Last week in Beijing, China’s premier chaired a special meeting to map out strategies for the next phase in China’s financial sector reform, the first such meeting in five years.

When what the Chinese call “Reforms and Opening up to the Outside World” began in late 1978, China’s economy was governed little by monetary factors. Instead, plans, quotas, directives and ration coupons allocated virtually all goods and services, including all labor, investment, material inputs and distribution of final product. Nevertheless, money still mattered. Government budgets were prepared and examined, and deficits were avoided. Prices—the link between physical flows and money—were administratively set to keep real and monetary flows in balance. The banking system consisted essentially of a single mono-bank that acted as a comptroller for government budgetary activity, which included the finances of nearly all enterprises and government agencies—their investment decisions, allocation of funds from depreciation charges and distribution of all profits. Government finance and economic activity were thus merged—with a miniscule policy role for taxation or credit of any kind.

Economic reforms over almost three decades have relentlessly increased the role of independent financial activity. First, in the 1980s, socialist communes in rural areas were broken up into family-farmed units. State-owned enterprises were placed under the control of individual managers, who were in principle hired to deliver profitability. Bankruptcy became a legal possibility. As reforms disbanded many ration systems, prices adjusted in the direction of scarcity and demand for products like cotton cloth and vegetables. China’s mono-bank broke into a central bank and four large so-called commercial banks. Other bank-like institutions and activities appeared, including trust and investment companies, local investment banks, finance companies, rural and urban credit institutions, savings clubs and even experimental private banks. Credit instruments included so-called bank loans, government treasury bills, a smattering of corporate bonds, and a wide variety of informal promises to pay issued by local governments and their various projects. The decade ended with financial turmoil and reform-induced social unrest at Tiananmen in 1989.

A second phase of economic and financial reforms in the 1990s greatly accelerated the pace of change. Price reforms eliminated food ration coupons, but at the cost of high rates of inflation in the period 1992-95. Stock markets, albeit heavily government manipulated, were launched early in the decade, along with indigenous brokerages and investment banks. Corporate governance initiatives advanced more modern forms, including stock-share companies and boards of directors. Some government bonds became tradable on secondary markets. Internal controls for major commercial banks strengthened dramatically as part of inflation-control efforts.

The process of establishing a legal framework for these reforms also gathered momentum in the 1990s with passage by the National People’s Congress (NPC) of a central bank law, a commercial bank law and a company law. China in the mid-1990s created three so-called policy banks, for agriculture, foreign trade and domestic infrastructure, as a way of relieving commercial banks of the burden of making government policy-directed loans, which continued on a large scale nevertheless. Indeed, recognition that many so-called bank loans from the 1980s had been prompted by government policy rather than profitability led to a series of steps in the late 1990s to recapitalize the four main commercial banks by transferring bad loans to holding tanks called Asset Management Companies (AMCs). Such transfers were at the same time part of an aggressive reform of corporate management that resulted in widespread closures, mergers and layoffs—with as many as 50 million workers laid off between 1996 and 2005.

Insulated from the 1997 Asian Financial Crisis because of strictly managed short-term international capital flows, China nevertheless struggled late in the 1990s with unacceptably slower GDP growth and declines in rural household consumption—mainly because of domestic...
policy errors. Despite these overall difficulties, by the end of the 1990s China’s economic and financial institutions had survived ten years of dramatic change.

The greatest pressure for market-based economic and financial reform in the new century came from China’s 2001 accession to the World Trade Organization (WTO), which included a range of requirements for reform and increased competition in banking and insurance. Beginning in December of last year (2006), foreign banks must in principle receive equal national treatment in China’s domestic banking markets. WTO accession did not, however, allow foreign investment banks and brokerages the controlling access to China’s domestic market that many had hoped for.

Continued recapitalization of state-owned commercial banks since 2000 ushered in a stronger role for the central bank in the process of financing such bailouts. This central bank role including creation of a new quasi-AMC named, for short, Huijin, in part backed by rapidly growing foreign exchange reserves. Increased reserves fed heavily by capital inflows in turn prompted introduction of exchange-rate system reforms that significantly increased the potential for flexibility in the price of China’s currency. The decade has also seen reforms creating or strengthening financial regulatory bodies overseeing banks, insurance and securities markets. Expansion of the banking system to so-called second-tier and stock-share banks, already significant in the 1990s, continued, as did activities of relatively new urban municipal banks, converted from earlier urban credit cooperatives. In recent years, three of China’s four major commercial banks have issued stock on Hong Kong and domestic stock markets and accepted minority strategic investments from some of the world’s largest banks.

It is impossible to mention here all dimensions of China’s market-based financial system and its reforms to-date, but the pace of change has been intense and has drawn China into a wide range of multilateral and bilateral international collaboration and consultation.

Nevertheless, China’s market-based financial system remains immature in nearly all dimensions. At the formal national and provincial level, it is decades away from playing the full-fledged mature role financial systems play in more established market economies operating at higher standards of living—like those in Hong Kong, Japan, North America and Europe. The markers of China’s financial immaturity include the system’s opaque corporate client base, whether state-controlled or private, its shaky consumer-credit client base, governance weaknesses in financial institutions themselves, immature regulatory institutions, ineffective supporting legal and judicial institutions, and inadequate accounting standards and institutions. At the same time, as we have seen, early-stage reforms addressing just these elements have advanced rapidly in the recent decade and can be expected to continue for several decades more.

When describing China’s market-based financial system it is essential to give an important place to what Chinese financial and investment statistics call “self-raised funds.” These are the combination of equity contributions and retained earnings, including depreciation charges, which firms and families apply directly to capacity expansion in ways that seem potentially most profitable to them. In this sense, these funds are highly market oriented. What is more important, these private funds are reportedly much larger as a source of investment funds than bank loans. In other words, evaluation of the scale and efficiency of China’s market-based financial system must necessarily include evaluation of the effectiveness of such private flows. Their scope and opportunity for profitable return is arguably greatly expanded by the large-scale public investments in education, public health, transport, and communications which have underpinned recent decades of rapid growth.

China’s current and future challenge is to continue the rapid pace of market-based financial reforms while at the same time sustaining China’s overall high-speed economic growth. In this
regard, it is important to acknowledge the effectiveness and growth contribution of the second, non-market, dimension to China’s financial system.

B. China’s Publicly Directed Financial System

China’s evolving and so-far successful method for meeting the public financial dimensions of its many development challenges has utilized a public finance and fiscal system that goes beyond relying on market-based finance, government taxes, direct government borrowings and budgetary allocations. Without the successful operation and reform of government-directed finance, rapid growth of the kind China has implemented since 1978—and expects to continue for several decades—is difficult to imagine.

China’s domestic fiscal and public finance system relies on a number of fundamental non-market components. First is its capture, directly and indirectly, of citizen and business deposits in financial institutions as a major source of public funds. Second is the public administrative channeling of these funds, mainly through development banks and so-called commercial banks, to bottleneck investments vetted by public investment evaluation agencies—most importantly the planning commission (now officially known as NDRC, the National Development Reform Commission). Third is the administrative disciplining of public investment projects for cost-effectiveness and timely repayment of related loans, as project-related fees, taxes and profits become available. Fourth is Communist Party and government pressure on large firms in bottleneck sectors to fund rapid expansion of their operations. Finally, fifth, China’s central bank, far from being independent, is necessarily an integral part of this quasi-public investment funding system.

At the outset of reforms in the early 1980s, virtually all Chinese finance was government-directed at one level or another. Superficial reform of the banking system and company governance in this decade in principle converted government budgetary control to autonomous decisions on use of bank-loans and retained earnings. In practice, investment and labor remuneration decisions were heavily guided through the Party affiliations of leaders and managers in most financial and corporate entities. Since before the reform period, state enterprises and collectives routinely played a public investment and management role, using internal funds for infrastructure, social services and employment maintenance as a public good. A 1980s example of partial formal reform in this system, which in practice changed little, was the “disbursement-to-loan” (bogaidai) policy converting government budgetary disbursements for corporate activities to state bank loans supporting those same activities. Few of these “policy” loans were ever repaid, leaving them as non-performing assets on bank balance sheets.

Important reforms in the 1990s gradually honed the use of policy lending to restrict it more narrowly to “public goods” investment lending in two very different dimensions. The first is public infrastructure—roads and railroads, urban and rural water systems, ports, airports, government offices, educational institutions, and, in a less strictly public goods sense, telecommunications backbones, electric power generation and distribution grids and other energy supply networks, especially gas and petroleum. The scale of the need for such investments was far greater than China’s weak tax base and budgetary borrowing could support.

The second “public goods” component interprets economic development leadership as a public resource. Investments in this category have encouraged expansion of productive capacity more rapid, in the opinion of government officials, than market forces would foresee as necessary or profitable—in basic industries like steel, chemicals and telecommunications and in services like transportation, tourism and healthcare. In many cases, the bulk of actual investment
funds in these sectors came from retained earnings and other equity-related sources, but bank lending also continued to play a role.

The 1990s also strengthened the independent financial role of banks in particular by allowing them to opt out of lending for many public projects they found financially unattractive. At the same time, management of public and quasi-public expenditures continued to improve with the introduction of competitive bidding for implementation contracts on many public projects. At the same time, the same reform of state enterprises in the latter 1990s that produced so many closings, mergers and layoffs also eliminated many corporate lending obligations for state banks.

Since 2000, reform in the public dimension of China’s financial system is best represented by the growing role of China’s State Development Bank, created as part of banking reforms in the middle 1990s. The State Development Bank raises funds by selling bonds to state-owned commercial banks and has become a sophisticated issuer of a wide range of instruments. In addition to supporting major infrastructure projects like dams and airports, it has evolved a strategy of making numerous modest loans to many of China’s municipalities and counties for a wide range of infrastructure and other public projects. Its compliance strategy has been to insist that any county or municipality that wants to receive lending for a new project must remain up to date on the servicing of its existing debt to the Development Bank. As a consequence, it reportedly has the healthiest balance sheet of any Chinese bank and is one of the most profitable banks in Asia.

In sum, China’s publicly directed financial mechanism is an integral part of its overall financial system. Its effectiveness in large part reflects China’s administratively set low deposit rates at state commercial banks—supported by the limited alternative passive investment opportunities for citizens and companies. These low deposit rates help ensure a reliable low-cost flow of funds for strategic public investments, defined broadly. It is this public and quasi-public lending which arguably enables the hardware and software underpinnings of China’s largely competitive profit-oriented economic expansion.

Any evaluation of China’s financial system and its prospects, therefore, must recognize that both market-based and government-directed dimensions are inseparable aspects, the Siamese twins as it were, of China’s financial system.

C. Evaluating the Effectiveness of China’s Financial System

China’s two-part financial sector is open to criticisms that it allocates investment funds inefficiently. In addition, some critics write that low interest rates and government directed credit saddle the banking system with excessive and poor-quality loans, which will eventually require government-assisted work-out. China’s high rate of national savings – over 40 percent of GDP in 2005 – is presented as evidence of excessive and inefficient lending.\(^2\)

Evaluation of these criticisms and China’s financial sector performance itself, however, leads to the opposite conclusion. China’s financial system appears to generate a reasonably good rate of return to investment and has succeeded in sustaining over 15 years of rapid growth, with capital investment efficiency roughly equivalent to India’s.

One of the crudest measures of investment effectiveness is one of the most persuasive because it is so straightforward—the incremental capital-to-output ratio (ICOR). This is the ratio, for any year, of (a) how much capital is contributed to productive processes by the end of the

previous year and (b) how much additional output is generated in the current year as a result. There are a number of ways to calculate ICORs, but in low-inflation countries with relatively stable investment rates, the variations are not large. It is also important to acknowledge that ICORs can vary significantly from one year to the next because of variations in demand-induced growth, so rather than reporting individual yearly results, it is more meaningful to consider 5-year, 10-year and even 15-year averages.

For China, a major factor in calculating its ICOR is to agree on an accurate real GDP growth rate. After its 2004 economic census, China revised its official growth rates for recent years, to an average annual growth rate of 9.5 percent for the five years 2001-05. The GDP measurement method behind these averages is known as the production method. Using a different method, the expenditure method, which is arguably more widely used internationally, average growth for this five-year period is either 11.9 percent or 12.3 percent, depending on data choices for household consumption.

Given China’s rate of investment in fixed assets as a share of GDP supporting growth in these five years, roughly 39-percent, different growth rate statistics yield different average ICORs—an ICOR of 3.9 with official growth data and an ICOR of 3.1 with expenditure-account growth data. For the fifteen-year period 1991-to-2005, China’s ICORs are 3.4 and 3.3 for official and expenditure methods, respectively.

These ICOR measures of overall investment efficiency are respectable. Similar calculations by the author for India, with its heavily market-based financial sector, are 4.1 and 5.3 respectively for 2001-06 and 1991-2006. China’s ratio of investment required for new output gains is thus significantly lower than India’s, even though India’s economic growth is based more heavily on services sectors, which are by their nature less dependent on capital investment for growth. Even if we select favorable years for India, to avoid its poor growth year of 2002-03, India’s three-year ICOR for 2003-to-2006 is 3.5, roughly in the range calculated for China over longer periods.

For rapidly growing Asian economies in earlier decades, Kwan, 2004 reports that Japan’s ICOR in the 1960s was 3.2, while South Korea and Taiwan in the 1980s were 3.2 and 2.7, respectively. To the degree that these records are better than China’s, they are only marginally so.

Some research appears to dispute these results, but on closer analysis, China’s respectable measures for investment efficiency hold up to scrutiny. In the same research note cited above, Kwan calculates China’s ICOR for the three years 2001-03 but obtains a significantly higher figure of 5.0 by using lower, pre-revision growth rates and by using a measure of investment known to be too high because it includes purchases of land and used equipment. With revised official growth data and a fixed-asset investment share taken from China’s national accounts (that averages 35 percent for the relevant three years), China’s ICOR for 2001-03 calculates out to be 3.8, significantly lower than Kwan’s result.

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3 For the methodologies behind these different estimates by the author, see Albert Keidel “China’s GDP Expenditure Accounts,” China Economic Review, 12 No. 4 (2001), pp. 355-67.
In short, by the measure of its ability to allocate investable funds in ways optimal for sustaining high-speed growth over many years, China’s financial system seems to have been doing its job quite well so far. A second empirical exercise, measuring the overall rate of return to investment in China, corroborates these results.

A recent National Bureau of Economic Research working paper by Bai, et.al. cited already calculates annual non-labor income as a percent of China’s total net accumulated capital stock and obtains a rate of return on capital that falls from 25 percent in 1993 to 17.5 percent in 2001 before rising to 21 percent in 2005. The authors note that even as China’s share of GDP allocated to fixed asset investment rose above the 40-percent level in 2005, the rate of return on capital held steady. Adjusting their methodology to allow similar calculations for China and all countries in the Penn World Tables, Bai, et.al. report that China’s rate of return to capital was higher than that for 49 other economies, that is, higher than for all but two economies in the sample.

These empirical results are useful. They qualify the common theoretical impression that China’s financial system must be inefficient because of government’s heavy interference directing credit to infrastructure and other “strategic” projects. China’s financial system is also thought to be inefficient because of the still limited role for foreign firms in its investment banking and brokerage businesses. Finally, as mentioned above, the high level of investment as a share of GDP is considered by many to be a sign of wasteful investment. Whatever the logic of these criticisms, actual developments in China’s economy as reflected in overall economic performance imply that such theories require significant adjustments for a real-world economic setting such as China’s.

D. Risks to China’s Financial System

Given that China’s financial system appears to be performing adequately, and given the current and future needs of China’s economy, what are the risks that this financial system could suffer a major crisis? The cursory review below of the various dimensions of China’s financial system indicates that the only significant risks of crisis would stem from policy blunders in the direction of privatizing banks and other institutions too precipitously or opening China to short-term capital inflows and outflows prematurely. In other words, many of China’s non-market government interferences in financial sector operations serve in important ways to protect the system from debilitating crises such as those encountered by Mexico in the middle 1990s, non-China East Asia in 1997, Russia in 1998 and Argentina in 2001. Sector-by-sector treatment shows why China’s risk of such crisis is extremely low—barring overly exuberant liberalizing blunders. In all these considerations, one central underpinning of China’s financial system’s stability is the lack of independence for its central bank, the Peoples Bank of China.

China’s three development banks, created in 1994, and its postal savings bank, reconstituted in 1986, form one of the system’s stabllest components. Their assets are largely national infrastructure projects and officially sanctioned activities, implicitly guaranteed by local and central governments. For the postal savings system—recently converted into a state-owned bank—a large share of assets is in central bank deposits. These institutions’ liabilities, with the possibly significant exception of the Export-Import Development Bank, of are all in domestic currency deposits and bonds, so that in the case of asset quality deterioration—such as failures of

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7 Bai, et. al., 2006, cited above.
8 Bai, et.al. 2006, Figure 10.
local governments to repay loans in an economic slump—central bank liquidity support presents a maximum risk of inflationary pressure—which the central bank has shown more than willing to sterilize by selling its own paper. The risk of crisis from these institutions is thus virtually nonexistent.

In the area of China’s financial sector risks, commercial banks have received the most attention, with a number considered technically insolvent, given the alleged poor quality of their loan portfolios. These assessments rely on statistics for NPLs (non-performing loans) which are of questionable quality, even though the formal reporting system has been reformed from the lenient original Chinese system to one closer to international standards. The strong likelihood is that NPLs are a more serious problem than official data indicate, although several factors argue in the other direction (e.g. that some client firms do not service loans because they can get away with not doing so, or that NPLs were especially serious during the growth recession of the latter 1990s, when NPLs were underreported, whereas now that corporate financials and debt service have improved, they may not be underreported any more).

The critical insight for evaluating these institutions is the realization that China’s commercial banks are not really banks. Despite their IPOs and foreign strategic investors, they are basically government-controlled deposit-taking institutions. The central bank, which is forbidden by the central bank law from lending directly to the state budget, appears however quite free to backstop all kinds of financial institutions with little regard for what happens to its own balance sheet. The quality of its assets appears to be irrelevant to China’s financial system health, and its liabilities are essentially currency in circulation, reserve deposits and central bank bonds issued to absorb that currency when necessary. Most of the banking system is thus in effect still an extension of the central bank, which is of course in no way independent from policy makers. The high degree of continued government ownership and control is in effect a limitless pool of contingent assets hidden on the books of these so-called banks. This is not a system at risk for financial failure.

In addition to the major state-owned commercial banks, China’s banking system contains numerous “second-tier” middle-sized specialized and “share-holding” banks as well as relatively small urban cooperative banks. In terms of risks posed by creation of new NPLs during the recent 2002-2004 surge in bank lending, these secondary banks, especially the relatively young urban cooperative banks, were the most irresponsible—not the large “big four” state commercial banks.

Risks associated with poor management of these other, second- and third-tier, banks have an interesting twist. The government might indeed allow one or more of these to fail. China’s central bank governor has publicly stated that this would be a possibility. By stripping all equity stakes from “owners” of such a poorly managed bank—while compensating depositors or transferring their claims to other banks—bank regulators and the central bank could discipline the entire second-tier banking community by weakening the moral hazard associated with confidence on the part of many of these firms that they would not be allowed to fail. Rather than precipitating a crisis, engineered failure of one or more such institutions would be a major step forward in market-based banking reform.

Chinese formal domestic bond markets consist largely of exchanges in the negotiable share of treasury bills outstanding, certain large corporation company bonds, sale of paper by specialized banks, including the central bank and development banks, to commercial banks, and experimental sale of RMB denominated paper by international institutions like the International Finance Corporation and the Asian Development Bank. With the exception of a few issuances by MOF of longer-term treasury bills, there is little long-term basis for determining a Chinese
yield curve, and in any event, prices on what secondary markets there are find themselves subject to direct and indirect government supervision.

The main reason that China’s bond markets are so underdeveloped is the bad reputation of bonds and bond-issuers in China’s recent decades. Failure to honor both corporate bonds and local government bonds irritated not only the purchasers but also the central bank, which in general helped make good on such losses. In general, therefore, China’s bond market is immature for good reason and is likely to develop slowly as a share of financial intermediation. In the absence of crisis-prone bond transaction patterns, such as the large-scale economy-wide issuance of high-yielding junk bonds to support risky real estate or other investments, bond markets are unlikely to become the source of significant financial risk for a decade or more.

China’s stock markets, like its bond markets, are immature and hampered by poor information about listed companies, in spite of government efforts to administratively select the candidates best qualified for listing. China’s stock markets in 2006 enjoyed a recovery after a several-year slump induced by failed efforts to resolve one of the markets’ most problematic aspects. For most listed firms, the shares that are openly traded on the market have generally been only a subset of shares outstanding. The overhang of “non-traded” shares, once government indicated they might become traded, dampened prices until early 2006, when a new approach promised to chip away at if not eliminate the overhang without undermining shareholder equity values.

Recent IPOs have indicated that a second shortcoming is still serious—under-pricing of IPO issues to provide a windfall to those with access to pre-IPO purchase options. For many years Chinese stock-market clients used the markets more as a gambling mechanism or get-rich-quick vehicle, since those with privileged access to under-priced initial offerings frequently saw the prices of their assets jump considerably on the first day of trading. China’s stock markets thus still cannot and are not taken seriously as well-functioning financial institutions. The most fundamental reason remains that information about the listing companies is still too unreliable to support a well-functioning market. With stock markets’ place in the economy still so thin, its fortunes will not be in a position to influence a country-wide crisis for at least a decade. One illustration of its essential insignificance is the abysmal performance of the market up to early 2006, while the overall economy boomed.

Finally, the array of institutional investors in China is large and growing, from insurance companies to pension funds to trust companies, finance companies and mutual funds. Many institutions and practices are in their infancy, such as mutual funds, QDIIs and QFIIs (qualified domestic/foreign institutional investor schemes). Many larger institutions, such as insurance companies, are also state-owned or state-controlled. Others, such as certain pension funds, have had little chance to accumulate assets, remaining pay-as-you-go systems with no major role in financial activities. Finally, some, like large international trust and investment companies, are on the fringes of legality by borrowing or accepting investments from abroad while investing domestically. The quality picture for many of these institutions is mixed, but none of them is large enough or poorly enough operated to represent a major risk of financial crisis any time soon. Trust and investment companies (TICs), especially those engaged in international transactions, could threaten crisis because of obligations denominated in foreign currencies, but China’s management of the Guangdong international TIC failure during the 1997-98 Asian financial crisis showed that a nimble, if uncodified, regulatory arrangement is potentially operational.

In short, because of the heavily regulated nature of China’s short-term international capital flows, the major risks posed by one or another institutional failing are virtually all denominated
in local currency. The real risk of a local-currency crisis would thus only become significant if
government unwisely tried to privatize a major bank while its balance sheet still relied on the
contingent assets represented by government control and central bank accommodation. Such
privatization would be a major blunder any time in the coming decade, and such complete
privatization is indeed not likely for several decades.

The second major risk to China’s financial system would emerge from a too-early opening up
to short-term capital flows. Without adequate internal controls in corporations and financial
institutions, and without effective regulatory bodies to ensure operational discipline for such
internal controls, freeing up capital flows would expose the economy to the all but irresistible
temptation to borrow internationally on terms denominated in foreign currencies at rates that
looked attractive because they did not include foreign exchange risks. China’s exchange markets
and relatively small and vulnerable capital markets would find themselves exposed to the kind of
one-two punch of speculative surges in and out of both markets that Hong Kong endured during
the Asian financial crisis of 1997. China’s domestic enterprises have many years if not decades
to go before their internal controls have matured, and regulatory agencies need both to
consolidate their functions and significantly strengthen their oversight capabilities. Until these
tasks are completed, opening the capital account to unmanaged short-term flows would invite
crisis.

In sum, barring major policy blunders privatizing large state banks or liberalizing
international capital flows, the risk of financial crisis in China is remote.

E. Current Reforms and China’s Ultimate Finance Challenge

As introduced briefly at the outset of this essay, China’s financial system, in two parts, has
undergone rapid change in recent decades, and especially in the last dozen years. With the
completion of its once-in-five-years national financial reform work conference this past weekend
(January 20, 2007), the current reform emphasis is clearly in several directions that point to a
long-term phasing out of government-directed finance in favor of a more commercially-oriented
system. The communiqué from the conference outlined a number of steps which, with some
exceptions, emphasized continuity with past reforms rather than a sudden or dramatic new
departure.

For example, emphasis on preparing the last of China’s “big four” commercial banks, the
Agricultural Bank of China (ABC), for stock market listing is a continuation of the process
begun in 2003, when China’s cabinet, the State Council, announced its intention to convert all of
the big four banks to stock-share governance systems. ABC has by far the worst balance sheet in
the big four, so listing will require lengthy preparation. This meeting emphasized the
continuation of this reform direction.

Most interesting, perhaps, from a system reform perspective, is the work conference’s
decision to begin introduction of commercial banking operations, but not deposit-taking, for the
State Development Bank (SDB), the largest of China’s three development banks. While the
adjustment will apparently start gradually, SDB will begin making commercial loans to for-profit
enterprises, although the bulk of its business will continue to be infrastructure and other public
projects, and it will continue to raise funds through its state-of-the-art (for China) bond issuances.

9 Based on New China News Agency (Xinhua) reports on-line, January 20, 2007:
But reform directions for both ADB and SDB indicate the very long-term goal of commercializing most of China’s current two-part financial system.

In this regard, an extension of the ADB’s reform is the work conference’s additional emphasis on reform of all rural credit systems, especially rural credit cooperatives (RCCs), which despite the launch of major reforms in 2004 still face a severely under-patronized rural client base where the potential for micro-credit and other appropriate instruments is seen as an important vehicle for reviving the rural economy—and by so doing assist China’s poverty-level households and an ambitious priority program to construct a “new rural community.” RCCs were effectively bankrupt throughout the country at the end of the 1990s, and accelerated RCC reform is a natural development in pursuing a long-term goal of commercializing rural credit in ways that contribute to rural households and firms’ commercial viability.

Many other aspects of the financial sector program going forward represent both continuity and long-term preparations for commercialization of the system. The conference stressed its emphasis on building and strengthening all aspects of capital markets, but especially corporate bond markets, in part by increasing transparency and strengthening regulatory capabilities. The meeting also stressed strengthening international competition—a clear priority given the December 2006 coming in force of WTO accession requirements granting national treatment to foreign banks operating in China. But goals in this category also include stronger commercial operations in foreign exchange markets and more capital account opening—presumably through QDIIs and QFIIIs.

Finally, workshop results mentioned the need to achieve rough balance in international payments, and they encouraged further reforms in interest rates (such as for deposits, loans and inter-bank activity) and improvements to monetary policy mechanisms. All these programs conform to a pattern stressing gradually increased commercialization of the whole system.

The outcome of China’s financial work conference directs attention to what is China’s ultimate financial sector challenge. At some point, China will have had to have dismantled its government-directed credit apparatus and have in place, ready to step to the fore, a mature and competitive modern financial sector. This means, in the best of all worlds, that the structure and partially mature dimensions of the eventual modern commercial system must continue to take shape and gain experience while the government-directed dimension continues to improve the way it carries out its essential functions of funding public and other strategic projects on a scale and at a pace that a private commercial system could never accomplish.

The final conversion to a fully commercial system is more than twenty years away and possibly more than thirty, according to opinions of knowledgeable Hong Kong financial specialists. In the meantime, the question is not whether China’s financial system can catch up with the rest of the economy, but how it can continue to do the job of underpinning its success as it gradually grooms its replacement—a fully commercialized financial system for the middle of this century.