

China

2006 and beyond

The Chinese financial system has come of age. **Howard Davies** examines what financial reforms the country is considering.

'The Chinese economy has expanded at around nine per cent a year for a quarter of a century'

In many respects, the Chinese financial system is already very well developed. Earlier this year the McKinsey Global Institute published a report on the world's capital markets. At the end of 2003 the global financial stock had reached \$118 trillion, with the Chinese share at around four per cent.

But that share of financial assets has been growing fast. Over the last ten years Chinese financial assets have been growing at 14.5 per cent a year, almost twice as fast as the world average. So the Chinese financial system is maturing rapidly. Its financial stock as a percentage of GDP is already slightly higher than that of the Eurozone. Indeed, China's financial stock is six times the size of India's.

But China has been developing in an atypical manner. China accounts for four per cent of the global equity stock, one per cent of private debt, two per cent of government debt, yet nine per cent of global bank deposits. Put another way, 62 per cent of China's financial stock takes the form of bank deposits, compared with only 20 per cent in the US, 30 per cent in the Eurozone, and even in India the figure is only 45 per cent.

So the system remains very heavily dominated by the banks, and bank deposits are still growing more rapidly than equities, which is uncharacteristic for a country at China's stage of development. We typically find that in countries with GDP around the Chinese level the securities markets begin to develop more rapidly.

This dominance of bank finance has meant that the problems of the banking system are of more than usual significance in economic terms. A country so heavily reliant on bank finance cannot afford a banking system which is weakly capitalised and poorly managed. The non-performing loan (NPL) prob-

lem is the one which has attracted the greatest attention overseas. Estimates of its scale have varied hugely. Some external commentators have put the figures as high as 50 per cent of the total size of the Chinese banks' balance sheets. Official figures put it at around 15 per cent. Whatever the precise number, it is important to ask why the position has deteriorated so far, even if one accepts that considerable efforts are now being made to grapple with the issue, efforts which are being met with some success.

Essentially, we should see the NPL problem as one arising from a long period of very rapid growth, combined with political influence over lending decisions at local level.

The Chinese economy has expanded at around nine per cent a year for a quarter of a century. But while aggregate growth has been high every year, in individual regions and individual industries the picture has been much more varied. For every ten remarkable successes, there have been perhaps two or three corresponding failures. And the after-effects of those failures have reverberated through the financial system. Loans provided to the failed enterprises have remained on the balance sheets. Industrial waste, as it were, has silted up the banking system.

But why have Chinese capital markets not developed more rapidly and made a greater contribution to financing growth?

Chinese equity markets have behaved very disappointingly in recent years. The Shanghai market has repeatedly hit record lows. Why is this, at a time when the economy has clearly been doing well? Essentially because the government still owns two thirds of the equity in the country's listed firms, and its periodic attempts to sell, or rumours that it may do so, depress

prices. On top of that, the brokers are trying to stave off bankruptcy, having promised investors guaranteed returns they now cannot honour. But the biggest problem is the poor quality of the listed companies.

Looking briefly at the bond market, a superficial view might suggest that the prospects are brighter. Over the last few years far more bond finance has been raised than new equity investment. However, most of this new issuance and secondary market turnover has been in public sector bonds of various kinds, and the corporate bond market is still very small by comparison with the total outstandings in government and public sector agency debt.

So, what needs to be done? The highest profile problem relates to the non-performing loans. That, in turn, divides into two: dealing with the stock of NPLs and stemming the flow in the future.

Dealing with the stock has already involved significant capital injections, and the establishment of asset management companies – 'bad banks' which take the worst loans off bank balance sheets and try to work them out.

Within the banks themselves, a new and more commercial approach is developing as younger managers have been given targets to reduce NPLs. The announcement of moves towards flotation and the introduction of foreign minority shareholders has added additional impetus to this effort.

There remains a good way to go. Even if the actual proportion of NPLs is close to the government's estimate, that is still around ten times the proportion experienced in well managed British banks. But the authorities have made good progress, and indeed have grappled with the problems with great speed and determination. The reforms needed in the capital



GETTY IMAGES

markets may be more difficult. The government will certainly need to reduce the share overhang represented by its own holdings. Plans have been announced to begin this process through a scheme in which tranches of government shareholdings are offered to the market. It is too early to say how successful this exercise will be in removing the dampening effect on markets, but an important start has been made.

The securities regulator, the China Securities Regulatory Commission (CSRC), has set up an embryonic

investor compensation scheme for those investors who have lost money through fraudulent activities by securities firms. Again, this could be a very helpful move, though it is too early to assess its impact. The CSRC has stepped up its enforcement activity against securities firms who have misused client funds. And there has been one case of a significant capital injection by a foreign firm.

So far it is not easy to see any positive impact in terms of market confidence. In the short term, one perhaps should not expect a signifi-

cant rise in prices. The Shanghai market in fact continues to trade on a higher price/earnings multiple than Hong Kong, which suggests that current equity prices may not be artificially low. It may be some little time before confidence returns sufficiently for new Initial Public Offerings (IPOs) to emerge, which would be the best sign of a revival in the market's fortunes.

On the bond side a different agenda for change is needed. There is a need for efficient and transparent pricing benchmarks. The arrival in

the Chinese market of independent rating agencies would be helpful. With some kind of ratings structure, it would be possible to envisage listing non-guaranteed bonds, to encourage the development of credit discipline in the market.

Bond markets elsewhere also benefit significantly from liquid secondary markets and repo markets which allow short selling. There is also typically a range of derivative products which add liquidity, and there are instruments, notably interest rate swaps, which facilitate hedging strategies. Some of these features of the debt markets in New York and London will not be easy to replicate in China in the short term. But it is important to develop a strategy to introduce reforms and liberalisation over a period.

But what is needed, above all, is stronger corporate governance in Chinese companies. There is a powerful relationship between corporate governance standards, investor protection and the vitality of capital markets.

The CSRC has issued a rather good corporate governance code. But we know in the UK that there can be a considerable distance between the issuance of a good practice code and its adoption by companies. Full implementation may not occur until there is greater pressure from rating agencies and investors.

The third area in which continued progress is needed relates to the regulatory environment in China. Here the authorities have made very significant strides. The establishment of three separate regulatory commissions for banking, securities, and insurance was a positive step. They have begun large scale training programmes for their staff. In the case of the CSRC it has imported top experts from Hong Kong. All of this displays a degree

of openness to external influences the like of which has not often been demonstrated in other countries.

But in international regulation the goal posts keep moving. The technical requirements on banking supervisors associated with Basel II and its implementation are considerably more onerous than those associated with Basel I. The China Banking Regulatory Commission (CBRC) faces a considerable challenge in upgrading the skills of its existing staff and recruiting more.

The same is undoubtedly true in the other commissions as the markets become more open and more competitive. The focus of regulation is shifting towards the enforcement of transparency and disclosure and away from a 'command and control' structure. The skills and mindset needed to operate in this new market-oriented world are very different. Regulators must also create a climate in which it is expected that their staff will challenge the institutions in their charge. Creative tension is the key to well functioning systems elsewhere in the world.

There is also a need for stronger collaboration between the three Commissions. The interactions between banking, securities and insurance markets are growing and it is no longer possible effectively to regulate one sector without understanding something of the others. In China, we are already seeing the arrival of multi-functional financial groups. So, as the reform process continues, there is a clear requirement for some kind of overarching body to ensure consistency of the regulatory approach taken in the different sectors. ■



Howard Davies

is director of the School. He is a member of the International Advisory Council of both the China Banking Regulatory Commission and the China Securities Regulatory Commission. This is a summary of a speech he gave to the Kuala Lumpur Business Club, Malaysia, in September. See www.lse.ac.uk/collections/meetthedirector

China's challenges

China's impressive rate of economic growth has catapulted it onto the world stage. With a fifth of the world's population and a GDP that makes it the sixth largest economy in the world, China's growth prospects will increasingly affect the global economy.

In the past four years since accession to the World Trade Organisation (WTO), China has emerged as a major trading partner of the developed economies in the West. In 2004, the European Union (EU) became China's largest trading partner and China was the second largest trading partner of the EU. China's trade with the US, EU and Japan is in the vicinity of \$200 billion. It has become one of the leading destinations for foreign direct investment (FDI), attracting more than \$60 billion per year, and it also holds the third largest stock of FDI in the world. In terms of competition for natural resources and energy, China's rapid growth has also been felt globally, as has the impact of its currency, the RMB.

China's model of economic growth has been centred on the transition from a centrally planned economy into a more market-oriented one. The context is also important, as China is a developing country whose population remains primarily rural. The gradualist transition path of China has allowed the government to phase in reform incrementally, maintaining stability in the economy. Perhaps chief among the challenges confronting Chinese policy makers, therefore, is the legacy of central planning, premised on the close ties among different parts of the state sector, such as the state, state-owned enterprises and state owned banks. Policy-motivated lending has generated a significant amount of non-performing loans in the economy. In terms of macroeconomic stability and the foundations for a market economy, reform of the banking and financial sectors is paramount in China's growth prospects.

Another key area plagued with legacy problems is the provision of social securities. The 'iron rice bowl', a system of lifetime employment, was accompanied by the 'three insurances', which are health, unemployment and life/casualty insurance provided by the state-owned enterprise. With the restructuring of the state-owned enterprises in the mid 1990s, the fragility of a system that is devoid of a social safety net is apparent. The sustainability of economic growth with social guarantees will be one of China's most significant challenges in the coming years.

Other challenges will include addressing a growing rural-urban divide, considerable rural-urban migration, rising urban unemployment, infrastructure and energy constraints, and environmental degradation, among numerous others.

Despite this, China's prospects remain bright so long as reforms take into account the economic, legal and social facets of marketisation. The recalibration of the economy towards consumption and the alleviation of social insecurities will help stimulate growth in the near future. The opening of China's domestic market will attract foreign firms enticed by the potential market of 1.3 billion people and will assist the introduction of international best practice into China. In short, China has arrived. ■



Dr Linda Yueh

is an MSc tutor in the Department of Economics, and a fellow in economics at Pembroke College, University of Oxford. She is also an associate of the Globalisation Programme at the Centre for Economic Performance, LSE, and a member of the Management Committee of the Asia Research Centre at LSE.