



China's Financial Markets: Fit for purpose?

Howard Davies
Director, LSE

LSE and Confucius Institute

14 October 2010

In a series of lectures since 2004, I have

- mapped the changes in the Chinese financial system
- identified the challenges ahead for China's authorities

Disclaimer:

I have been a member of the International Advisory Council of the China Banking Regulatory Commission (CBRC) since 2003. From 2004 – 9 I was a member of the IAC of the China Securities Regulatory Commission.

But

nothing I say should be seen as the official view of either of those two organisations.

Two topics



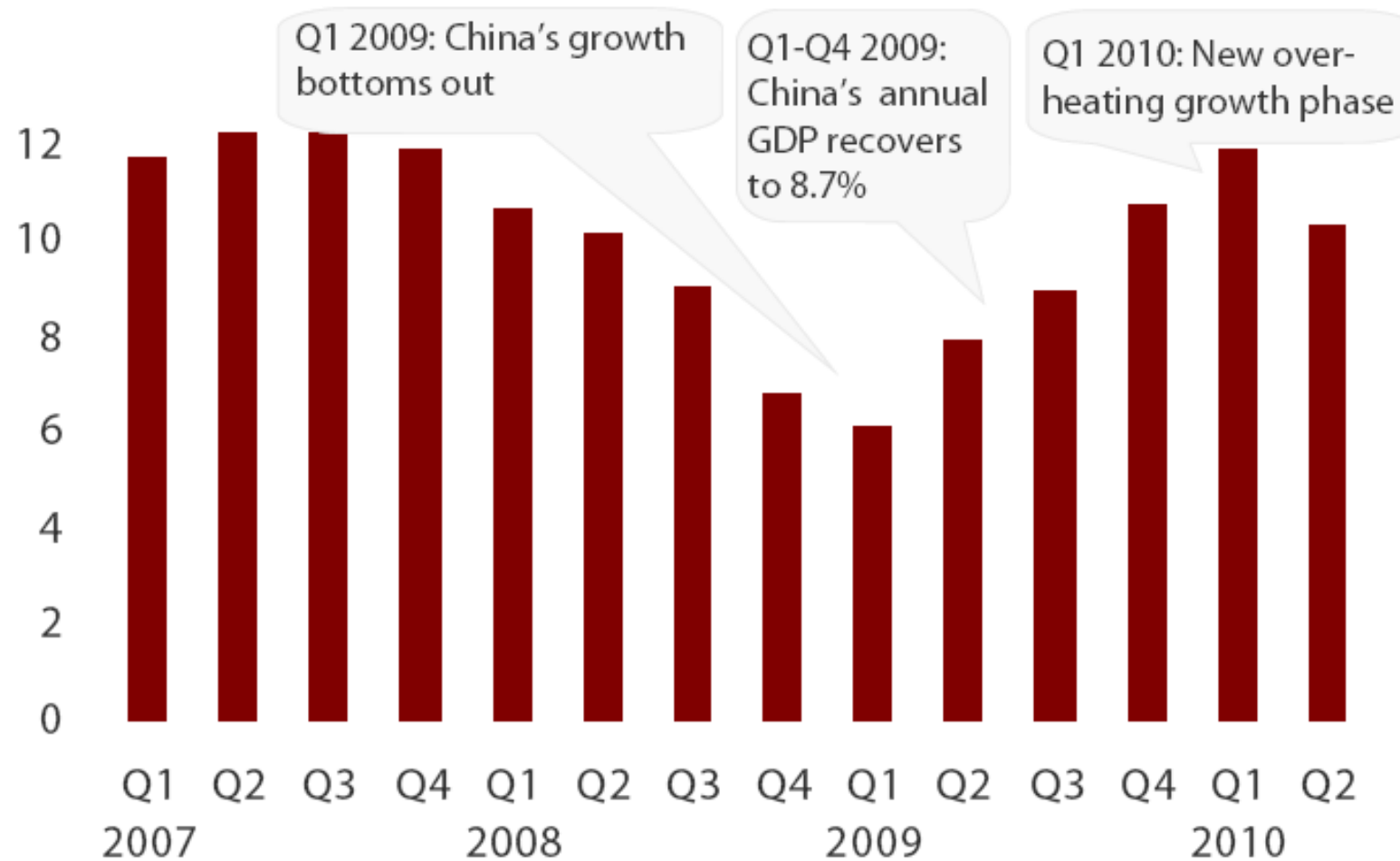
- The recent growth performance of the Chinese economy, and the causes of international tensions
- The state of the financial system and the future reform agenda

1. The recent growth performance of the Chinese economy, and the causes of international tensions

The fiscal stimulus boosted recovery, but the growth rate is now slowing



China quarterly GDP growth, % y-o-y, 2007 – Q2 2010



Source: China Monthly Economic Indicators. The BEIJING AXIS Analysis.



“China’s currency manipulation would be unacceptable even in good economic times. At a time of 10% unemployment, we simply will not stand for it.”

**Charles Schumer
Democratic Senator, New York**

“In the current environment, with high unemployment around the world and policy interest rates as low as they can go, this is a predatory, beggar-thy-neighbor policy.”

Paul Krugman

“Countries with external deficits need to save and export more. Countries with external surpluses need to boost consumption and domestic demand. ... As I've said before, China moving to a more market-oriented exchange rate would make an essential contribution to that global rebalancing effort.”

Barack Obama

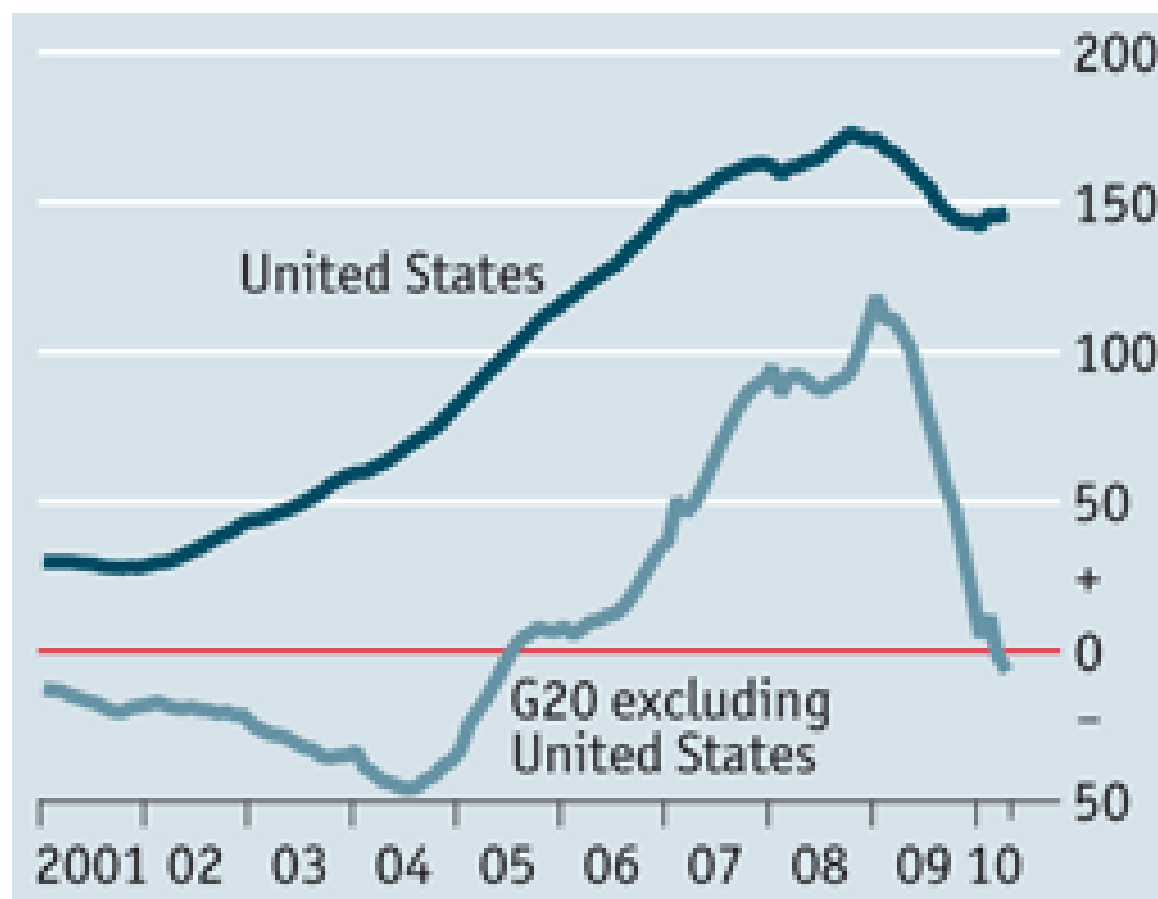
“Do not work to pressurise us on the renminbi rate. Many of our exporting companies would have to close down, migrant workers would have to return to their villages. If China saw social and economic turbulence, then it would be a disaster for the world.”

**Wen Jiabao
Brussels, 6 October 2010**

China's trade imbalance is heavily focussed on the US



China's 12-month trade balance with US and G20, \$ Billion, 2001 – 2010 Q1

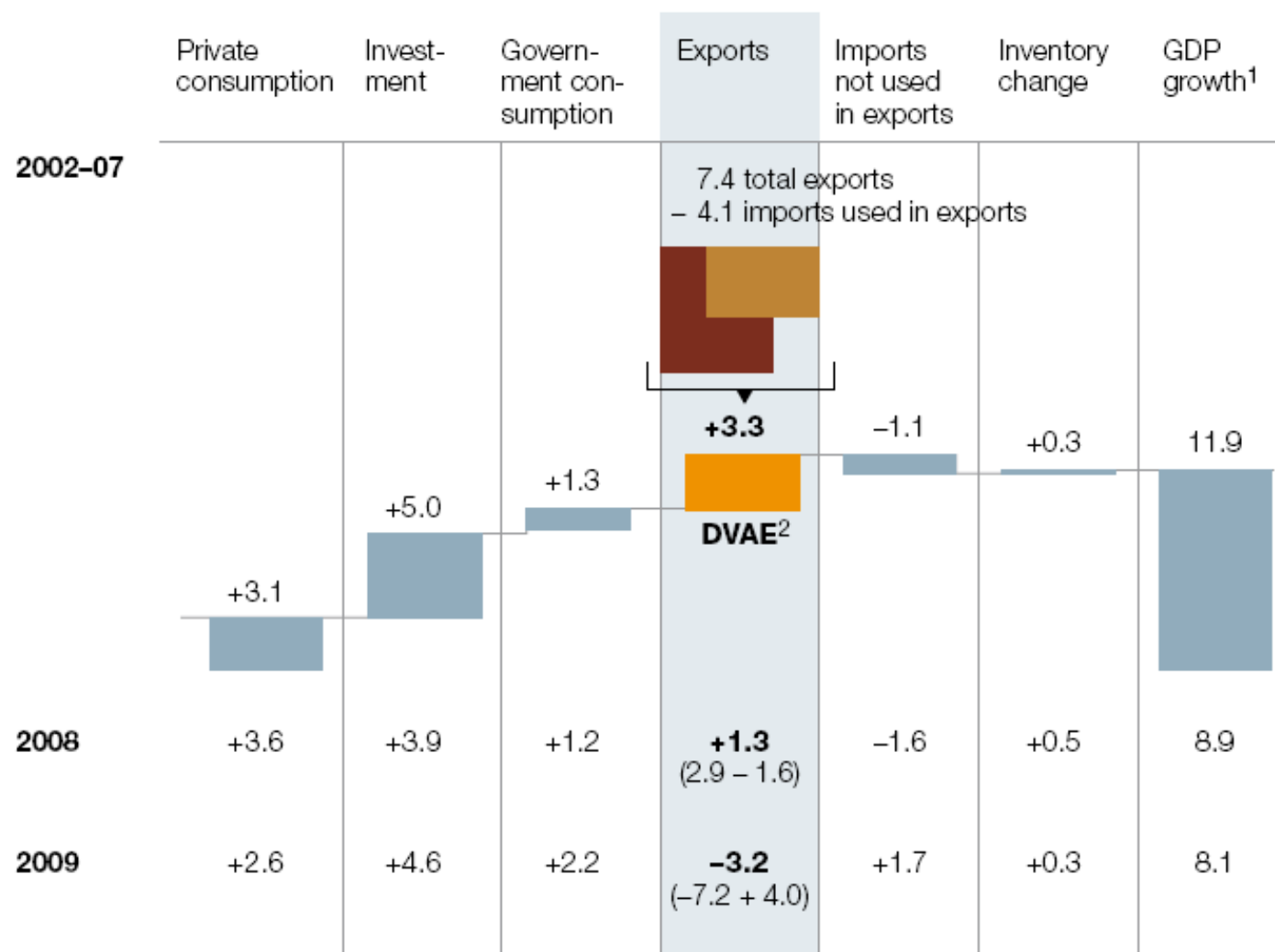


Source: CEIC.

Since 2007, the contribution of exports to overall growth has declined dramatically



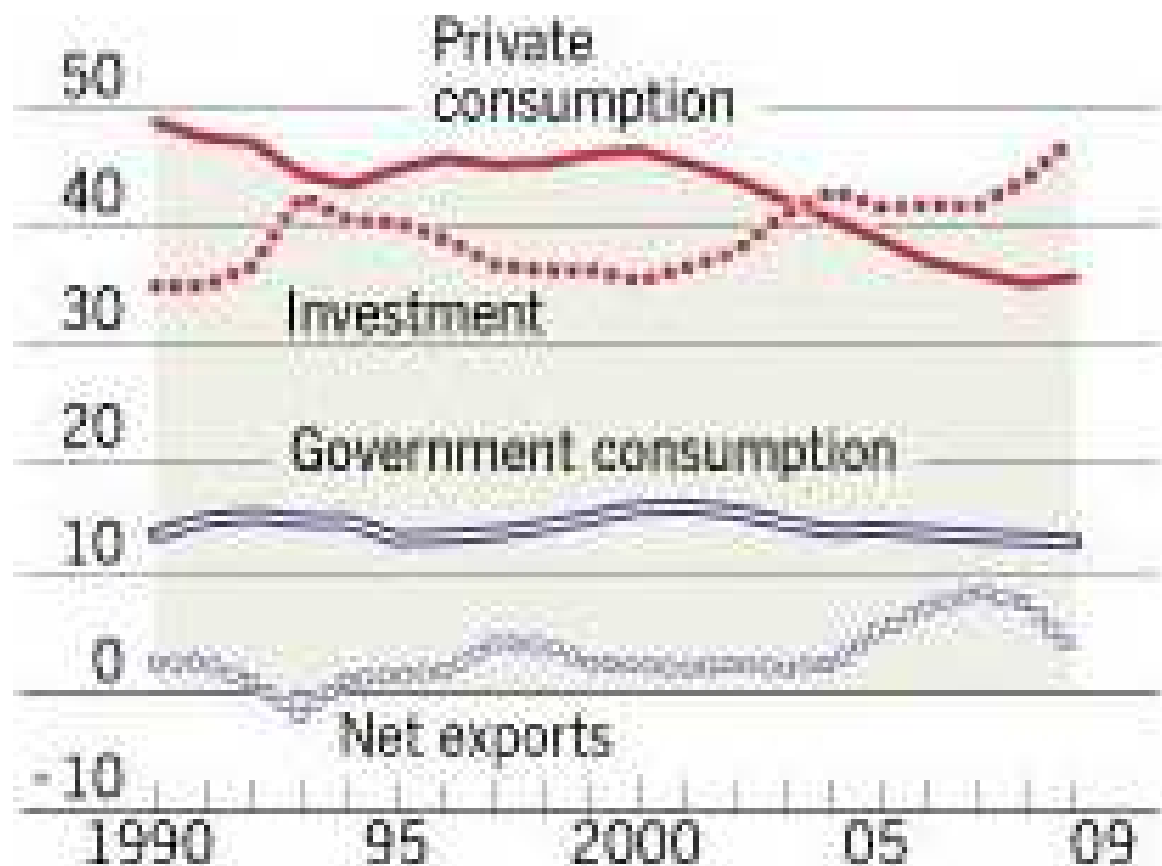
Decomposition of GDP growth, %, 2002 – 2009



Source: McKinsey Quarterly: A truer picture of China's export machine. September 2010.

But private consumption remains weak, and investment rates are very high

Composition of Chinese demand, % of GDP, 1990 – 2009

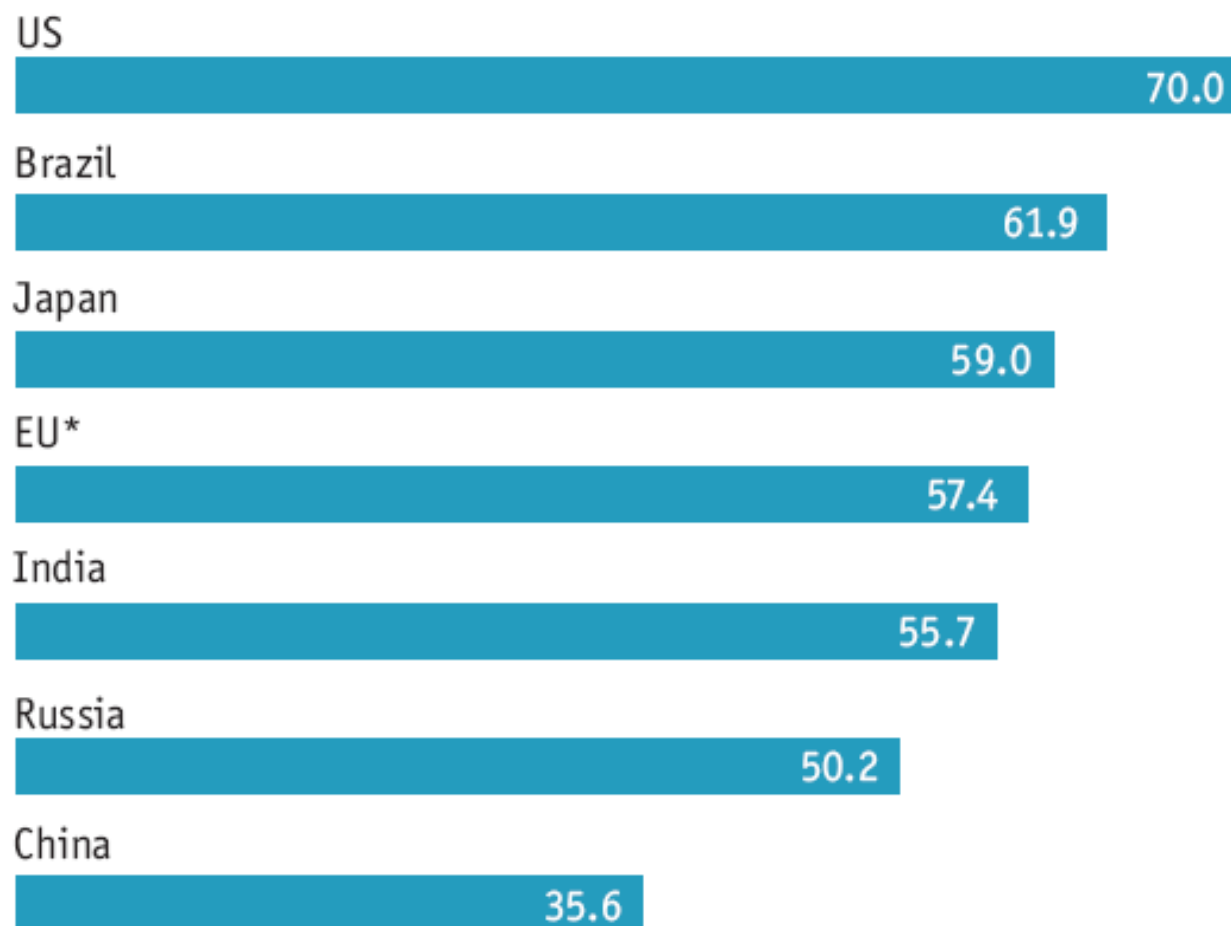


Source: Haver Analytics.

By international standards, consumption is very low



Private consumption, % of GDP, 2010



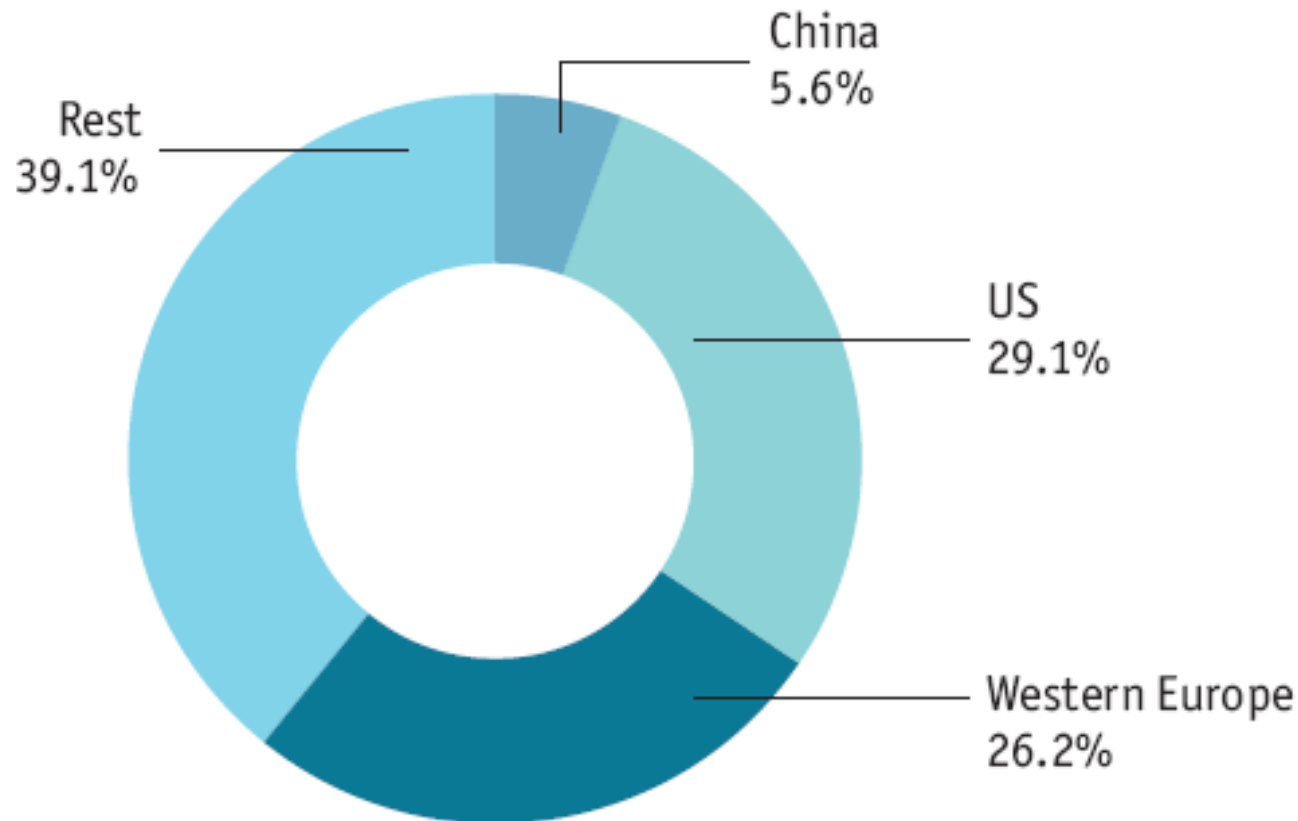
*2008

Source: Economist Intelligence Unit forecasts.

China's private consumption is less than a quarter of that of the US or Western Europe



China's share of global private consumption, %, 2010*



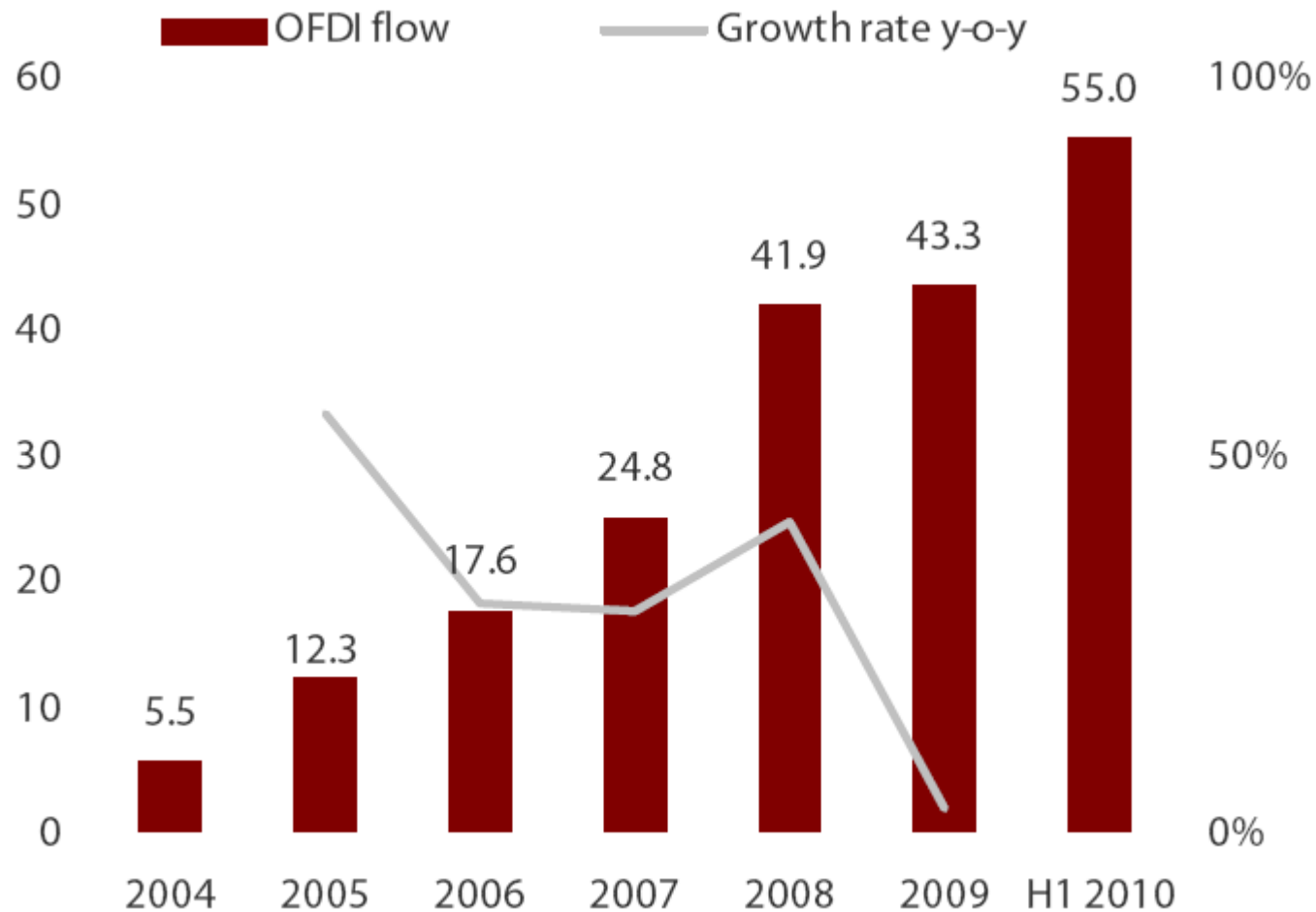
*Forecast

Source: Economist Intelligence Unit/ Haver Analytics.

Outward FDI is over ten times as large as it was five years ago



China outbound FDI flow, \$ Billion , 2004 – H1 2010



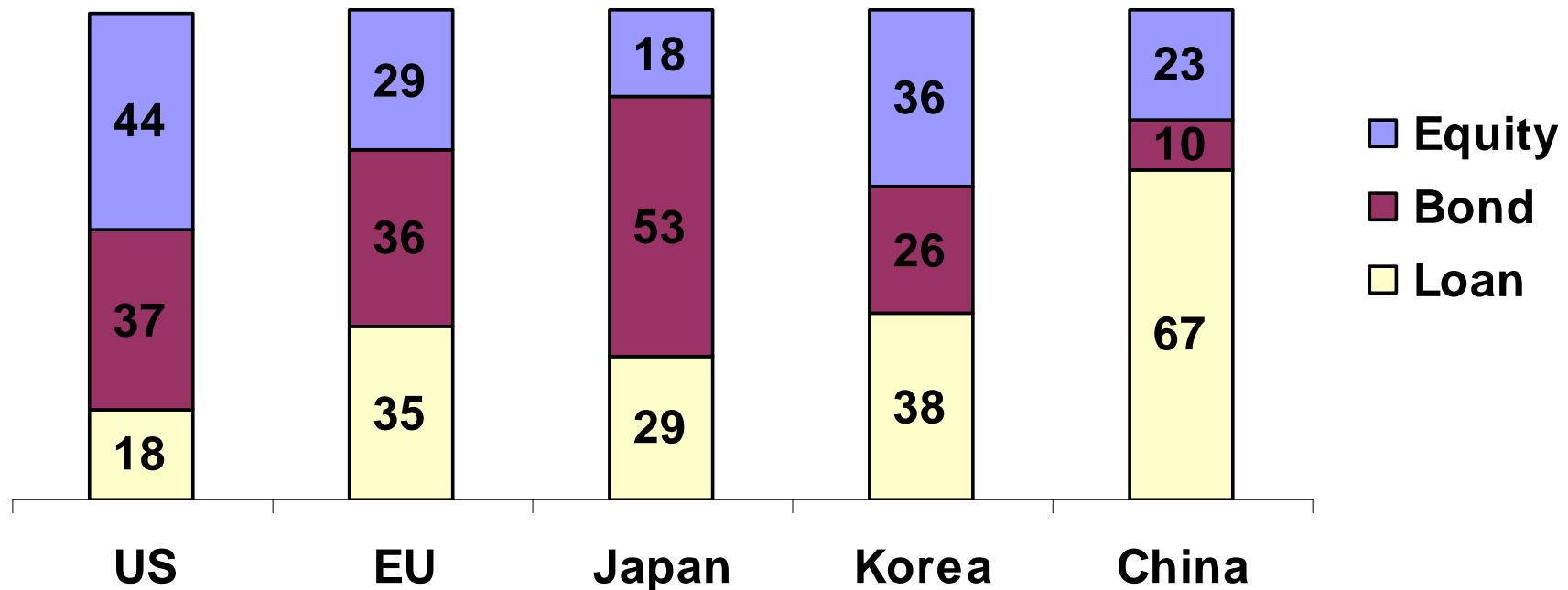
Source: China Monthly Economic Indicators. The BEIJING AXIS Analysis.

2.The state of the financial system and the future reform agenda

China's financial system remains dominated by banks



Financial intermediation by type, %, as of March 2010



Source: Morgan Stanley.

“A” Shares (Shanghai/ Shenzhen)



- First stocks listed in 1991
- Free-float market cap of \$670 Billion
 - 9th largest globally
- Total market cap of \$2.1 Trillion
 - 3rd largest globally
- Daily transaction volume \$25-30 Billion
 - 2nd highest globally
- Foreign investors need QFII (Qualified Foreign Institutional Investor) quota to participate

“H” Shares/ “Red Chips” (Hong Kong)

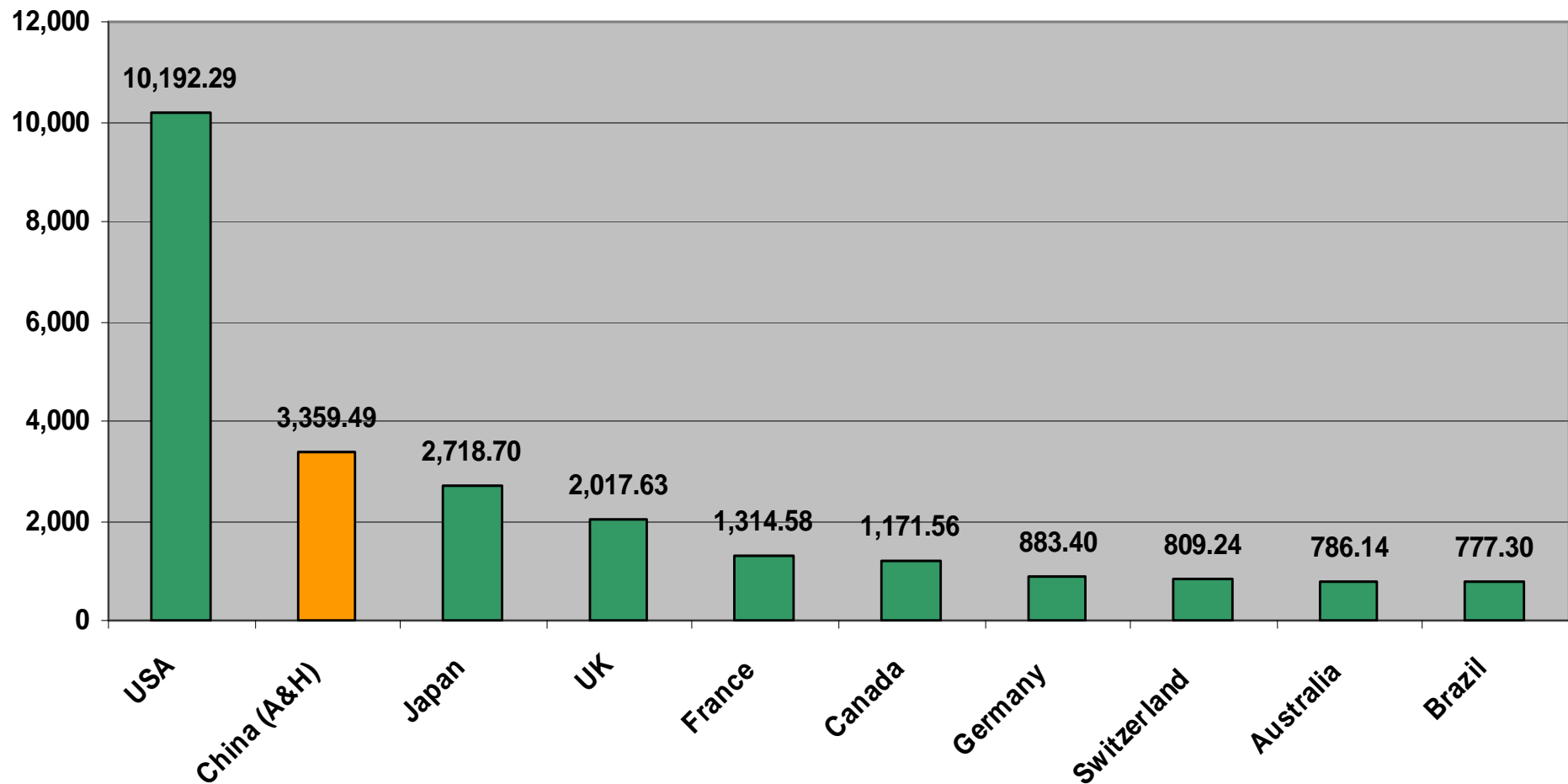


- Chinese companies listed in Hong Kong
- Freely accessible by global investors (part of various MSCI benchmarks)
- Free-float market cap of \$570 Billion
-10th largest globally
- Total market cap of \$1.2 Trillion
-6th largest globally
- Trades \$5 Billion daily

The A and H markets together are now the second largest in the world



Top 10 equity markets by full (non-float adjusted) market cap, \$ Billion

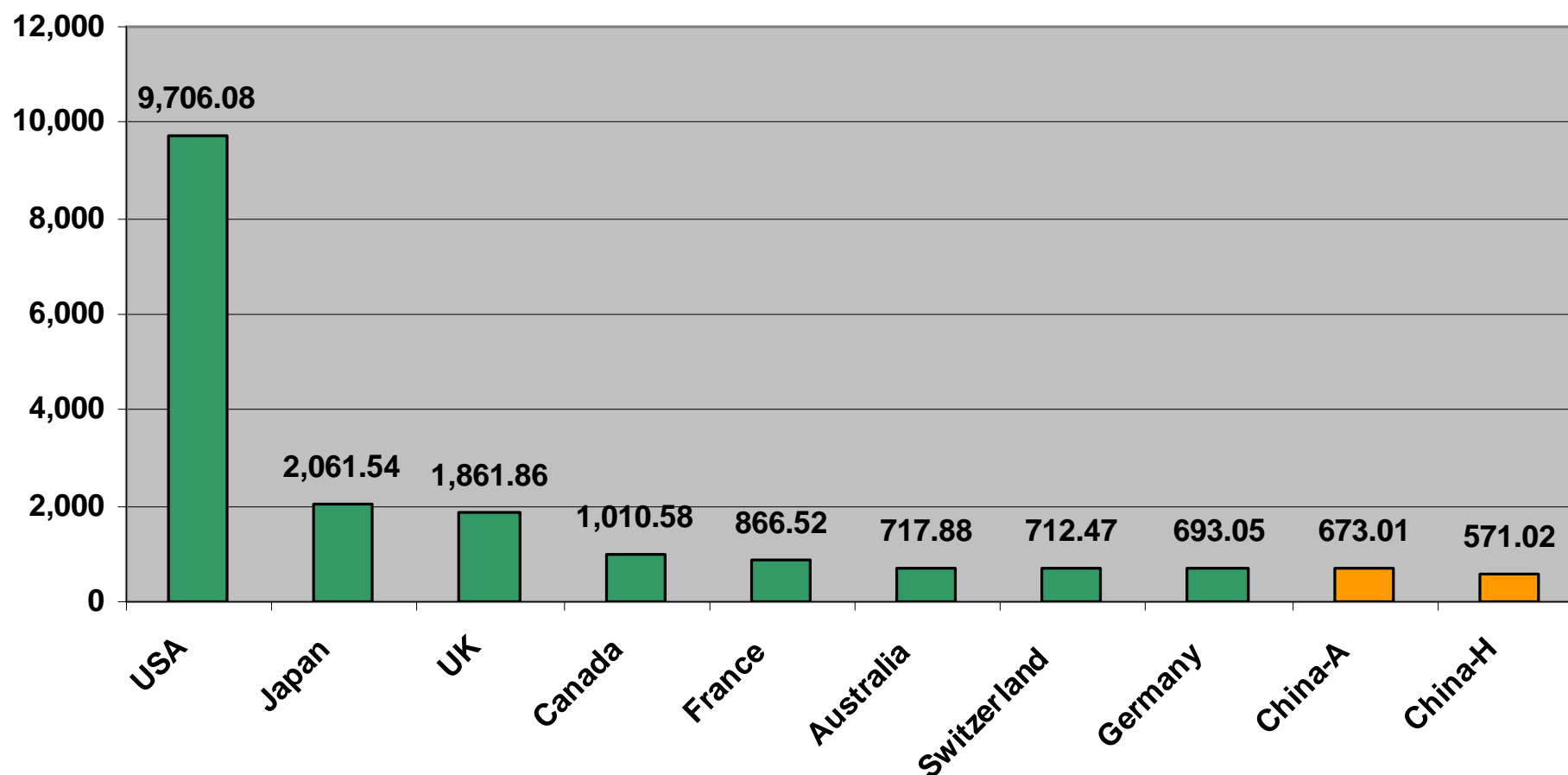


Source: MSCI.

But the free floats are relatively small



Top 10 equity markets by free-float market cap, \$ Billion

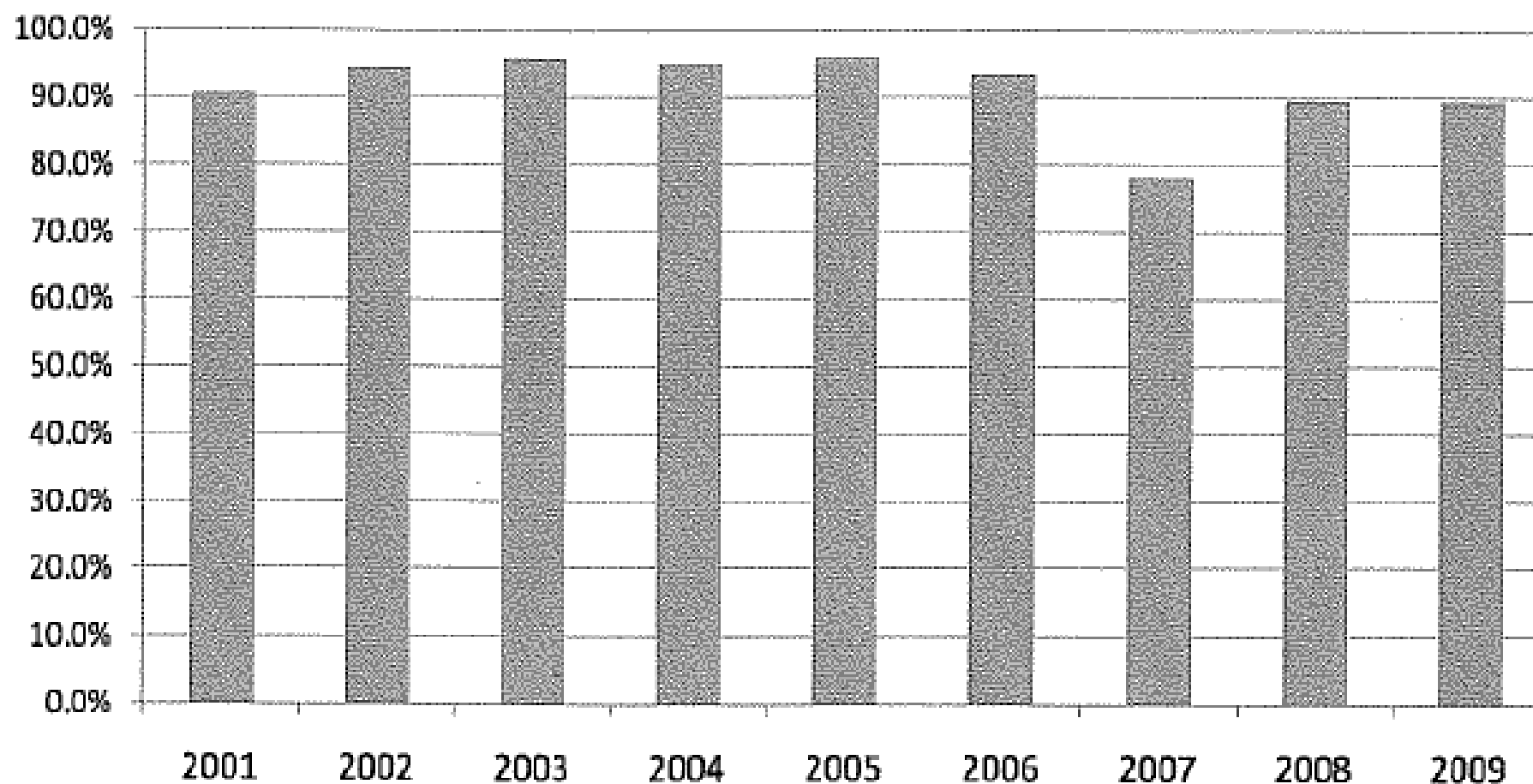


Source: MSCI.

So banks remain the dominant source of new capital



Bank lending, % of total capital raised, 2001 – 9

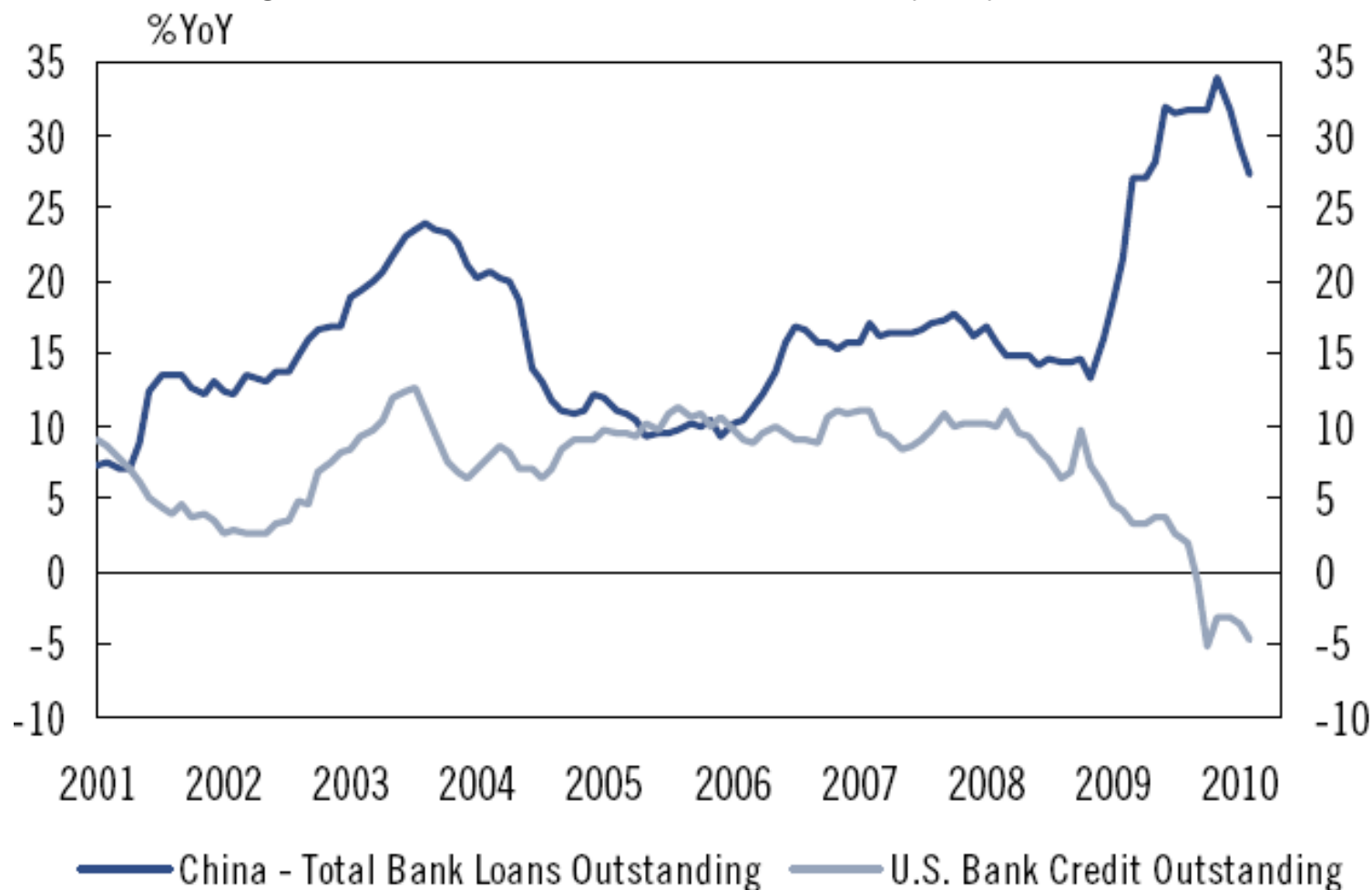


Source: RBS.

The behaviours of the Chinese and US banking systems have diverged dramatically



Total outstanding bank loans in US and China, % y-o-y, 2001 - 2010

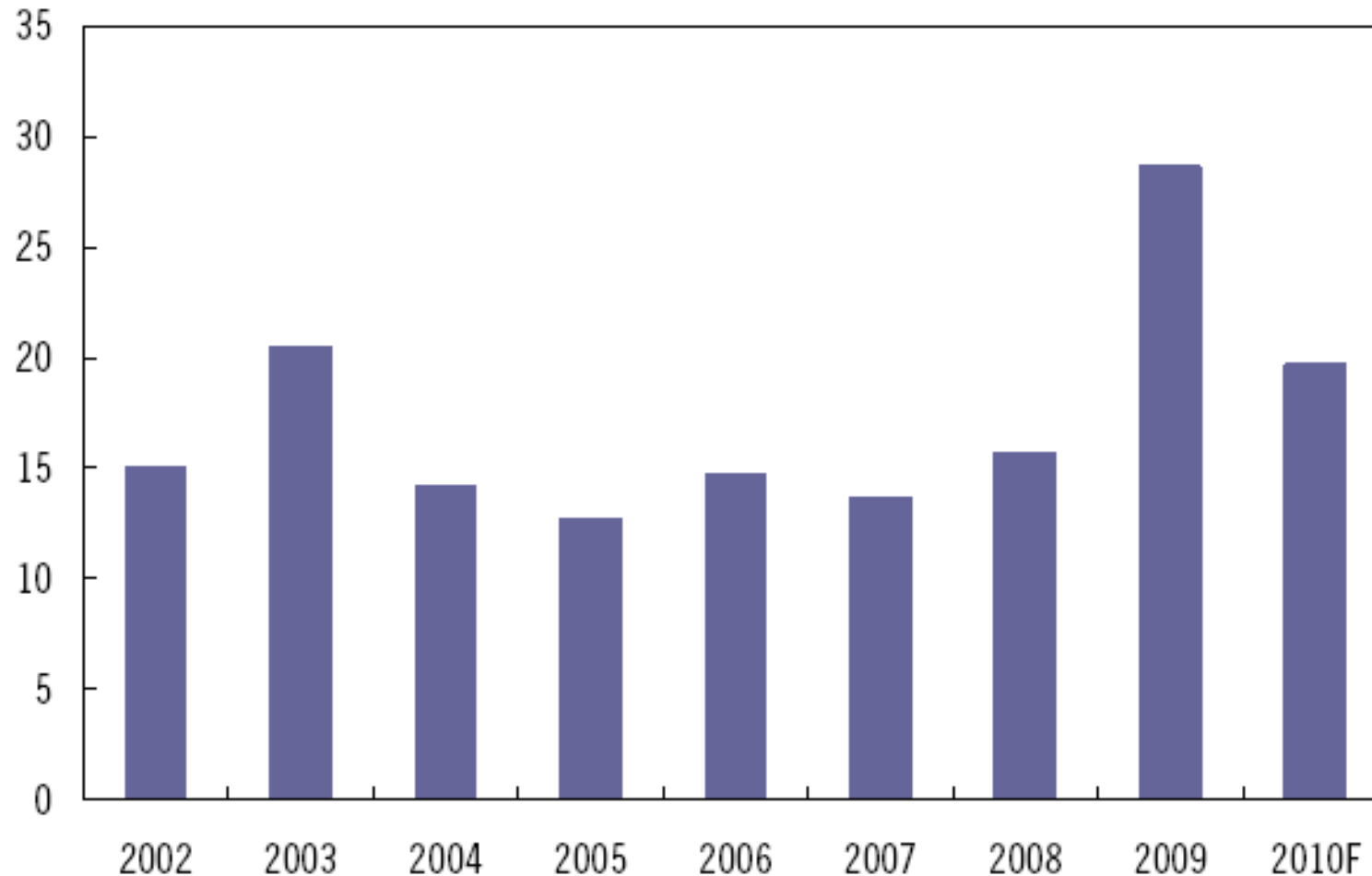


Source: Citigroup Global Markets. Global Macro Focus. Chief Economist Essay – Is China Blowing Bubbles? 24 March 2010.

Bank credit expanded very rapidly in 2009



China increase in bank credit, % of GDP, 2002 - 2010

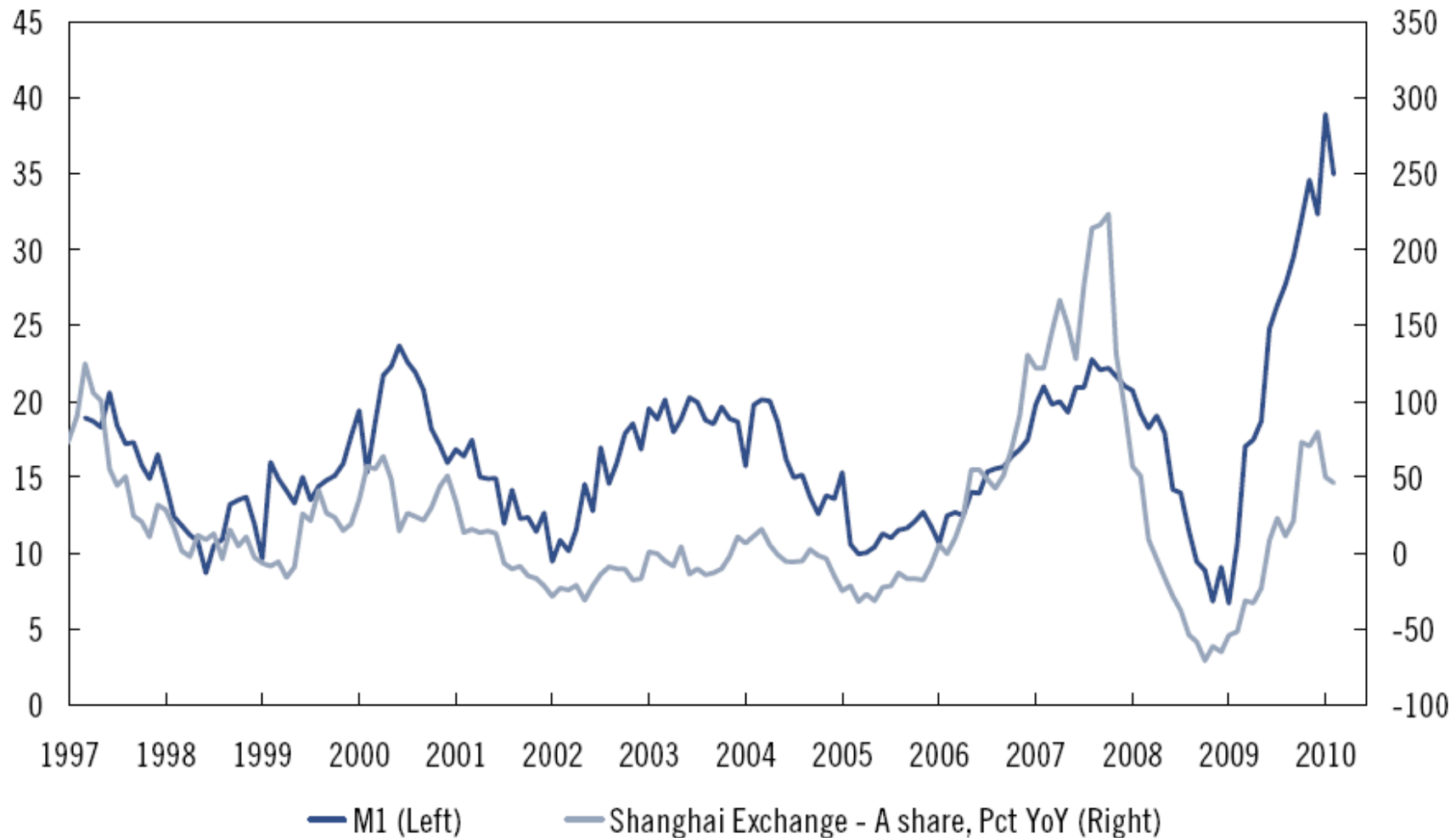


Source: Citigroup Global Markets. Global Macro Focus. Chief Economist Essay – Is China Blowing Bubbles? 24 March 2010.

Easy liquidity boosted equity prices too



The relationship between liquidity supply and share price, 1997 – 2010

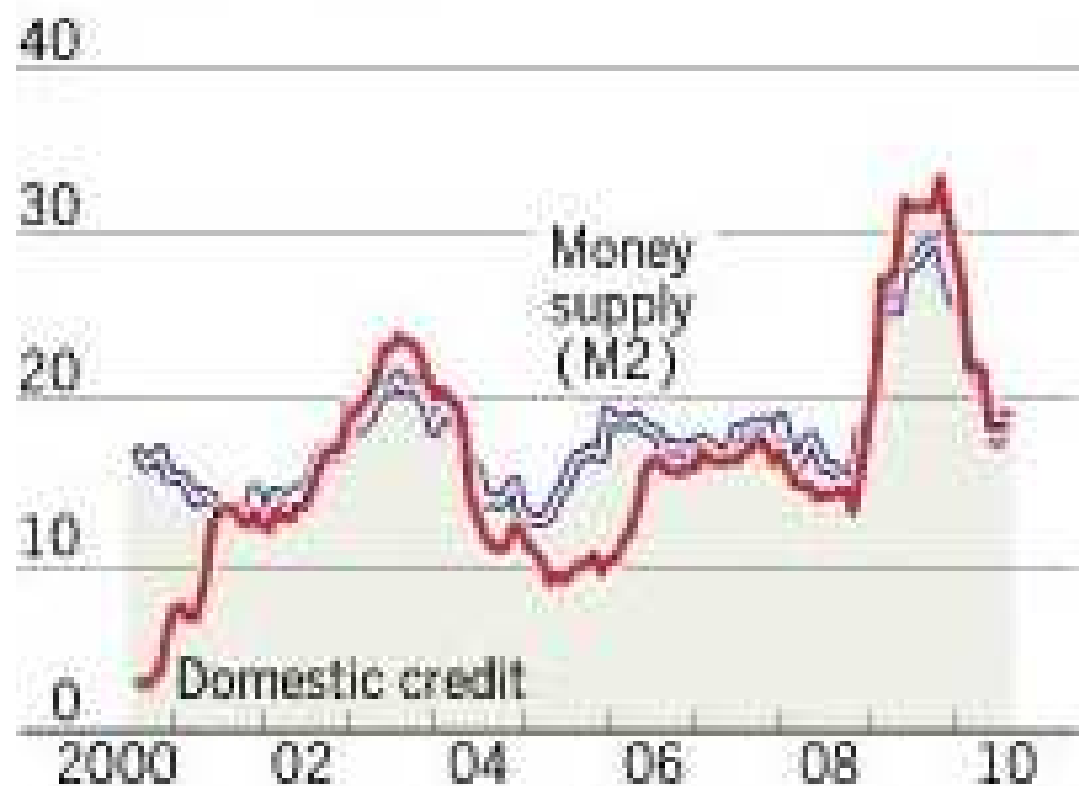


Source: Citigroup Global Markets. Global Macro Focus. Chief Economist Essay – Is China Blowing Bubbles? 24 March 2010.

But credit growth has responded to regulatory tightening



Chinese broad money and credit growth, annual % change, 2000 – 10

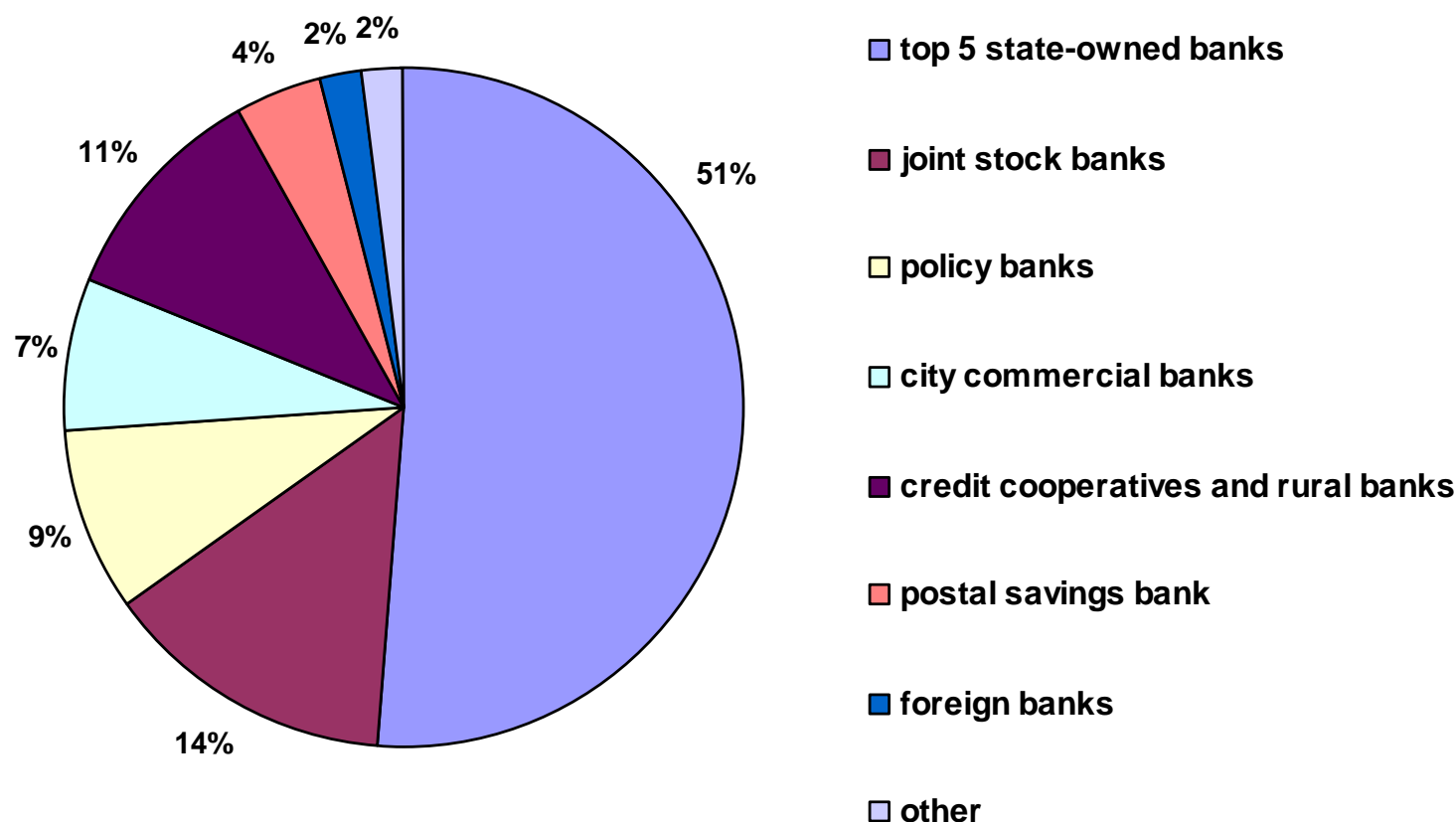


Source: Lombard Street Research.

The banking system is quite diverse



Market share of Chinese banking institutions by assets, %, 2008



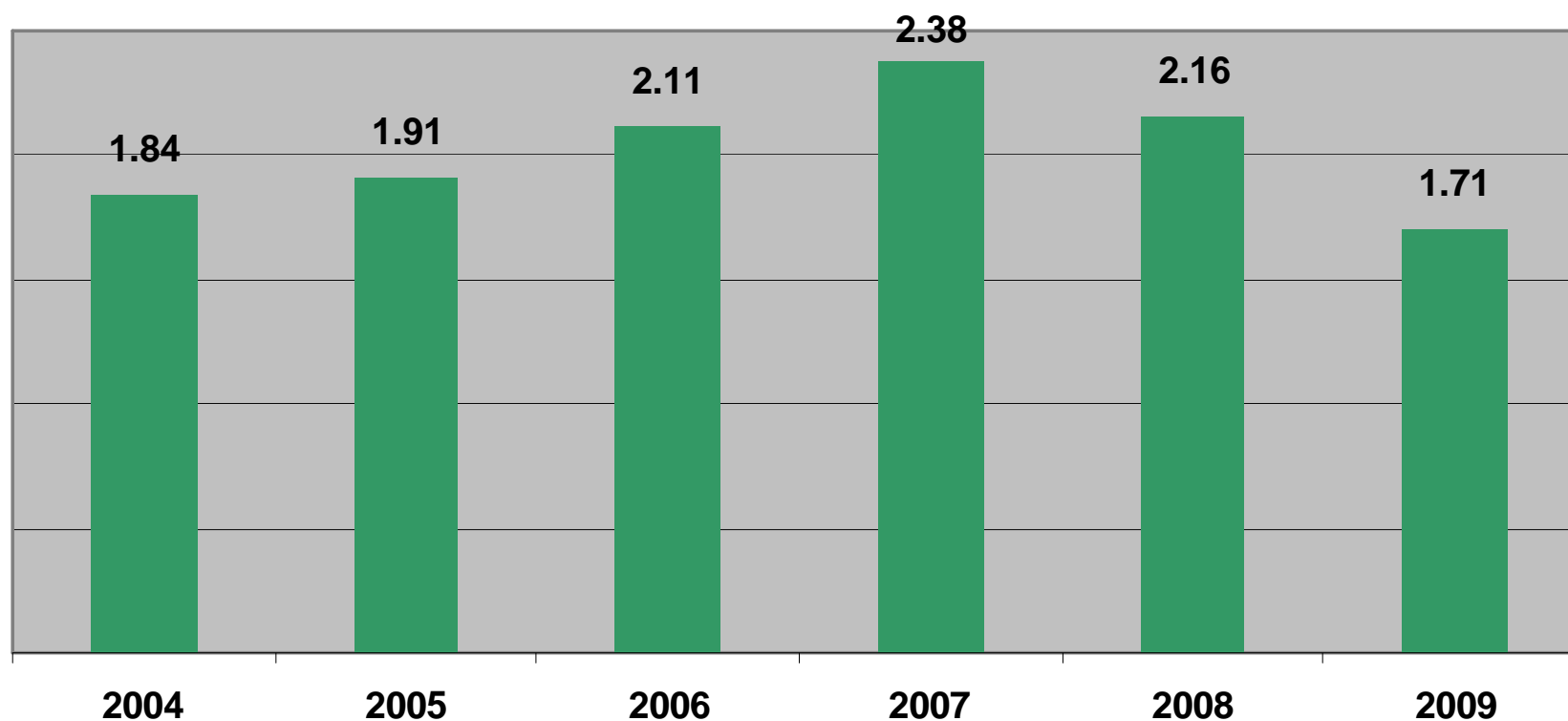
*Includes: village and township banks, lending companies, mutual credit companies, finance cooperatives, trust companies, financial leasing companies, auto finance companies, and money brokerage firms.

Source: China Banking Regulatory Commission. 2008 Annual Report.

Foreign banks still play only a modest role



Market share of foreign banks in China, % of the total banking assets, 2004 – 9

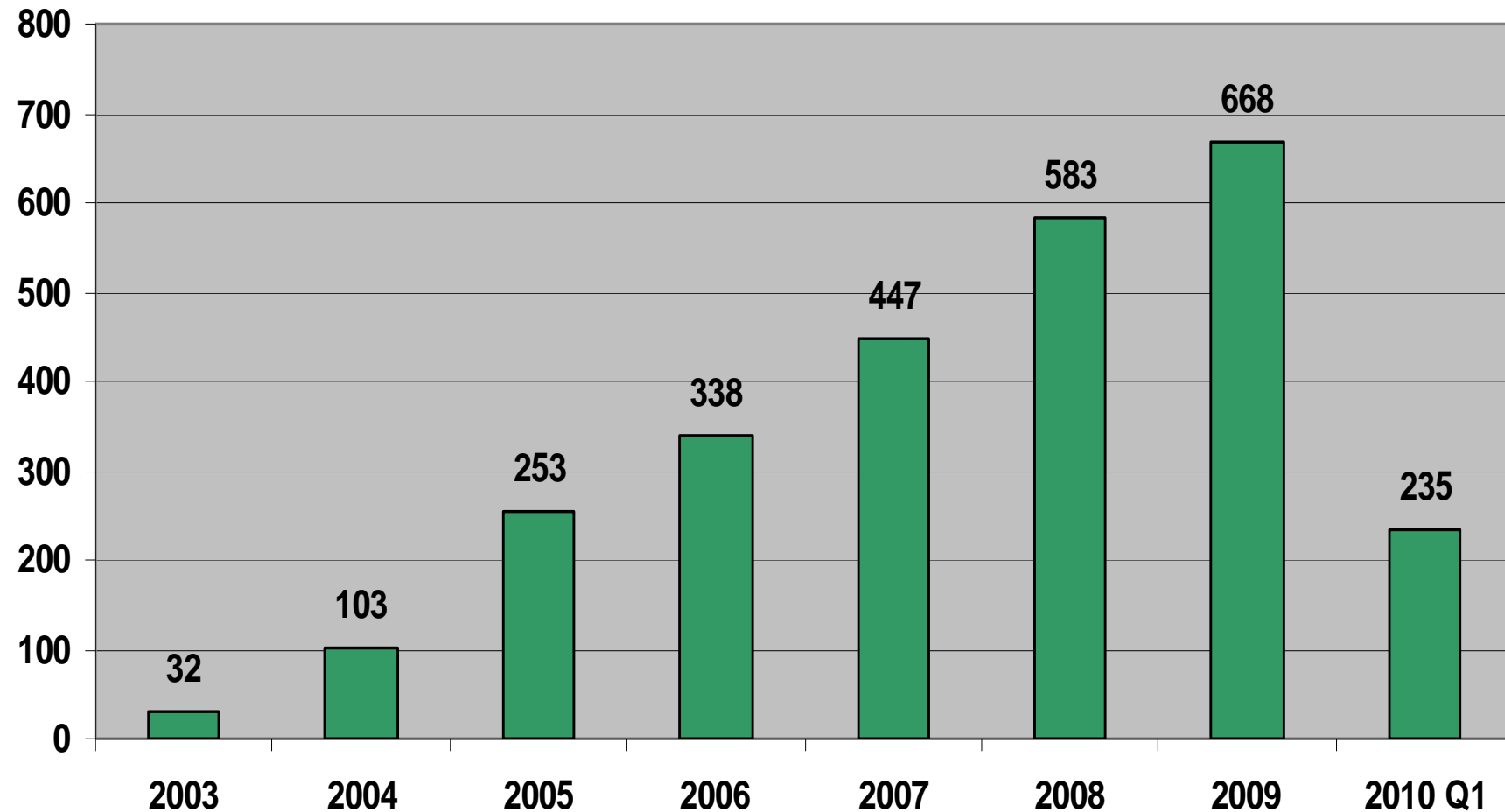


Source: China Banking Regulatory Commission. 2009 Annual Report.

Chinese banks have become very profitable



Chinese banking industry profits, RMB Billion, 2003 – 2010 Q1

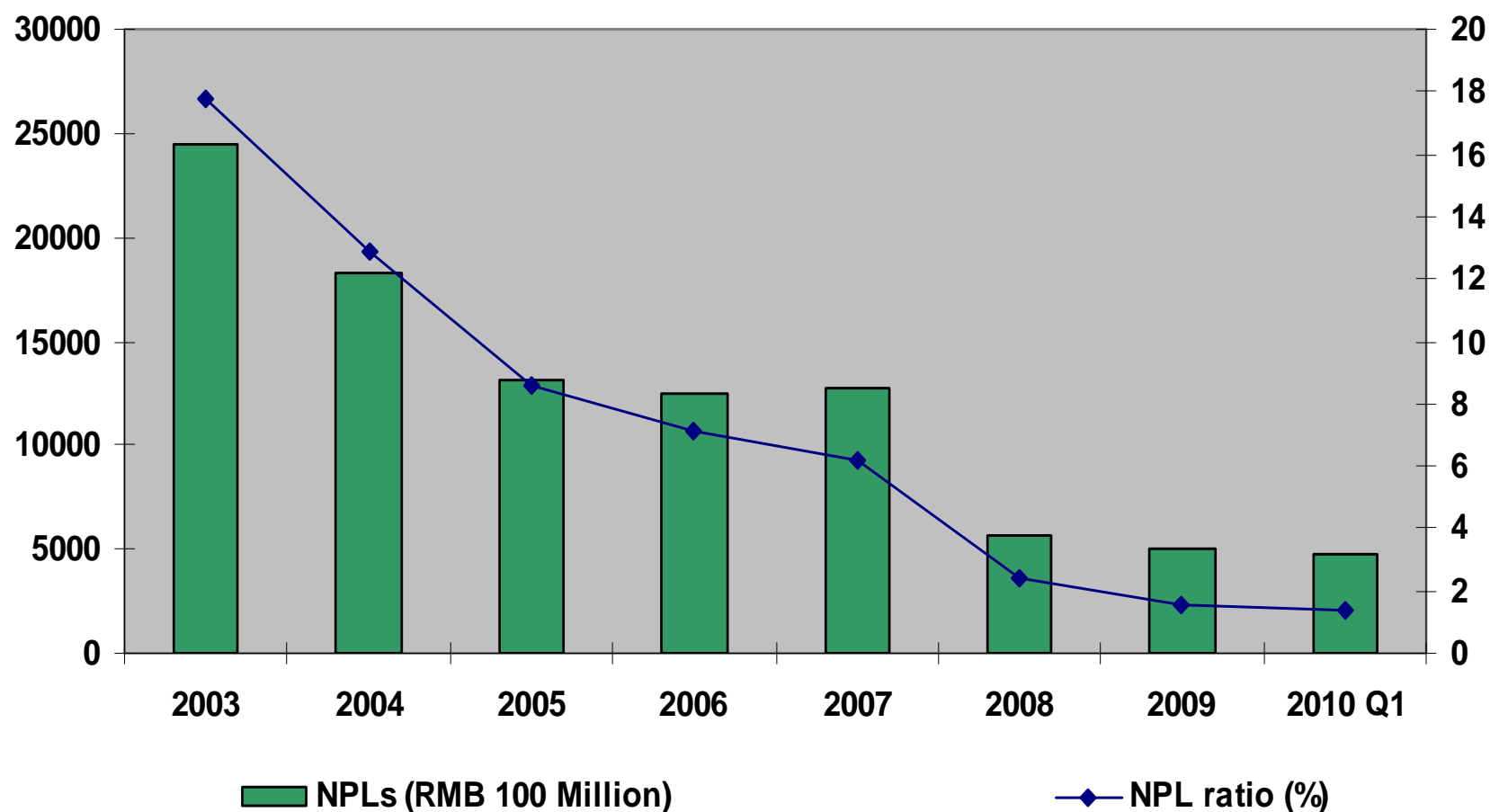


Source: China Banking Regulatory Commission. LIU Mingkan: Latest Economic and Financial Conditions. 17 June 2010.

Non-performing loans have fallen sharply



NPLs (RMB 100 Million) and NPL ratio (%), 2003 – 2010 Q1

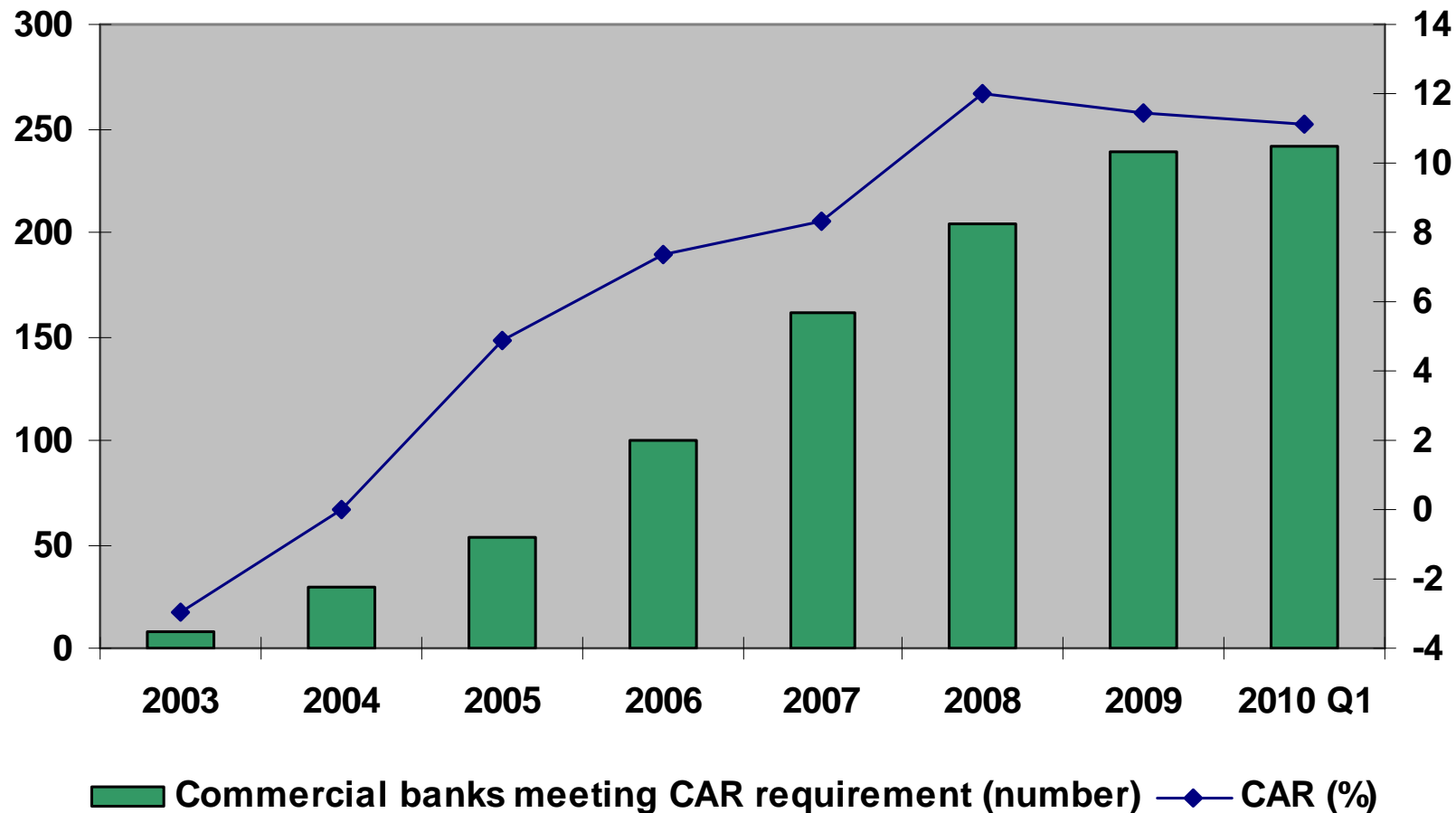


Source: China Banking Regulatory Commission. LIU Mingkang: Latest Economic and Financial Conditions. 17 June 2010.

Their capital reserves have strengthened



Commercial banks meeting CAR requirement (number) and CAR (%),
2003 – 2010 Q1



Source: China Banking Regulatory Commission. LIU Mingkang: Latest Economic and Financial Conditions. 17 June 2010.

There are three Chinese banks in global top 20 by tier 1 capital



Top 20 World Banks, 2010

		Country	Tier 1 capital (\$m)
1	Bank of America Corp	US	160,388
2	JPMorgan Chase & Co	US	132,971
3	Citigroup	US	127,034
4	Royal Bank of Scotland	UK	123,859
5	HSBC Holdings	UK	122,157
6	Wells Fargo & Co	US	93,795
7	ICBC	China	91,111
8	BNP Paribas	France	90,648
9	Banco Santander	Spain	81,578
10	Barclays Bank	UK	80,587
11	Mitsubishi UFJ Financial Group	Japan	77,218
12	Lloyds Banking Group	UK	77,034
13	Crédit Agricole Groupe	France	75,504
14	Bank of China	China	73,667
15	China Construction Bank Corp	China	71,974
16	Goldman Sachs	US	64,642
17	UniCredit	Italy	56,245
18	Groupe BPCE	France	54,141
19	Société Générale	France	49,990
20	Deutsche Bank	Germany	49,576

Source: The Banker. Top 1000 World Banks. July 2010.

And there are 84 Chinese banks in the top 1000



Top 1000 World Banks, 1990 - 2030

	1990	2000	2009	2010	2020*	2030*
West	778	703	621	588	500	475
Europe	444	388	365	319	285	270
US	222	199	159	169	140	135
Japan	112	116	97	100	75	70
Middle East	58	77	88	90	90	95
Latin America	40	50	49	44	40	45
Rest of World	20	20	49	57	70	65
Asia	104	150	193	221	300	320
BRICs	33	43	130	146	200	215
Brazil	18	18	13	10	20	20
Russia	-	4	33	21	30	30
India	7	12	32	31	40	45
China	8	9	52	84	100	110

Source: The Banker. Top 1000 World Banks. July 2010.

But there are weak areas, which point to the need for further reform



China: Financial Development Index

		Rank/ 55
Strengths	IPO activity	1
.	Currency stability	7
.	Bank size	8
.	Equity market development	13
.		
.	Bond market development	29
.	Bank efficiency	30
.	Financial sector liberalisation	43
Weaknesses	Securitisation	44

Conclusions

1. China has steered its financial system safely through a difficult period
2. Standards of supervision are now comparable with developed countries
3. China has retained the flexibility to influence credit conditions which other countries are now trying to recover

But...

Challenges ahead



- The degree of state ownership to maintain

The state's ownership of financial firms remains large



<u>Top five banks</u>	<u>State ownership</u>	<u>Seven largest securities firms</u>	<u>State ownership</u>
ICBC	51%	Citic	37.8%
China Construction Bank	48%	Haitong	42.5%
Agricultural BoC	100%	Guotaijunan	60.5%
Bank of China	70.8%	Yinhe	99.9%
Bank of Communications	26%	Guangfa	60%
		Shenyinwanguo	52%
		Guosen	40%
<u>Three policy banks</u>		<u>Five largest insurance companies</u>	
China Development Bank	100%	PICC	~100%
Agricultural Development BoC	100%	Ping An Group	7%
Export-Import BoC	100%	China Taiping	~100%
		CPIC	48.4%
		China Life	68.4%

Source: 2008 Annual Reports.

Challenges ahead



- The degree of state ownership to maintain
- Reducing dependence on the banking system

More dynamic equity and bond markets will require



- Stronger corporate governance
- More robust and impartial enforcement of contracts
- Derivative markets and diverse credit ratings

Challenges ahead

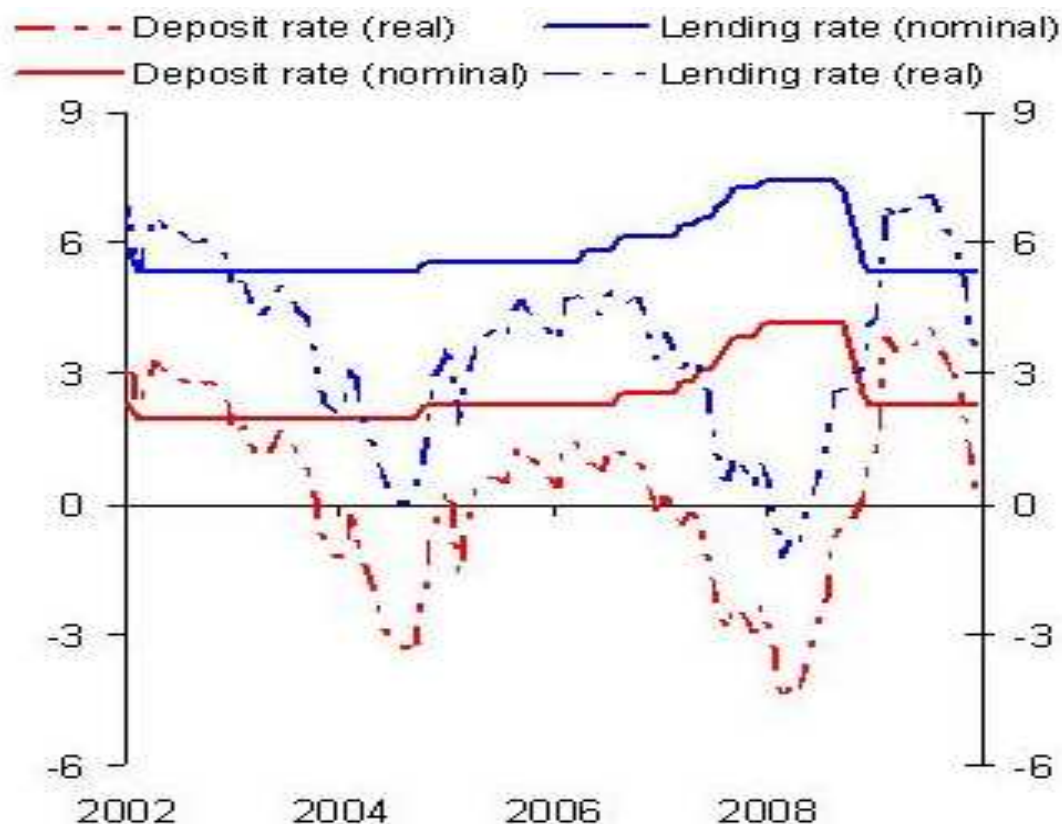


- The degree of state ownership to maintain
- Reducing dependence on the banking system
- Overcoming financial repression

The average real GDP growth has been much higher than the real deposit rates, leading to income redistribution from households to other sectors of the economy



Real and nominal deposit and lending interest rates in China, %, 2002 - 2009



Source: Lorenzo Bini Smaghi. Reserve accumulation: the other side of the coin. Speech at the 5th High-Level EMEAP-Eurosystem Seminar. 10 February 2010.

In China, the financial repression is more than three times the proceeds from the personal income tax



Implicit tax on households and main beneficiaries, Q1 2008

	Implicit tax	
	RMB Billion	% of GDP
Household net deposits (deposits – loans)	255	4.1%
Corporate net loans (loans – deposits)	55	0.9%
Banks' net gains (gains on widening interest rate margins minus opportunity cost of holding sterilization assets)	64	1.0%
Government (as residual)		2.2%

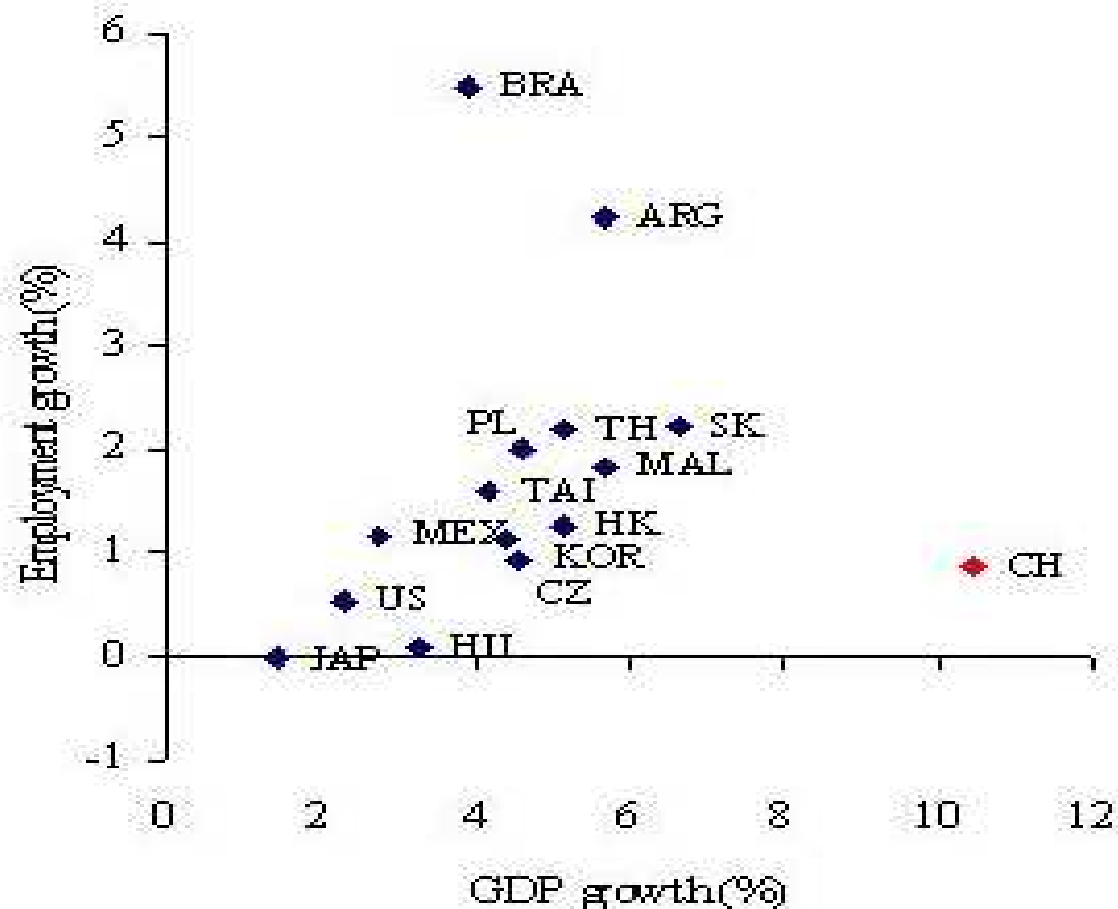
Note: Financial repression is defined as an implicit tax on households due to the decline in the real return on savings deposits. Lardy (2008) quantifies this implicit tax by calculating how much higher household interest income would have been in Q1 2008 if households had received the same real rate of interest on their net RMB-denominated savings deposits as in 2002, when the real lending rate was close to the real GDP growth rate.

Source: Nicholas R. Lardy. Financial Repression in China. Peterson Institute for International Economics. September 2008.

China's recent growth has not generated many jobs



Employment growth (%) vs. GDP growth (%), 2001 – 2008 averages



Source: Lorenzo Bini Smaghi. Reserve accumulation: the other side of the coin. Speech at the 5th High-Level EMEAP-Eurosystem Seminar. 10 February 2010.

Challenges ahead



- The degree of state ownership to maintain
- Reducing dependence on the banking system
- Overcoming financial repression
- Stronger credit control and risk management in banks



China's Financial Markets: Fit for purpose?

Howard Davies
Director, LSE

LSE and Confucius Institute

14 October 2010