China and Financial Reform (slide1)

It is almost impossible to speak about finance without adding the word crisis. But this speech is not about the crisis. So those who want to wallow in it can leave now.

It is part of a series I have given here in the last five years, watching the evolution of China's financial system.

My perspective: advisor to CBRC and CSRC. I have been proud to work with chairmen Liu Ming Kang and Shang Fulin who have done astounding jobs But nothing I say commits them, of course.

Aim to review what has been happening more recently in China, and we are bound to talk about the crisis at the end. Seems unlikely that the Chinese can completely escape. Indeed some people think it could be quite unpleasant. But that is for later.

My thesis is that reform programme has gone reasonably well so far of in banks but is as far advanced in equity and bond markets. There remain some damaging distortions in the financial system and China now faces some difficult choices.

But first, let us look at what has been happening in China in recent years.

First point that the Chinese financial system is quite sophisticated by the standards of developing countries (slide 2). The Mckinsey concept of financial depth includes bank deposits and other financial accounts. China on this measure very different from India and Russia.

We can see this on the global spectrum (slide 3). China has a deep financial system in relation to its GDP per head.

Incidentally we have assumed for a long time was financial deepening was a one way trip. Globally, financial assets were109% of GDP, in 1980 to 350% in 2006. In other words global financial wealth was 100% of world GDP 30 years ago and is now 350%. Even 20 years ago only 33 countries had financial assets whose value exceeded their GDP. By 2006 that was over 60 countries. Impact of this crisis likely to be that trend towards further deepening slows down, or conceivably reverses. That could be the consequence here and in the US-though probably not in China.

Let us turn to the banks. Because as we can see, China's financial assets have dominated by the banking system to an unusual and probably unhealthy extent. We can see the dangers of a system based heavily on banking in the present crisis.

When I began at CBRC the big problem was Non Performing Loans (slide 4)

30% of all loans outstanding were non performing at the beginning of this decade. That has now been dramatically reformed (Slide 5). The CBRC figures may possibly understate a little, but few think the position is radically different.

Other side of this is that the share of banking assets in China in banks which meet global capital standards has risen very significantly. Ten years ago Chinese banks unable to operate overseas as did not meet Basel standards. Allowed to open subsidiaries, if at all. That is not now the problem. Major tribute to CBRC. Coherent reform programme:

-bad banks, asset management companies

-huge capital injections. We used to regard this as eccentric, but now we can see the logic!

-partnerships with overseas banks to improve management and IT

-board members from overseas and improvements in corporate governance

-Flotation, in Shanghai and sometimes elsewhere.

Through this period banking assets have grown rapidly (slide 6).

And the return on equity of the reformed banks has risen sharply (slide 7).

There are still some problems.

Agricultural Bank of China has not yet been reformed.

There are still significant cultural problems. In our system there are many creative tensions which are supposed to create discipline in banks. Between lending officers and credit officers between both and risk managers. Between all of them and internal auditors. Between all of those them and external auditors. Between the whole bank and regulators, and rating agencies etc. At present, these tensions do not properly operate in China though they are gradually being introduced. And of course we cannot say that they have worked wholly effectively here in recent years.

Another problem is that competition in Chinese banking system has not developed as much as expected.

In spite of the WTO commitment which has technically been fulfilled, foreign banks are still not very significant. (Slide 8)

There are 24 subsidiaries and a few more branches. And the asset numbers and growth figures can look reasonably impressive and the growth figures,

But it is still quite a restrictive approach. Each branch must be approved. Here a branch means something very different, the entitlement to have as many outlets as you want. And there have been severe restrictions on their ability to do RMB business.

So the market share of foreign banks is still very modest (slide 9).

And there is a further problem. There remain many administered controls on banks in China which have had some perverse consequences. A particularly interesting paper published this August by Nicholas Lardy called ‘ A note on financial repression in China’.

Lardy is a senior fellow at the Peterson Institute for International Economics, who was formally at the Brookings institution. His argument runs as follows (slide 10). He points out that the way in which the People’s Bank have administered interest rates in recent years has had a major impact on the distribution of income and wealth. In February 2002 the People’s Bank fixed the maximum interest rate banks could pay on demand deposits as 0.72%, a rate that remains unchanged. But inflation, as measured by the consumer price index, has moved from slightly negative in 2002 to almost 5% in 2007 and now 8% in the first quarter of this year. So the real rate of return on demand deposits went from 1.5% to -7% during that period. By the first quarter of this year the real return on one year deposits was minus almost 4%. This is an implicit tax on households. (Slide 11). Because households are large net depositors in banks.

The consequence of this tax is very significant indeed. (slide 12)

If households had received the 2002 interest rate their income would have been higher by the equivalent of just over 4% of GDP in the first quarter of this year. This implicit tax is more than three times the proceeds of the only tax imposed directly on households-the personal income tax.

Who benefits from this large implicit tax on households? How is the balance distributed between corporates, the banks and the government itself?

Corporates are a significant beneficiary in that the real interest rate on loans has fallen and most loans go to companies not to households. In 2002 corporates were paying a real rate of just over 7% of one year money. By the first quarter of this year the real interest rate was slightly negative, so corporate borrowers in the first quarter of this year face an interest rate on one year loans 8% lower in real terms than in 2002. So corporates are benefiting by about 1% of GDP from a transfer from households.

Banks are also benefiting. The average spread on loans in the banking system has risen during this period, contributing to the rise in bank profits which we have just seen.

But what the People's Bank grant to banks in the form of cheap deposits, it partially removes through its massive sterilisation operations. To maintain the RMB rate against the dollar, the government has intervened massively in the foreign currency market, which is partially reflected in the growth of foreign exchange reserves which rose to about to $1.8 trillion at the end of June, up from only $200bn at the end of 2002. To prevent this leading to massive increases in the domestic money supply the People's Bank increased the reserve ratio for banks from 6% to 17.5%, which compelled the banks to put an additional 5 trillion RMB on deposit on the central bank. That imposes a tax on banks because they receive lower interest rates on their deposits than they would get if they lent their money to customers.

The consequence is that Chinese banks are not large beneficiaries of this financial repression. So the main additional beneficiary is the government. The government gains from the tax it imposes on the banks by sterilisation operations.

So this tax on households, which contributes low spending in China, is the consequence, on this analysis, of the exchange rate being lower than it would otherwise be. It also makes it difficult to assess just how well the banks are doing. Are the large increases in profits reported by most banks the result of improvements in corporate governance, business procedures, risk management and productivity? Or are they simply due to the widening of spreads due to People's Bank control of benchmark interest rates?

This question is very difficult to answer. And according to Lardy it means that 'whilst the central government has long articulated the goal of transforming banks to operate on commercial principles, financial repression is currently inimical to achieving that goal'.

This mechanism does appear to have distorted the Chinese economy considerably. We have it on no lesser authority than Wen Jiabao (slide 13). His critique was that growth had come to depend disproportionately on increasing investment spending and a rising external surplus. Consumption as a share of GDP has fallen sharply and its contribution to growth is now unusually low both in comparison with other countries and in comparison with China's earlier reform period. The government have often said that they want to rebalance growth and increase household consumption as a share of GDP, but they have repeatedly failed to achieve that. Since 2004 the share of house consumption in GDP has continued to fall, to the astoundingly low level of only 35% in 2007.

One important reason for this continued decline in household consumption as a contributor to growth is that household interest income as a share of GDP is falling even though household savings have risen. So this financial repression, so called, reduces the growth of household income and makes it less likely that the government will achieve the goal of balancing the sources of economic growth.

In turn, that makes China more vulnerable to changes in demand elsewhere. It makes it difficult for household spending to take up the slack from falling exports.

Furthermore, repression make it more difficult for China to develop an efficient capital market. It works because savers have few alternative financial assets, following the earlier analysis I gave of the high dependence of China on the banks. Equities are an option, but extreme price volatility in the equity markets is off putting to small savers. Real assets are another alternative and that has been seen in the form of high increases in property prices (slide 14). China has not seen the kind of extravagant rise in property prices that we have observed in the US, the UK and elsewhere in Europe, but they have been rising pretty rapidly, none the less, and creating the potential for a dangerous bubble.

There is a very small bond market, and it is dominated by government paper and paper from other government guaranteed institutions.

Before I come on to the consequences of all of this, and the prospect for the financial sector, just a word briefly about the other two dimensions of financial markets.

The performance of the stock exchange in China has been dramatically bad in the last year or so. (slide 15) The Shanghai market has lost more than two thirds of its value.

You can see that the market began to decline earlier than markets elsewhere and there is no sign of it reaching a trough.

There are many reason for this. The proportion of free float is low in many companies. There is a large overhang of government shareholdings. Poor corporate governance standards in many cases. Shareholders receive that minority rights are poorly protected. Many brokers undercapitalised and in a poor financial condition. Too many perceptions of insider dealing.

The same is true of the bond market. The lack of derivatives has impeded the development of the market as well. Great nervousness by the authorities about the development of a derivatives market in China, for reasons which are now more understandable than they were in the past.

Just a brief word about insurance (slide 16)

Still very undeveloped in China. Foreign companies beginning to make an impact, though only 6% of the market so far.

Ping An has been very successful, but other companies remain poorly developed. Ought to be a focus of reform, but not the same impetus in the CIRC as in the two other commissions.

So what about the prospect?

Obviously it depends on the likely growth rate. There are signs that economic growth is moderating (slide 17). China has achieved an average rate of over 10% a year for almost twenty years. Remarkable performance. But many of us fear that at some point that has to change. Will the financial crisis be the trigger? Probably not directly, but there are certain indirect mechanisms under way.

One of them is the exchange rate. The RMB has been strengthening against the dollar, though the nominal effect of strengthening has been smaller. That undoubtedly has an impact on exporting firms. Probably not so much impact on the banking sector which does not have large unhedged foreign currency exposures.

The impact can be seen in the form of declining external trade volumes. The trend is not very marked yet, but looks clear in terms of its direction. Since manufacturing is over 50% of Chinese GDP, and given the still depressed nature of the Chinese internal consumption, export markets are particularly sensitive. Hard to think other than that the propensity of the US and the UK to import from China will decline in the next year. Even though China is exporting more to the rest of Asia, the US has an impact.

Another ominous trend is the growth of inflation (slide 20). Some would say that this is likely to tail off as growth slows down elsewhere. I think that is true. But China faces a version of the dilemma we have here whereby demand is weakening significantly, but reported inflation remains uncomfortably high.

And there are signs that investment is slowing down (slide 21). Investment has been the great motor of the Chinese economy. Not surprisingly given what I have said about low and even negative real interest rates for companies. Can an economy survive with this investment rate indefinitely? Especially when demand overseas is slackening.

All that brings us to the question of what next for China and particularly for the financial sector.

There is an optimistic view, presented by the government. On Sunday when Jiabao said 'our economic fundamentals haven't changed, and the economy is moving in the direction we expected. The strength of our financial institutions has generally increased, and their ability to make money and withstand risk has risen. Market liquidity is ample and the financial system is stable and safe. This will help us withstand any negative external impact. We are full of confidence in the development of the economy and in the stability of the financial system'.

These words may have been borrowed by a speech by Gordon Brown about six months ago! We can excuse all politicians for saying this kind of thing. Few of them say that they fear that they are riding for a fall and that something very nasty is about to happen.

On the other hand, there are those who foresee big trouble ahead. One quote on Reuters from an unnamed senior Chinese official was 'China's financial crisis will kick off between 2009 and 2010 and will be triggered by a turning point in RMB appreciation. By that time international capital will flow out instead of coming in and the Yuan will face depreciation pressure. China will face a liquidity shortage and financial crisis will therefore follow'.

What is my view?

Well I fear that I have been a bear throughout this crisis and forecast recession here 12 months ago. I have seen nothing to change my mind.

On the other hand, Chinese financial institutions have not made the egregious errors made by banks here. While there are signs of asset appreciation, they are not so dramatic as elsewhere. So I would see China as getting a weak form of our disease, not a strong form. But I think it unlikely that they will manage to escape with nothing at all. (Slide 21)

The big political question in relation to financial reform in China is of course whether the path they have been on for some years, essentially following the UK and the US, with more competition, liberalisation, less direct control, growth of some derivatives markets is the one to follow. At a meeting with the vice-Premier Wang Qisheng this summer, he asked politely whether he should continue to take his Wall Street teachers' lessons seriously? He might just as well have said Lombard Street as Wall Street. It is a very good question. And it is one to which no one has a good answer. I suspect that some elements of the financial system in New York and London are worth rescuing from the wreckage, but that China would now be wise to pause for a moment of reflection before continuing on with its reform programme. There is no doubt that the Anglo-American model has taken a hit. How severe that hit is we cannot say.

But it certainly causes those of us who have been honoured to asked to advise the Chinese some cause for thought. (Slide 22)

A final question. IS this the opportunity for China to take over the world through its sovereign wealth fund? We have already seen some interesting signs of a transfer of wealth, CIC owns almost 10% of Morgan Stanley, for example.

In fact, at present, CIC is relatively small (slide 23) by the standards of sovereign wealth funds. It could clearly grow rapidly if the Chinese wanted. And I think we will see some transfer of economic power. We have already seen that Chinese banks are very large. Three of them are now in the world's top ten by market capitalisation-though some of that is due to the falls of market values of western banks, rather than a rise in Chinese.

This is another unanswerable question at this point. One worth further reflection. So China now needs to reassess the direction of its reform programme, and the desired end-point , in the light of the crisis. I will review the decisions made, and their implications, this time next year.