U.S. House of Representatives: Committee on Financial Services

Hearing on "U.S. Interests in the Reform of China's Financial Sector"

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Financial Sector Liberalization in China

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I. Introduction

Chairman Frank and honorable members of the House Committee on Financial Services, thank you for the opportunity to share with you my views on the state of financial sector reforms and liberalization in China.

The process of financial liberalization in China is important for two reasons. One is that it has implications for China's balanced economic development, which is obviously of interest to the U.S. The second is that the pace and manner in which this liberalization is conducted will have repercussions on the bilateral economic relationship between China and the U.S. Hence, this hearing, which follows closely on the heels of the Strategic Economic Dialogue (SED) meetings, is indeed timely.

On the narrow issue of whether China is meeting its WTO accession commitments in terms of opening-up its financial services sector to foreign participation, my assessment is that, by and large, China is indeed hewing to the letter of the law. The practical reality, however, is that there are still significant administrative burdens on foreign firms that wish to enter China, but these are hardly insurmountable and vary considerably in intensity across different segments of the financial sector.

It is important to place the opening-up of the financial sector in the context of the broader agenda for reform of this sector. The Chinese authorities fully recognize that it is in China's own interest to open up the financial sector in a manner that goes beyond WTO commitments. Many of their policy statements and actions—such as the prominent role they ascribed more than two years ago to foreign strategic investors in improving corporate governance in domestic banks—bear testimony to this.

The Chinese authorities have serious concerns, however, about the preparedness of local financial firms to deal with foreign competition and about their own regulatory and administrative capacities to handle an influx of foreign financial firms. They are also concerned about precipitously lifting restrictions on cross-border capital flows, which they believe will inevitably happen with a larger foreign presence in domestic financial markets. These concerns have made them cautious and it is useful to keep this perspective in mind while discussing how they may be persuaded to push harder on certain aspects of financial sector liberalization that are in their own long-term interest and are also congruent with U.S. interests.

II. Key Features of the Chinese Financial System and Their Consequences[1]

The state-owned banking system remains dominant in the Chinese financial system. Deposits in the banking system amount to more than 160 percent of GDP. By contrast, the total capitalization of the Shanghai and Shenzhen stock exchanges amounts to about 60 percent of GDP and the capitalization of the corporate bond market is equivalent to only around 1 percent of GDP. Of the total financing raised by the domestic nonfinancial sector in the first quarter of 2007, 98 percent was in the form of bank loans, 2 percent was from equities and virtually nothing was from issuance of corporate bonds.

Capital controls have played an important role in protecting the banking system from external competition by restricting the entry of foreign banks until recently and by making it harder to take capital out of the country. In conjunction with the limited development of debt and equity markets, this means that the state-owned banking system is effectively the only official game in town, for both borrowers and savers. The lack of competition has limited financial innovations and kept the risks of the financial system heavily concentrated among banks.

It is important to keep in perspective the size of the banking system and why it is so crucial to the effective functioning of the economy. Gross domestic savings in the economy amount to about 50 percent of GDP (of which about half is accounted for by households). This annual gross savings figure of over $1 trillion dwarfs net FDI inflows, which have averaged about $60 billion in recent years. Thus, no matter how large the beneficial spillover effects of FDI, reliance on foreign capital inflows will not obviate the problems of a moribund domestic financial system. The size of domestic financial flows being intermediated through the banking system also points to the urgent need to reform banks in order to prevent further misallocation of resources on a massive scale.

Until the late 1980s, lending operations of state-run banks were largely determined by the government. Most bank financing, under directives from the government, went to state enterprises—many of them financially unviable and held together by cheap capital and handouts from the state—creating a legacy of a large stock of nonperforming loans.

The government has moved aggressively to rid the banks of these legacy problems as a first step towards banking reforms. They have focused on the four large state-owned commercial banks, which together account for about two-thirds of total banking system assets. They have already eliminated a large swath of nonperforming loans from the books of three of these banks, recapitalized them, and given them permission to undertake IPOs and list in foreign equity markets. Reform of the last of these four large banks—the Agricultural Bank of China—remains a daunting challenge and is likely to be taken up in tandem with other rural financial sector reforms (this would encompass other smaller institutions such as rural credit cooperatives).

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[1] Many of the figures in this section are taken from the *China Financial Stability Report 2006* and the *Monetary Policy Report* for the first quarter of 2007. Both documents are from the People's Bank of China and are posted at www.pbc.gov.cn/english

Despite the honorable intentions of the authorities, however, the legacy of the era of directed lending lives on in some ways--Chinese banks have still not developed risk-assessment expertise or been given the right incentives to lend based purely on commercial considerations. Thus, lending to state sector enterprises remains far more attractive to banks than lending to the private sector, and this tilt towards lending to state enterprises has been exacerbated by the quantity constraints imposed on banks' credit expansion in recent years.

Corporate governance reforms in these banks have also stalled. To make headway on some of these problems, the government has sought to attract foreign strategic investors to take minority ownership stakes in these banks and thereby push them to undertake reforms to nudge them towards international best practices. But there is still a long way to go in getting domestic banks on a sound footing as robust commercially-oriented financial institutions.

Banking sector weaknesses have contributed to the unbalanced pattern of economic growth, with investment and exports being the key drivers of growth in recent years. The lack of financial market development has played a key role in restraining private consumption growth. The uncertainties engendered by the transition to a market economy, the limited availability of instruments to borrow against future income to finance purchases (major durable goods, housing etc.), and the lack of international portfolio diversification opportunities have all contributed to high household savings.

Financial system repression and controls on outflows of capital have together meant that there are few alternatives to funneling these savings into deposits in the state-owned banking system. Households willingly hold bank deposits despite the weaknesses of the banking system because of implicit deposit insurance provided by the government. This provides abundant liquidity for banks to expand credit which, because of the distorted incentives faced by lenders, largely finances investment by state enterprises. State enterprises that do make profits were, until very recently, not required to pay dividends, encouraging them to plow retained earnings back into investment. Thus, the investment boom in recent years has been fueled by cheap credit and overoptimistic expectations of future demand growth in sectors that are doing well at present.

In the last few years, investment has accounted for more than half of nominal GDP growth; the level of investment now amounts to about 40 percent of GDP. While factor accumulation is a time-honored path to higher growth for developing countries, whether such a high level of savings intermediated mainly through an inefficient banking system can produce long-lasting welfare gains is dubious. The costs of these inefficiencies are probably ultimately borne by depositors, in terms of low real returns on their savings, or through the financing of fiscal transfers to firms and financial institutions.

The investment boom has also raised fears of a resurgence of nonperforming loans if the economy, or even the few sectors that have accounted for much of the recent rise in investment growth, should falter. Indeed, higher inflation is not the only risk on the horizon—there are also risks of asset price bubbles and of future deflation resulting from a buildup of excess capacity if investment growth is not restrained.

The authorities are keenly aware of these problems and have made financial sector reforms a core priority. How does opening up of the financial sector to foreign participation fit into the reform agenda and how much progress has been made on that front?

III. Opening-Up of the Financial Sector: Progress and Challenges

The major WTO accession commitment concerning the financial sector was in terms of opening up the banking system to foreign entry by the beginning of 2007. That commitment has been met in principle, although foreign bank entry remains restricted in some ways. There has also been progress in other areas of financial sector liberalization.

Foreign ownership stakes in the large domestic banks are still limited to 25 percent (20 percent for any single investor). Locally incorporated subsidiaries of foreign banks can now offer a wide range of commercial banking services to retail customers, including taking RMB deposits and making RMB loans, issuing debit and credit cards etc. Setting up a subsidiary bank requires a minimum paid-in capital of $130 million (RMB 1 billion), a requirement on par with that for domestic banks. Similarly, subsidiary banks need to keep their loan to deposit ratio below 75 percent and no single borrower must account for more than 10 percent of a bank's total loan portfolio.

Most such requirements are no different from those imposed on domestic banks but they pose some transitional challenges for foreign-owned subsidiary banks since earlier restrictions on their operations have limited their deposit base and their loan-to-deposit ratios are much higher than the threshold. The government has, however, given foreign banks a couple of years to meet all these requirements. Branches of foreign banks (that do not incorporate locally) are on a tighter leash and face many restrictions on their ability to raise deposits and make loans.

Qualified foreign institutional investors are now allowed to invest directly in renminbi-denominated assets and the quota has recently been raised from $10 billion to $30 billion. This is a ceiling, however, and it remains to be seen how the approval process works. At the recently concluded SED, the Chinese agreed to permit foreign firms to set up new securities firms as joint ventures, although foreign firms are still proscribed from setting up wholly-owned subsidiaries. A number of foreign insurance companies have been authorized to carry out business in the domestic insurance market, and easing of licensing requirements for insurance companies has been promised in time for the next round of the SED.

In short, there has been progress in many dimensions of financial sector opening, although some of this progress seems grudging and restricted in many ways.

What accounts for the slow progress in opening up the financial system to foreign participants? One of the key issues is that regulatory and supervisory capacity remains limited. The authorities seem to recognize that a delicate balance will need to be struck between picking up the pace of reforms and not getting too far ahead of institutional constraints. Continued interest rate liberalization, for instance, is important for the banking system to function efficiently. But an all-out sprint towards full liberalization without adequate regulatory and supervisory mechanisms in place could create perverse incentives that could decrease financial system stability.

Financial system regulation in China is carried out by three major bodies—the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC) and the China Insurance Regulatory Commission (CIRC). The People's Bank of China (PBC) is also involved as it has responsibility for overall financial stability.

These regulatory bodies are facing difficult challenges as the complexity of financial transactions and instruments increases. Furthermore, as financial firms diversify into different realms of business, it becomes increasingly important to monitor cross-sector and cross-market risks. As both domestic and foreign financial firms increase their presence across national borders, cross-border risks will also start becoming important. The level of expertise in the regulatory bodies and the degree of coordination among them in dealing with these risks need to be upgraded to deal with these challenges. Indeed, this is one area in which further cooperation between the U.S. and China could benefit both countries—the U.S. could enhance its transfer of regulatory and supervisory knowledge to China and thereby set in place the conditions for the authorities to become more confident in opening up to foreign firms.

There is also considerable internal opposition to allowing foreign participation in the financial sector, both from entrenched interests such as existing firms and from policymakers who fear job losses and financial market disruptions if domestic financial intermediaries are not given more time to prepare for increased competition.

For all of these reasons, opening up of the financial sector must be placed in the context of broader economic reforms. It is important, for political economy reasons, that calls for such opening not be seen as being promoted by foreign governments for the sole purpose of benefiting foreign financial firms. Indeed, the case for opening-up can be made quite effectively just in terms of promoting the development of the Chinese economy. This will also help to illustrate the fact—which often gets lost in the midst of heated polemics—that the interests of China and the U.S. are closely aligned even in spheres where there would seem to be a direct conflict of economic interest.

IV. The Place of Financial Sector Reform in the Overall Reform Agenda

Financial sector reforms are an essential requirement for macroeconomic and financial stability and, therefore, for sustained and balanced growth. In turn, to be effective, financial sector reforms require a conducive macroeconomic and institutional environment. Rather than seeing reforms or opening-up of the financial sector reforms as isolated policy goals, the importance of simultaneous and complementary reforms in several dimensions needs to be recognized by Chinese policymakers and to be emphasized by U.S. policymakers as part of the bilateral policy dialogue.[2]

A more independent monetary policy is a key requirement for macroeconomic and financial stability, particularly as the economy becomes more market-oriented and complex, and as its rising integration into the global economy makes it more vulnerable to macroeconomic shocks from abroad. A more flexible exchange rate is a prerequisite for being able to direct monetary policy instruments such as the interest rate to meet domestic objectives rather than be constrained by the exchange rate objective. For instance, in present circumstances, giving the PBC room to raise interest rates by freeing it from having to target the exchange rate would help rein in credit to enterprises and deter reckless investment, reducing the risk of a boom-bust cycle.

On the flip side, the lack of effective macroeconomic management could generate risks via the financial sector. In the absence of room for maneuver on interest rates, liquidity flows into the economy could result in asset price bubbles, including in the real estate and stock markets. These markets could become vulnerable to sudden and unpredictable shifts in investor sentiment, which could send them tumbling at the slightest provocation, with broader ripple effects throughout the economy. Moreover, forcing the nominal exchange rate to remain stable has contributed to a rising trade surplus and large capital inflows over the last few years, leading to a gusher of liquidity pouring into the domestic banking system and making the monetary authorities' job of controlling the magnitude and quality of credit expansion much harder. Clearly, exchange rate policy has important implications for financial stability.

The argument that the financial system needs to be fully modernized before allowing currency flexibility has it backwards. Indeed, durable banking reforms are likely to be stymied if the PBC's ability to manage interest rates is constrained by the exchange rate objective. The PBC then has to revert to its old practice of telling state banks how much to lend and to whom, which hardly gives banks the right incentives to assess and price risk carefully in their loan portfolios. This makes financial reforms even more complicated than they already are.[3]

For developing the domestic financial sector, opening up of the capital account—to inflows as well as to outflows—could also serve as an important catalyst. Inflows—including in the form of direct foreign participation in financial intermediation activities—can bring in technical expertise on developing new financial instruments, creating and managing risk assessment systems, and improving corporate governance. Indeed, the approach of using foreign strategic investors, including U.S. banks, to improve the efficiency of domestic banks is a strategy the Chinese authorities see as playing a useful role in their overall reform effort.

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[2] Eswar Prasad and Raghuram Rajan, 2006, "Modernizing China's Growth Paradigm," *American Economic Review*, Vol. 96, No. 2, pp. 331-36.

[3] "Exchange Rate Flexibility in China: Why it Really Matters and How to Make Progress" Eswar Prasad's testimony at the Senate Finance Committee hearing on "Risks and Reform: The Role of Currency in the US-China Relationship" March 28, 2007. Posted at http://prasad.aem.cornell.edu

Opening up to capital outflows should also be encouraged. Allowing outflows would help increase efficiency by creating competition for the domestic banking system and limiting the captive source of funds (bank deposits) that now keeps domestic banks flush with liquidity. Some progress has already been made on this front by raising the caps on the amounts of money that individuals and institutional investors can take out of the country.

It is not enough, however, to permit Chinese residents to take financial capital out of the country; they also need access to instruments for investing abroad. There is likely to be a strong pent-up demand for retail products that give Chinese households the ability to diversify into a broad range of foreign assets. The authorities may be concerned about opening up the floodgates to outflows while the domestic banking system is in poor shape. But there are ways to allow outflows in a controlled manner--for instance, closed-end mutual funds that could be run by foreign financial services firms and that would allow for international portfolio diversification by domestic investors. An approach of this sort would have the added benefit of stimulating development of securities markets.[4]

In summary, opening-up of the financial sector could have important benefits for domestic financial market development. Thus, the narrow interests of the Chinese authorities as well as those of U.S. and other foreign financial firms that are seeking to enter China are in fact much closer than is generally recognized. In order to extract the full benefits, however, it will be important to see this process as part of a much broader set of reforms that should proceed in tandem, including moving towards a more independent monetary policy regime and a more open capital account. Political economy considerations must also be given their due, and the bilateral dialogue through forums such as the SED may therefore be important in bringing to the fore these common interests.

[4] For a specific proposal along these lines, see "Reserve Relief" by Eswar Prasad and Raghuram Rajan in *Wall Street Journal Asia*, February 26, 2007. The proposal is discussed in more detail in IMF Policy Discussion Paper PDP/05/7 by the same authors.