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Policy Forum Article

China's Banking Sector as the Foundation of Financial Reform

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Abstract

China is in the process of undertaking financial reform in many directions—introducing small private banks in the banking sector, promoting bond and equity finance, increasing exchange rate and capital account liberalization, enhancing financial regulation, and promoting the efficiency and scope of finance. While some foreign analysts have focused on the importance of liberalizing the exchange rate and capital account, we believe these aspects of reform take second priority to traditional banking reform, even though the ongoing process in practice is to slowly implement reforms in all areas at once.

Key words: China, banking system, financial system, reform, liberalization

1. Introduction

China is in the process of undertaking financial reform in many directions—introducing small private banks in the banking sector, promoting bond and equity finance, increasing exchange rate and capital account liberalization, enhancing financial regulation, and promoting the efficiency and scope of finance. While some foreign analysts have focused on the importance of liberalizing the exchange rate and capital account, we believe these aspects of reform take second priority to traditional banking reform, even though the ongoing process in practice is to slowly implement reforms in all areas at once.

China's reform agenda for the financial industry is ambitious, and analysts do not expect all of it to be carried out. Even so, the leadership is implementing gradual reforms in a number of areas all at once. China's style of approaching reform in many areas at once has been justified by Fan and Woo (2009), who present China's history of success implementing reforms from all different angles at the same time rather than choosing a particular order of liberalization. This contradicts widely accepted theory, pioneered by Ronald McKinnon in McKinnon 1982, that economic reforms must take on a particular order to ensure that certain institutions are in place before less basic, more sophisticated or more forceful reforms can be put into effect. McKinnon stated that the goods market must be liberalized prior to the financial market.

Evidence of the detrimental effect of capital account liberalization that takes place prior to domestic financial development has been noted in prior research. Eichengreen et al. (2011) find

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that capital account liberalization has positive effects only for countries that have well-developed financial institutions, strong accounting standards, and reliable legal regulations and enforcement. Findings from Gupta et al. (2011) find that for India, limited financial channels along with government ownership of banks and high fiscal deficits limit gains from financial liberalization. Further, although China's capital account is to some extent open, further opening would require allowing an increased in flows of bank assets and liabilities.

In China, not only are the capital account and exchange rates controlled to varying degrees, but the banking sector is also implicitly controlled. Basic logic tells us that if China's domestic financial sector is not market-oriented, liberalization of the capital account and exchange rate regime will be distorted,[1] since equating external with internal conditions will not lead to a market-based equilibrium. This is confirmed by the scholarly literature. Johnston (1998) states 'capital account liberalization…introduces an external dimension and urgency to financial sector reforms. Capital inflows will either be channeled through domestic intermediaries or compete with them'. Stiglitz (1994) underscores this idea, noting that the financial industry is information-sensitive, and therefore particularly vulnerable to potential market failure. Capital account liberalization has resulted in banking crises in a number of countries, including Mexico, Brazil, Turkey, South Korea, Iceland, Russia, Latvia, and others (Ocampo et al. (2008); Reinhart and Rogoff (2009).

We go even further and make the case that within the domestic financial sector, the banking sector should take precedence in the order of reform, before the non-government bond and equity markets. In the process of financial market development, banks often necessarily precede stock and bond markets because banks are to some extent tools of the state. Neither the stock nor the bond market has such a status, especially for China where banks play more important roles than equity and bond markets.

1. such distortion can be overcome later on when the financial reform proceeds with market reform.

China's bond market is dominated by government bonds, and the corporate bond market is underdeveloped, which we believe is as it should be in the short run until the banking sector is better developed. While government bond markets are essential in funding fiscal deficits, short-term non-government bond markets are secondary to the banking sector, which dictates many liquidity and risk conditions in the financial industry. This is the case for several reasons. First, if interest rates in the banking sector do not reflect credit conditions, if they are repressed, bond interest rates that reflect bank policy (such as government or policy bonds) are likely to be repressed as well. In fact, this has been shown to be the case, as Porter and TengTeng (2009) note, since regulating the deposit interest rate impacts the supply of funds available to the financial system, impacting the interbank rate. Second, banks lend to the best credit risks and are constrained in lending to other borrowers. Therefore, if riskier borrowers go to the bond market, the bond market will suffer from high levels of risk. Indeed, we have seen that within the corporate bond market, bond issuers may be highly rated but some are in fact subpar, as evidenced in the first corporate bond failure in March 2014 of Chaori Solar, which had been rated AA at the beginning of 2013. As the firm's conditions deteriorated, the bond was downgraded in step. There was little to no prescience that the firm might default, even though debt had been growing and losses were reported even while the bond was AA rated.

Development of the corporate bond market in its current inception is therefore questionable. Further, although some scholars believe that the [corporate] bond market acts as an alternative to the banking sector, evidence shows that bonds are very weak substitutes for bank loans. Finally, as Hawkins (2001) points out, in countries in which banks' bond holdings are significant, valuation of bonds becomes questionable. This is the case in China, where banks hold 67.5 per cent of the government bond market (Bai et al. 2013), which comprise the largest proportion of the bond market. This points to the conclusion that market distortions must be worked out from the most basic area of financial operations, the banking system.

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Market forces must be expanded in the banking sector to correct the distortions discussed earlier. This means not only lifting the deposit interest rate ceiling, which was carried out this year, but also loosening lending quotas, eliminating preferences for lending to government projects, and removing the band around the benchmark deposit and lending interest rates at which banks can borrow or lend.

The oligopolistic structure of the banking sector also contributes to market distortions, and this structure must be broken to allow for greater competition, especially from private banks. Currently, the Big Four banks, Industrial and Commercial Bank of China, Bank of China, Agricultural Bank of China and China Construction Bank, extend almost half of all loans in China. Many empirical studies have shown that state owned banks are less profitable and efficient than non-state owned banks in China (see, for example, Jiang et al. 2013). These banks crowd out smaller banks since they are perceived as more stable. They therefore have better access to deposits and other sources of loanable funds. These banks tend not to extend loans to small and medium sized enterprises (SMEs), which has cut off financial access to a large percentage of the Chinese economy. Since SMEs provide about 60 per cent of China's GDP, this restricted financial access has led to large inefficiencies in capital funding and distorted interest rates.

The case can also be made that the equity market is secondary to the banking sector. Issues in China's equity market have less to do with lack of interest rate marketization as in the bond market, and more to do with insufficient information stemming from governance issues, which can result in high stock price synchronicity (Lin et al. 2015). Where firms have incentives to hide good or bad performances, stock prices are more likely to converge. There is evidence that those with private information are able to act on this information in trading activity (Chi 2014), as some key information remains hidden. Therefore, even if stock prices reflect given firm fundamentals, which several researchers have found, they cannot reflect withheld information; this means that if the stock market is efficient in terms of given information, it is not efficient in terms of undisclosed information. This reality is evidenced by the fact that the China Securities Regulatory Commission has attempted to deal with fraud among new listings as well as insider trading, but transparency and corruption-related issues continue to penetrate the stock market. If nothing else, the stock market bubble and consequent meltdown occurring in the summer of 2015 have revealed that the stock market is far from efficient.

While there has been extensive debate about the best path of financial development, the more recent institutional view provides some evidence that development of the banking sector before the bond and stock markets may be the best progression. Chinn and Ito (2006) assert that the banking system must be well developed prior to development of the equity market, basing the conclusion on regression analysis. The authors find that in countries with high (low) levels of legal and institutional development, financial openness does (not) help equity markets, since a threshold level of institutional development is necessary in order to reap the benefits of liberalization. Data from 1980 to 2013 show that, relative to the banking system, domestic private bond markets and stock markets become larger as GDP increases (Sahay et al. 2015), which may indicate that these markets are second in order of importance to banking. The reason for this may be because, under the Pecking Order theory, equity finance is a very costly form of finance, after internal finance and debt finance, due to the cost of paying dividends and sending appropriate market signals.[2]

In order to develop the banking sector, information must become more widely available. While a nascent financial credit scoring system is to be implemented in 2017, information is

2. One might argue that pushing forward capital account liberalization and full currency convertibility would help to hasten domestic banking system reform, although we believe this is a dangerous path. In other nations, capital account and exchange rate liberalization without a robust domestic banking sector (or insufficient banking reform) has opened the door to financial crises. This gave way to crises in the Nordic countries and in Southeast Asia, in particular.

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needed now. Further, the quality of this system is uncertain, particularly since it will also include information on legal violations and other aspects. Individual and firm credit scoring requires a consistent and objective scoring mechanism.[3]

China's banking sector does already have several important components in place. Mechanisms to carry out monetary policy are well developed, banks outside of the Big Four number in the thousands, and many interest rate controls have already been lifted.

Monetary policy is smoothly carried out by the central bank through quantitative measures such as required reserve ratio, open market operations, central bank lending, and rediscount mechanisms and to some extent price mechanisms and administrative policies. Evidence reveals that the PBC is moving toward more price-based monetary policy. Fernald et al. (2014) find that China's monetary policy transmission channels, particularly interest rates, have moved closer to those of Western economies. Additional work must be done to enhance price-based monetary policy, such as creating a short-term interest rate to guide expectations.

Over 3,500 banking institutions exist outside the Big Four within China's financial system. These include policy banks, joint-stock commercial banks, city commercial banks, rural commercial banks, rural cooperative banks, rural credit cooperatives, village and township banks, foreign banks, and others. If trust, financial leasing, money brokerage, and other types of companies are added to this list, the number of banking outlets is even greater.

Around 120 types of interest rates were reformed between 1996 and 2007 (Huang et al. 2013). Liberalization was carried out in a specific order as set forth by the State Council and the Central Party Committee. Interest rates in the money market and bond markets were to be liberalized first, followed by the loan and deposit markets. For loan and deposit interest rates, liberalization was to be carried out on foreign currencies first, followed by domestic currencies; loans before deposits; and on long-term, large-value loans and deposits before short term, short-value loans and deposits (PBC 2005).

All of these measures are positive steps toward reform of the banking sector, but the latter must become a priority if reform of the wider financial sector is truly take root. This must occur before the stock and bond markets can become more market-oriented, and especially before capital account and exchange rate liberalization can take place. We strongly recommend that instead of taking on piecemeal reforms of the financial sector all at once, China's leadership focus on the banking sector, orienting this fundamental industry toward more market-based activity and interest rates, and then radiate reform outward.

3. [1]While an economy-wide credit scoring system is not yet in place, credit rating systems have been in place for some time. These may reveal some issues with the provision of credit information, even though credit rating systems are not applied directly to bank loans. Credit rating systems for financial instruments require great revision in order to be effective. Dagong Global Credit Rating, controlled by the State-owned Assets Supervision and Administration Commission, is China's leading credit rating agency. Dagong has rated government-issued debt highly, at times without sufficient justification. Dagong's Chairman Guan Jianzhong even accused his competitors, China Lianhe Credit Rating Co. and China Chengxin International Credit Co, of overrating firms to win business (Bloomberg). Credit rating companies in China often do not consider legal liability, since the legal infrastructure is lacking. Reported firm information often cannot be verified. Without a reliable, tested credit information system for the most basic financial services, banking, proper implementation of bond and equity services, among other things, will be stalled.

Informative

In this article, we discuss the centrality of China's banking system to the financial system as a whole, and make the case that reform and liberalization in the banking sector should take precedence to those in other areas of the financial sector.

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