Towards Openness and Stability

An Overview of China’s Financial System and Monetary Policy

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Introduction

- During the last thirty-five years or so, China has been one of the most successful economies in terms of growth.
- In 2014, the IMF predicts that it will overtake the U.S. and become the largest economy in the world in terms of Purchasing Power Parity.
- China has achieved this despite informal financial institutions, poorly functioning markets and an ineffective legal system underpinning their operation.
- China's financial system is dominated by a large banking sector. The role of stock market in allocating resources in the economy has been limited and ineffective.
- Many opinions indicate that the most successful part of the financial system is a shadow banking sector that consists of alternative financing channels, governance mechanisms and institutions.

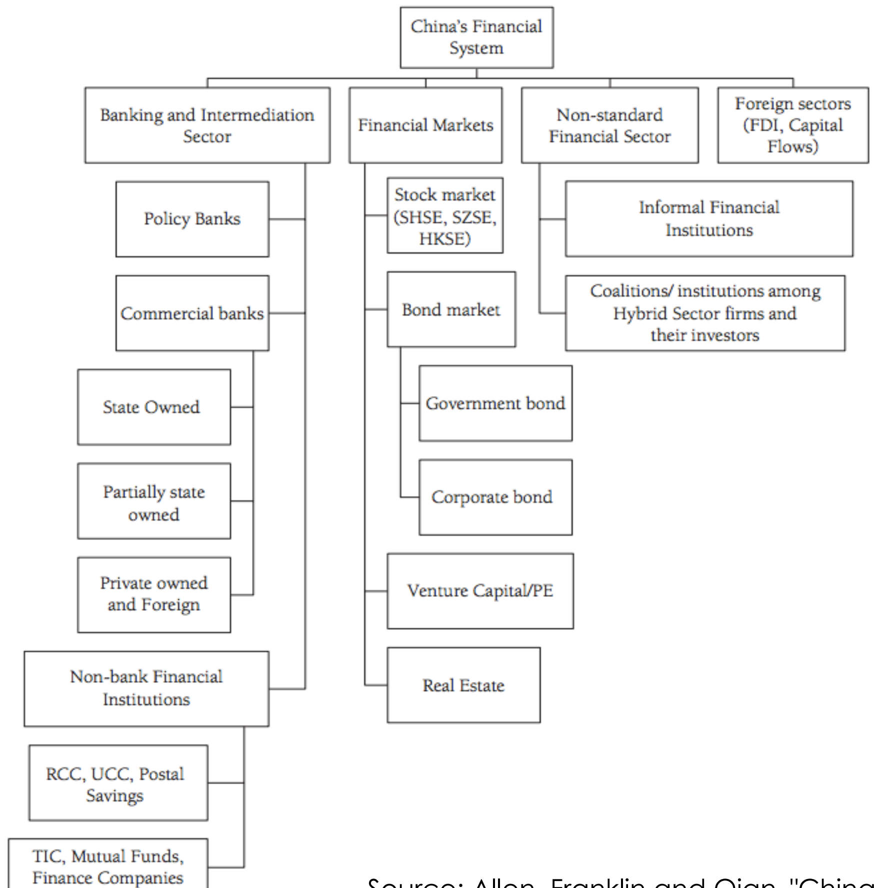
Introduction

- A brief review of the history of China's financial system
- The banking and intermediation sector
- Financial markets
  - Bond markets
  - Stock markets
  - Other sectors (asset management, trust companies, insurance, venture capitals)
- Informal sector
- Monetary policy

Introduction

- Questions to think about:
  - How does the structure of China's financial system imply potential fragility in the economy?
  - Is introducing freedom to the market beneficial or harmful to China's financial system?
  - What does it mean for a economy to have a mature and well-functioning financial system?

Overview of China's Financial System



Source: Allen, Franklin and Qian, "China's Financial System and the Law".

History of China’s Financial Market

- After founding of the People’s Republic of China in 1949, all of the pre-1949 capitalist companies and institutions were **nationalized** by 1950.
- 1950-1978: China’s financial system consisted of a single bank – **the People’s Bank of China** (PBOC), owned and controlled by the central government under the Ministry of Finance.
- PBOC served as both the central bank and a commercial bank, controlling about **93%** of the total financial assets of the country and handling almost all financial transactions.
- Finance the physical production plans: “cash-plan” and “credit-plan” to control the cash flows in consumer markets and transfers flows between branches.

History of China’s Financial Market

- 1978-1984: PBOC dissociated itself from the Ministry and became a separate entity, while three state-owned banks took over some of its commercial banking business.
- **The Bank of China (BOC)**: specialize in transactions related to foreign trade and investment.
- **The People’s Construction Bank of China (PCBC)**: created in 1954, was set up to handle transactions related to fixed investment, especially in manufacturing.
- **The Agriculture Bank of China (ABC)**: created in 1979 to manage all banking business in rural areas.
- Transition in the role of PBOC: central bank
- **The Industrial and Commercial Bank of China (ICBC)** was formed in 1984 and took over the rest of the commercial transactions of PBOC.

History of China’s Financial Market

- **1980s**: fast growth of financial intermediaries outside of the “Big Four” banks
  - **Joint-equity banks** such as CITICS and the China Everbright Bank were founded by raising money from public and private sectors, less government control.
  - **Special Economic Zones**: advantages in trading policy and business operations, regional banks (partially owned by local governments).
  - Rural area: network **of Rural Credit Cooperatives** (supervised by ABC)
  - **Non-bank financial intermediaries**: Trust and Investment Corporations (TIC), operated in selected banking and non-banking services with restrictions on deposits and loans.

History of China’s Financial Market

- 1990: **stock market**, two domestic stock exchanges SHSE and SZSE.
- Growth of real estate market, correlated with stock market.
- Notice the characteristics of high volatilities and speculative short-term behaviors by investors.
- Post-crisis reform after 1997: focused on state-owned banks regarding large amount of non-performing loans, set up regulation (China Banking Regulation Committee).

History of China's Financial Market

- **Institutional investors**: emerged in the late 1990s, the first closed-ended fund from which investors cannot withdraw capital after initial investment (1997), the first open-ended fund from which investors can freely withdraw capital (2001).
- 2003: Qualified Foreign Institutional Investors (QFII), operate through forming joint ventures with Chinese companies.
- 2011: China approved the RMB Qualified Foreign Institutional Investors (RQFII), allowing QFII to invest in Chinese stock and bond markets with a predetermined limit.
- 2006: Qualified Domestic Institutional Investors (QDII) invest in overseas markets.
- Pension fund: not yet a major market player because of limited capital and administration of pension system.

The Banking and Intermediation Sectors

- High household savings rate since the reform era (1980s): growth of the economy, sharp increase in personal income, limited investment opportunities.
- % Time and saving deposits to GDP: around 120% in 2012.
- Interest-bearing savings deposits are by far the most important form of deposits in China (good source for bank loans and other forms of investment)

The Banking and Intermediation Sectors

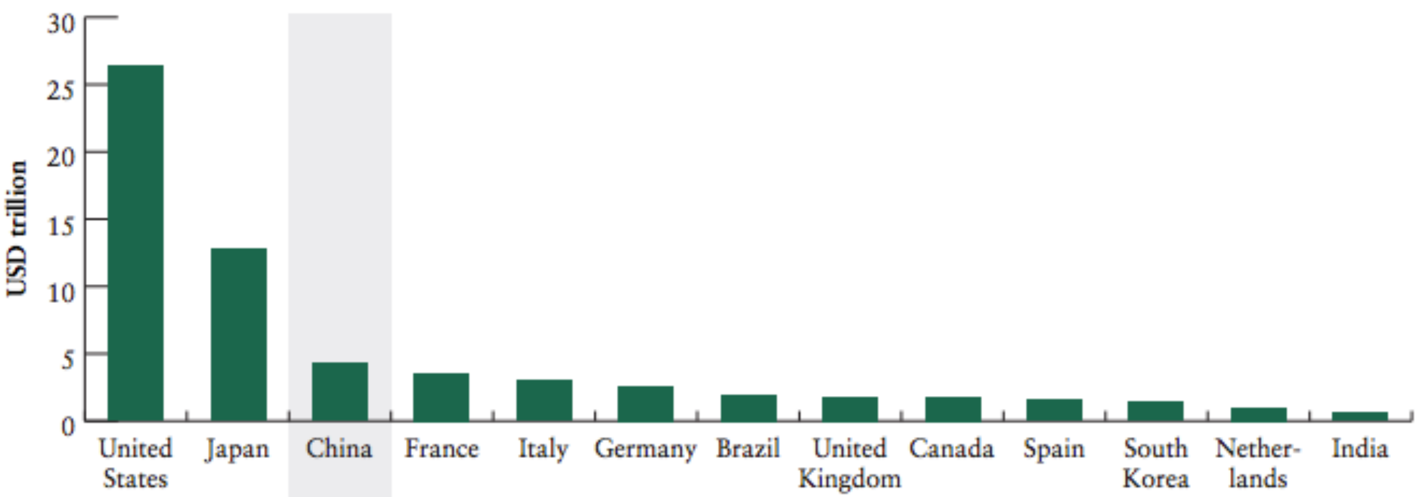
- Lending and deposit interest rates:
  - Banks are allowed to set their own deposit and lending rates but only within strict limits set by the PBOC (base, upper, lower)
  - For example: base rate is 3.5%, upper rate is 1.1 times the base rate and lower rate is 0.8 times the base rate.
- Banks generally pay the highest deposit rates they are allowed to pay and vary in lending rates by different types of loans.

The Banking and Intermediation Sectors

- Non-performing loans (NPL):
  - Came from excessive loans to small state-owned enterprises (SOE) before 2000.
  - Government promote efficiency in the SOEs by reducing NPL especially after the Asian currency crisis.
  - Efficiency of state-owned banks improved after partial privatization was allowed at 2002 (problems: incentive compatibility, corporate governance)

Financial Market: Bonds

- Third largest bond market in the world
- In the past: complicated regulatory arrangements often prevented firms from issuing corporate bonds.
- Beginning in 2010, the major regulatory departments start to coordinate better and reduce the difficulties in bond issuance.

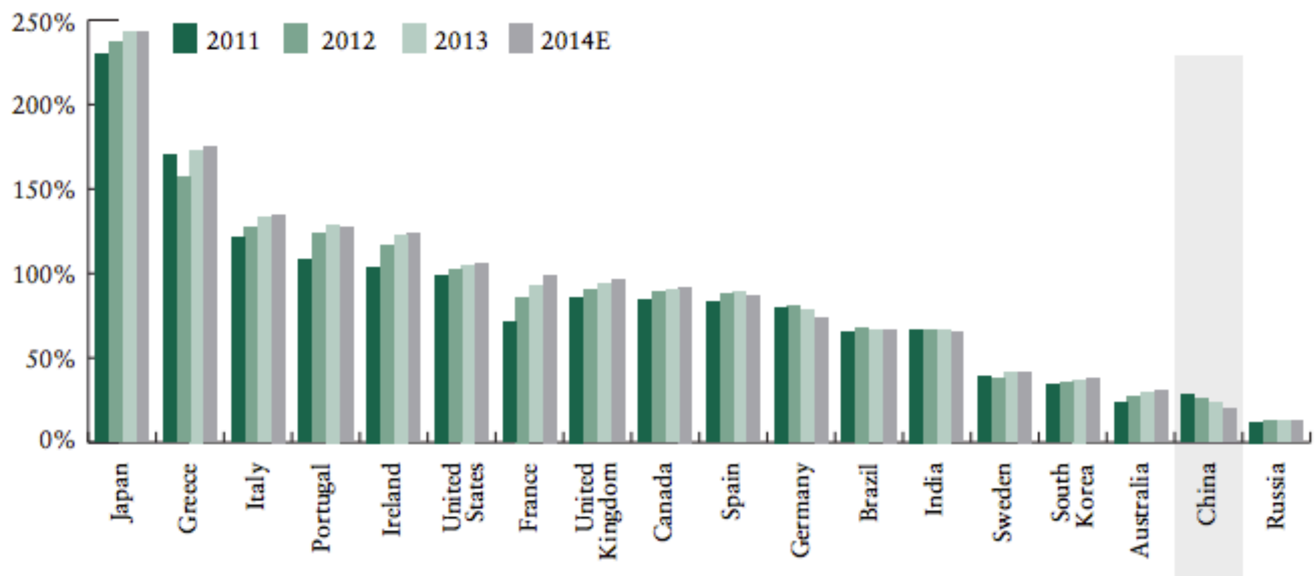


Source: Bank for International Settlements, as of June 2014

Financial Market: Bonds

- Trades: inter-bank bond market (regulated by PBOC), exchange bond market (regulated by China Securities Regulatory Commission). Inter-bank: 95% of the total trading volume.

- China's bond market is growing from a very small base. Despite many years of rapid growth, the country's government debt-to-GDP ratio is relatively low (indicate strong sovereign credit quality).



Source: IMF, as of December 2014

Financial Market: Stocks

- Structure:
  - Two main stock exchanges in mainland – SHSE and SZSE, another major stock exchange located in Hong Kong (traditionally focused on the equities of locally based firms, but has expanded to “H-shares”, shares of Chinese firms, usually majority owned by the government, which have gained permission to trade in HK).
  - A-shares: domestic firms listed on the SHSE or SZSE
  - B-shares: shares of Chinese firms that are allowed to be owned by foreigners and are often denominated in foreign currencies.

Financial Market: Stocks

- Speculative market behaviors creates excess volatility:
  - Cannot ensure dividends and force to sell the firm because of the state ownership.
  - Lack of institutional investors (e.g. pension funds are restricted from operating in stock market).
- Innovations (2010):
  - promotion of stock index futures.
  - allow traders to do leveraged trading and short sales.
  - The two innovations grant substantial edges to the institutional investors by allowing better risk hedging.

Informal Sectors: Shadow Banking

- Reasons of high growth in shadow banking:
  - Local government's borrowing behavior: major competitor with local firms for bank loans.
  - Structure of the Chinese banking industry: large banks dominate and tend to lend to large firms.
  - Under-development of the corporate bond market.
  - IPO regulatory framework creates difficulties for local firms to go public.
  - Periods of negative real deposit rates (Feb 2007 to Oct 2008) due to spurts of high inflation exacerbated the growth of shadow banking.

Informal Sectors: Shadow Banking

- **Shadow Banking**
  - Since 2009: includes entrusted loans, loans by small-scale lending companies, corporate bonds, informal finances, etc.
  - Provide funding for many entities in the Hybrid Sector
  - 2010: PBOC proposed the term **Total Social Financing**, a liquidity measure which covers loans in local currency, loans in foreign currency, **entrusted loans, trusted loans**, bank acceptance bills, **net corporate bond financing** and non-financial enterprise equity financing.
  - TSF became important monetary indicator since traditional indicators such as M2 fail to take all of the social financing sources into account.

Market Characteristics and Monetary Policy: A Motivation

- China has an extensive capital control regime in place, accompanied by various layers of regulations in financial markets. However, the rules are selectively and cautiously dismantled.
- Facing the needs to build a more effective system, the financial infrastructure of China is on a path to further maturity.
- The process of introducing volatility and controlling for risks and fragility is clarified through studying policy changes while thinking about the role that China takes globally.

Monetary Policy Openness: The Role of RMB

- As the size and dynamism of Chinese economy develop, the role of Renminbi (RMB) stands out, and its prospects becoming important.
- Three characteristics of a currency's role in international finance:
  - Capital account convertibility: the level of restrictions on a country's inflows and outflows of financial capital.
  - Internationalization: a currency's use in denominating and settling cross-border trade and financial transactions.
  - Reserve currency: whether assets denominated in the currency are held by foreign central banks as protection against balance of payments crises.

Monetary Policy Openness: Open Up the Capital Account

- Large number of restrictions on the free flow of capital across border.
  - In recent decades, the government started to encourage **outflows** by institutional investors (QFII), and restrictions in **inflows** have been loosen gradually (FDI).
  - Last year, China implemented policies that are similar to the setup of Special Economic Zones during 1980s and encouraged foreign trading within certain areas.
  - China also connected Shanghai and Hong Kong in financial market by introducing **Shanghai-Hong Kong Stock Connect** that allows investors to trade in both markets under certain mechanism and restrictions. Allows more access to foreign capital.
- China has stability in exchange rate and international reserve holding, while overall maintaining limited financial integration compare to other emerging markets.

Monetary Policy Openness: Open Up the Capital Account

- Opening capital account before freeing exchange rate: lack of shock absorber.
- e.g. capital flow volatility could not be effectively offset by a fixed exchange rate.
- Open capital account accumulates external debt.
  - For China, external debt is below 10% of GDP with a high level of international reserve asset as of 2013.
- Domestic risk: restrict central bank policy
  - Potential fragility in banking system and the unregulated part of financial system.

Monetary Policy Openness: Promoting International Use of the Currency

- One of the main part of the 12th Five-Year-Plan (2011-15)
  - Supports the expansion of the cross-border use of RMB and the gradual realization of capital account convertibility; HK as main offshore RMB market.
  - Since 2009: PBOC started to set up bilateral currency swap agreements with mostly developing countries: blends well with trade internationalization.
    - A pilot program that allows RMB settlement of trade with foreign partners, limited initially to five cities (Shanghai, Guangzhou, Shenzhen, Zhuhai, and Dongguan), and to the trade of Chinese residents with Hong Kong, Macao, and ASEAN countries. This established the first legal framework for using RMB to settle current account transactions.
  - The rapid trade internationalization of the RMB, however, does not imply the desirability or the necessity of the RMB financial internationalization, a process that would require much deeper financial liberalization.

Financial Markets: A Weak Link in the Renminbi as Reserve Currency Project

- Financial market development in the home country turns out to be one of the key determinants of a currency's international status.

- Three factors that are relevant to financial market growth:
  - Breadth: the availability of a broad range of financial instruments, including markets for hedging risk.
  - Depth: a large volume of financial instruments in specific markets.
  - Liquidity: a high level of turnover (trading volume).

Financial Markets: A Weak Link in the Renminbi as Reserve Currency Project

- Bank-dominated financial system, with the government direct control.
- Progress in developing equity market: capitalization and turnover now excess those of most other economies, with the notable exception of the U.S.
- Significant restriction applies to foreign investors, and concerns on volatility and weak corporate governance remain.

Financial Markets: A Weak Link in the Renminbi as Reserve Currency Project

- China's aspirations to make the renminbi a global reserve currency hinge in large part on the pace of development of the government debt market (current level is low, third largest, but significantly lower than the first two).
- Meanwhile, the status of currency depends on international financial transactions, and foreign exchange market turnover for RMB accounts is relatively low.
- China falls short on many aspects of financial system, and it is necessary to introduce reforms in order to proceed in internationalization of the currency.

The Reserve Currency

- A conclusion of main criteria:
  - Economic size
  - Open capital account
  - Flexible exchange rate
  - Macroeconomic policies
  - Financial market development

The Role of Central Bank

- The People's Bank of China: "to maintain stability of the value of the currency and thereby promote economic growth."
- Common tools used (OMO):
  - Window guidance policy (persuade banks and other financial institutions to obey the official guidelines)
  - Active adjustment in required reserve ratio
- Liberalizing interest rate
  - Making an ineffective tool more effective

The Role of Central Bank

- PBOC does not operate in a single-instrument environment, nor in an inflation-targeting framework. Instead, the PBOC uses a variety of policy instruments including both price-based as well as quantity-based and administrative policy measures.
- Objectives: economic growth and stable prices.
- Also relevant to exchange rate stability, fiscal targets (job creation, supporting different sectors).
- Monetary policy is implemented in conjunction with the annual economic development targets set by the National Development and Reform Commission. Explicit targets are set for inflation and GDP growth. In addition, an annual target for the broad money (M2) growth is set as the predominant intermediate policy target.

The Role of Central Bank: Price-Based Monetary Tool

- Deepening of the economic and financial reforms in China in recent years has created a need for a more market-oriented monetary policy framework.
- Until 1997, the PBC controlled credit and money directly, and monetary policy was mainly implemented through credit plans.
- An indirect policy management framework was adopted in 1998, and a reserve requirement ratio, open market operations and central bank lending have been introduced as the main policy tools.

The Role of Central Bank: Price-Based Monetary Tool

- Price-based method: interest rate as the main tool
- Used to set benchmark rates on required and excess reserves, rediscounting rate and lending/borrowing rate with different maturities.
- For now, no short-term rate to anchor policy expectations. The PBOC benchmark deposit and loan rates are currently considered the main policy interest rates in China.

The Role of Central Bank: Recent Policy Changes

- 7 June 2012: PBOC started to introduce some flexibility to the bank deposit rate, and banks are allowed to offer deposit rates over benchmark deposit rates by no more than 10%.
- 20 July 2013: the PBOC removed the restriction of 30% downward floating to benchmark lending rates, lifting the restrictions on lending rates.
- 21 November 2014 and 28 February 2015: the PBOC further released the upper limit over benchmark deposit rates from 10% to 30%, when it announced base rates cut.
- 11 August 2015: China devalued the RMB by 1.9% against the USD, after this, policy changed such that rate fixing will now be based on the performance in previous day's trading session.
  - Historically the rate was set by PBOC each day, and it occasionally set the exchange rate against the market indication.

Increase in Money Supply: Stimulus

- Broad money supply growth between 2007 and 2013 was greater than that of the rest of the world combined.
- Spur rapid economic expansion but create the risk of asset price bubbles and widespread loan defaults.
- % M2/GDP: 193% for China, 141% for UK, 89.6% for US, as of 2014 (The World Bank).
- Monetary injection through reserve accumulation (current account surpluses, buy dollars from exporters) and expansion of banks' balance sheet.
- Loss in bank capital quality, fuel bubbles in China's property and stock markets, given the restrictions placed on investing overseas.

Implications

- Important role of Chinese financial system in its economic growth: still vulnerable to risks and its opacity indicates volatilities in the market that could cause financial fluctuation.
- Needs to reform the financial system to achieve parity in the objective of changes in monetary policy.
- Introducing openness into the system requires careful monitoring in potential risks, difficult to manage the balance between openness and safety.

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