
10. The Last Battles of China's Financial Reform

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Introduction

China's financial reform began the moment its leaders decided to shift their policy focus from class struggle to economic development in December 1978. In 1998, Nick Lardy of the Brookings Institution published a book titled *China's Unfinished Economic Revolution*, in which he discussed changes in the financial sector during the reform period and outlined some necessary additional steps (Lardy 1998). More than 15 years later, the 'revolution' remains unfinished. Financial liberalisation is an important component of the comprehensive reform program approved by the Third Plenum of the Eighteenth Party Congress in November 2013.

China clearly lags behind many other emerging market economies in financial liberalisation. Many developing countries achieved market-based interest rates, floating exchange rates and capital account convertibility from the early 1980s. Chinese authorities started to accelerate the pace of reforms in these areas only recently. In the meantime, the Chinese economy recorded the most impressive growth performance during its reform period. This naturally begs the question of whether the conventional wisdom favouring rapid financial liberalisation is the right strategy or if the Chinese experience offers a pointer for other developing countries.

Financial reforms in China over the past decades exhibit a distinctive pattern of being strong on building an industry framework and growing transaction volume but weak on liberalising market mechanisms and improving corporate governance (Huang et al. 2013). On the one hand, China has already built a financial system with all types of financial institutions—from commercial banks to asset management companies, and from insurance agencies to regulatory bodies. The size of Chinese financial assets is also very large, even by international standards. Its bond market is already ranked third in the world in volume. The ratio of broad money supply M2 to GDP is close to 200 per cent—among the highest globally.

On the other hand, the Chinese financial system remains heavily repressed. According to one measure, for instance, financial repression in China is much more serious not only than the middle-income but also the low-income

economies (Figure 10.1). The authorities maintain a broad set of restrictions on credit allocation and cross-border capital flows. They also regulate, directly or indirectly, interest rates and exchange rates. This leaves limited roles for the market system to play. In addition, many financial institutions still show very strong old-style state-owned enterprise (SOE) behaviour, although they are already listed on domestic and foreign stock markets.

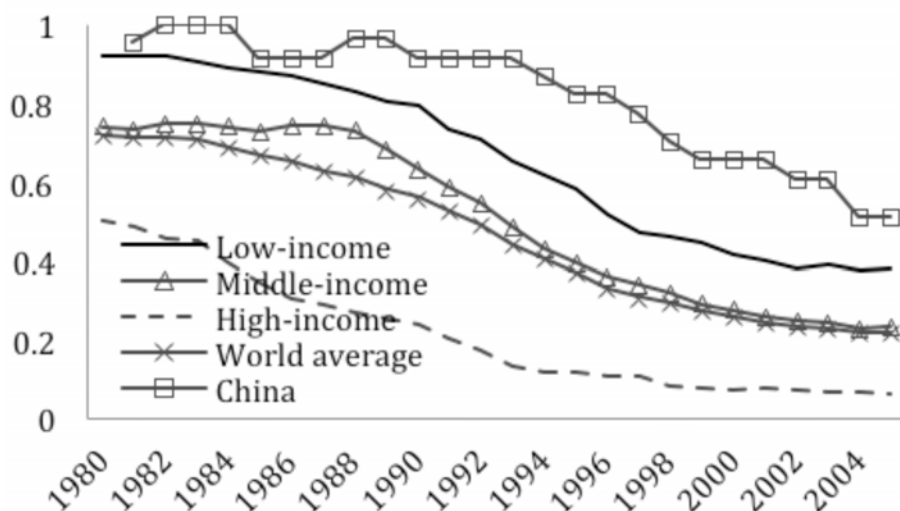


Figure 10.1 Financial Repression Indices for China and the World, 1980–2010

Source: Abiad et al. (2008); and authors' calculations.

Note that Figure 10.1 uses aggregate financial repression indices based on seven subcomponents, with higher values referring to a greater degree of repression. The central theme we attempt to explore in this chapter is how Chinese financial reforms might evolve in the coming years. Specifically, what kinds of changes, opportunities and risks might such reforms bring about? In order to offer insights on these important issues, we first analyse the rationale behind China's unique pattern of financial reform in the past. We then assess the achievements of and challenges caused by such a reform strategy. This helps us to understand why the authorities have now decided to accelerate financial reforms.

The comprehensive reform program contains reform measures in 11 areas, including opening to foreign and private financial institutions; developing multi-layered capital markets; building inclusive financial institutions; establishing market-based interest rates, exchange rates and risk-free yield curves; achieving capital account convertibility; and improving financial regulations. The central

motivation of these reforms is to complete the transition to a market-based financial system. The key steps are interest rate liberalisation domestically and currency internationalisation externally.

The biggest uncertainty is whether financial liberalisation might be accompanied by increasing financial risk or even financial crisis. China is probably the only major emerging market economy that is not experiencing major financial disruption. Only time will tell whether this record can be kept for long. Regulators will face a series of tough decisions, such as allowing default of failing trust products—when doing so could increase financial instability, and not doing so would encourage moral hazard. This suggests that while the Government has now decided to take bold steps in liberalisation, actual implementation of such reform is likely to be cautious. But the change will eventually contribute to transformation of the Chinese growth model.

The Logic of China's financial reforms

Despite more than 30 years of successful reform, the Chinese economy still exhibits the typical features of repressive financial policies. First, the People's Bank of China (PBC) still sets the base interest rates for commercial banks and intervenes heavily in foreign exchange markets. Second, the state influences allocation of capital, with the majority of funds raised through direct and indirect financing channels still going to the SOEs. Third, the PBC frequently adjusts the required rate of return (RRR) for commercial banks, with the ratio exceeding 20 per cent in mid 2011. And, finally, the authorities maintain strict capital account controls, especially over portfolio investment, debt financing and foreign direct investment (FDI).

This, however, did not stop rapid financial development in China. The Chinese financial sector has grown from a mono-bank system 30 years ago to a very comprehensive system, with all types of institutions, clientele, markets and assets. China's broad money supply (M2) is already greater than that in the United States. Many of the Chinese commercial banks are already among the world's top 10 according to market capitalisation. The financial system, however, shows a strong bias towards the banking system. Total bank deposits already accounted for 190 per cent of GDP in mid 2011. Stock market capitalisation was 80 per cent of GDP, while bond market capitalisation was only half that.

Financial repression also did not prevent sound macro-economic performance in China. With the exception of several years during the past three decades, China's macro-economic conditions were stable, with consumer price index (CPI) inflation staying mostly around 3 per cent. GDP growth averaged 10 per cent a

year during the reform period. China is the largest and most dynamic emerging market economy. It is also the second-largest economy in the world soon to overtake the US economy on a purchasing power parity (PPP) basis with significant influences on the income and welfare of people all around the world.

In this chapter, we review policy reforms and financial development in four broad areas: the banking sector; financial markets; the central bank and financial supervision; and exchange rates and external accounts. In general, China made significant progress in developing both the banking sector and the financial markets. Central banking and the capital account are the main areas lagging behind.

We can also classify changes in China's financial sector into four types. The first is construction of a financial framework. As China decided to move towards a market economy, development of a modern financial industry became necessary. For instance, the authorities took serious efforts to make the PBC a true central bank around the mid 1980s. They reconstructed the objectives of and tools for monetary policy. They also created lots of new financial institutions such as large and small banks, insurance companies and security firms. In the 1990s, the Government also developed the stock exchanges in Shanghai and Shenzhen and the interbank market. Clearly, when policymakers took these actions they had financial systems in advanced market economies in mind.

The second is promotion of quantitative financial development. Financial development can be defined according to both quantitative and qualitative measures. So, for instance, it can refer to growth of total outstanding loans and total banking assets. This may be reflected in rapidly growing numbers of financial institutions across the country. Meanwhile, it can also refer to the growing importance of capital markets in the country's total financing. China's financial development has been very rapid. While China's financial deepening, indicated by the rising proportion of M2 to GDP, is already well ahead of most developing and advanced economies, its financial intermediation still relies disproportionately on the banking sector.

The third is reform of financial institutions' governance structure and changing their behaviour. A typical example is ownership reform of the banking sector. Once a large and comprehensive banking industry was built in the mid 1990s, China faced serious financial risks because many banks did not allocate funds efficiently and control risk effectively. In part this was backward banking practice. But more importantly, it was related to the nature of public ownership of most banks. From the beginning of the twenty-first century, the authorities started to change the governance structure of the banks, through the introduction of foreign strategic investors and public listing on stock markets. Today, most major Chinese banks are listed on domestic or overseas

stock markets, with relatively diversified ownership structures. Most financial institutions have also introduced independent directors, new accounting systems, risk-control mechanisms and information disclosure practices.

And the fourth is liberalisation of the financial industry and markets. Liberalisation here may refer to an increase in market competition, such as the introduction of private and foreign financial institutions. The proportion of the state-owned commercial banks (SOCBs) in the banking sector, for instance, declined from more than 80 per cent to close to 50 per cent during the reform period. It may also refer to the freeing up of prices in financial markets, such as interest rates, bond yields, stock prices and exchange rates. The Government has already lifted most of the restrictions on interest rates, although regulation of commercial banks' deposit and lending rates continues. And, finally, liberalisation could imply the lifting of controls over domestic markets and the capital account. From the early years of the reform period, the authorities opened up channels for cross-border capital flows in areas of inward direct investment.

Comparatively speaking, China made remarkable progress in putting into place the basic framework for the financial system and growing its financial assets. The Chinese financial system already resembles a modern financial sector in advanced economies, although important differences in quality remain. China still lags significantly in freeing up key financial market prices, especially interest rates and exchange rates. It also made important improvements in both the behaviour of financial institutions and the allocation of financial resources. Most commercial banks still behave more like SOEs than listed companies. A simple characterisation may be that the Chinese Government made serious efforts trying to build a modern financial sector but was not willing to give up all the controls.

So why did the financial reform show a unique pattern of being strong on framework and quantity but weak on price and quality?

We will try to explain the logic of China's financial reform, applying the framework identified by Huang (2010) in a series of recent studies: asymmetric liberalisation of product and factor markets. Huang noticed that during China's reform period, final product markets have been almost completely liberalised, with prices freely determined by demand and supply, but intermediate goods market distortions and factor market distortions remain widespread and serious. For instance, the Government still intervenes in the prices of important energy products, such as electricity, gas and oil. It also influences key interest rates and exchange rates. Some of these distortions are legacies of the central planning system, while others were introduced during the reform period.

Such distortions have a common feature: they repress factor prices and input costs and lower production costs. For instance, when international crude-oil prices were at their peak around US\$150 per barrel, the domestic equivalent prices were only about US\$80. Again, the real deposit rates in China were frequently in the negative territory during the reform period. Such distortions are like subsidies to producers, exporters and investors. They artificially raise profits of production, returns to investment and the competitiveness of Chinese exports. They help promote economic growth but, at the same time, cause serious internal and external imbalances.

Huang and his co-authors argue that the main rationale behind the asymmetric liberalisation approach is the Government's objective of achieving the fastest possible economic growth. In a typical market economy, the Government's main function should be to provide public goods and services, such as social and legal protection. In China, however, promoting economic growth is a top priority for the Government. Deng Xiaoping once said that development is a hard principle. Economists have since found that GDP growth was the single most important economic indicator determining local officials' chances of promotion. This is, perhaps, why mayors in China act more like corporate CEOs than heads of local governments. And the Chinese Government is sometimes described as being production or development oriented.

Therefore, asymmetric liberalisation is a rational choice by the Government given its policy objective. Free markets for products help overcome the inefficiency problem of the central planning system. At the same time, the Government retains distortions in factor markets, subsidising certain economic activities and allocating resources according to policy priorities. In fact, in the pre-reform period, China adopted a similar strategy to support growth. In the mid 1950s, the Government devised the so-called 'unified purchase and marketing system' for agricultural products. It bought the products from farmers and sold them to urban residents, both at below market prices. This enabled urban industry to generate extraordinary profits, which were reinvested. This was one of the ways of facilitating urban industrialisation.

The same logic is applicable to China's financial liberalisation. From the beginning of economic reform, Chinese policymakers recognised the importance of finance for growth. Therefore, the Government immediately got on with the task of building a modern financial system from scratch. It resulted in rapid growth of financial infrastructure, including the banking sector and capital markets, and financial assets, including loans, stocks, bonds and other financial products. Rapid financial development is consistent with the general style of market-oriented reform. Empirical examinations have confirmed the positive impact of financial development on economic growth during China's reform period.

Policymakers probably also understood the benefits of financial liberalisation, highlighted in analyses by McKinnon, Shaw and others (McKinnon 1973; Shaw 1973). Therefore, the Government continuously expanded the roles of market mechanisms in the financial system. It introduced joint-stock and foreign banks to promote competition. It also gradually allowed market-determined interbank rates and Treasury bond yields and increased the flexibility of exchange rates. It even slowly reduced restrictions on certain types of cross-border capital flows, especially inward FDI.

But liberalisation is not the whole story of Chinese financial reform. The Government continued to play an important role in the operation of the financial system, such as controlling interest rates and exchange rates, interventions in capital allocation and restrictions on cross-border capital flows.

So why did the Government choose financial repression instead of full liberalisation during the reform period? First, repressive financial policies were consistent with the general asymmetric liberalisation approach—supporting growth through repressed factor costs. Specifically, depressed interest rates and exchange rates were like subsidies to investors and exporters and, therefore, were favourable for boosting investment and exports. An undervalued currency, for instance, promoted exports and discouraged imports. This was particularly true during the years following the Asian financial crisis as the Government pursued both strong economic growth and large current account surpluses. Similarly, very low real interest rates encouraged investment, which at least in part contributed to the rising share of investment in GDP during the reform period.

Second, repressive financial policies ensured that sufficient resources were available for economic activities and, particularly, priority areas identified by the policy. Mandatory capital allocation became necessary when interest rates were kept below market levels due to excess demand for funds. More importantly, the Government often used the financial sector as an important means of supporting economic policy. During the Global Financial Crisis (GFC), for instance, the Government adopted a RMB4 trillion stimulus package to boost growth. At the same time it mobilised massive bank loans, which would not have been possible without a majority ownership in many financial institutions. Similarly, in the late 1990s, the Government also called upon the banks to support its 'go west' policy.

Third, repressive financial policies were necessary for the gradual and 'dual-track' reform approach. A key feature of the Chinese reform was to let economic activities grow outside the planning system, without hurting the planned economy initially. This meant the Government needed to continuously support the SOEs, even if they were not profitable. During the 1990s, many banks

provided so-called 'stability loans' or policy loans to failing SOEs. Eventually, the Government had to abandon this practice due to the increasing financial burdens of the banking system; but the initial support, which was made possible under repressive policy, was critical for ensuring smooth progress of economic reforms.

And, finally, repressive financial policies might be critical for maintaining financial stability during the early stage of economic development. The general prediction that a fully liberalised financial system promotes efficiency and growth is dependent on a number of important assumptions, such as perfect competition and complete information. Without these, it would probably be easier for the Government to deal with problems of market failure and financial instability. China's own experiences provide some evidence of this argument. China would probably have suffered a major banking crisis during the Asian financial crisis and a recession during the GFC without majority state-ownership of the SOCBs and a still relatively tightly controlled capital account.

The case for acceleration of financial reforms

If financial policies worked so well in the past or, at least, if they did not prevent rapid economic growth in China, why should the Government accelerate reforms now? Here we provide three broad examples to explain why maintaining the status quo is no longer an option.

The first example is that the growth impact of repressive financial policies has changed from positive to negative. In an empirical examination of the Chinese case, Huang and Wang (2011) identified two theoretical effects of financial repression on economic growth: the 'McKinnon effect' and the 'Stiglitz effect'. The McKinnon effect refers to financial repression reducing economic efficiency and dampening financial deepening, and is thus negative for growth. The Stiglitz effect refers to financial repression helping financial intermediation and supporting financial stability, and is thus positive for growth. In the empirical analyses, Huang and Wang first constructed a composite financial repression index applying the principal component analysis method. The index shows steady decline during the first three decades of economic reform, confirming the trend of steady financial liberalisation.

Then they applied a typical growth equation, with the real GDP growth rate as the dependent variable, using a provincial panel dataset from China. In addition to financial repression (FREP), they also use investment rate (INV), trade openness (TRADE), size of the government (GOV) and the share of SOEs in the economy (SOE) as independent variables to explain growth performance. The basic estimation results reveal several important findings: between 1979 and 2008, financial repression had a positive impact on economic growth

(Table 10.1). The same conclusion holds for the period 1979–99. In Stiglitz's words, this is probably because, under imperfect competition and incomplete information, repressive financial policies actually enable the Government to better deal with market failure problems (Stiglitz 2000; Hellman et al. 1997).

When the empirical examination is focused only on the period 2000–08, however, the growth effect of financial repression turns out to be negative. This is probably because the McKinnon effect now outweighs the Stiglitz effect. If this finding is reliable then the conclusion is straightforward: while financial repression did not hurt growth in the 1980s and the 1990s, it is now reducing growth.

Table 10.1 Estimation Results of the Impact of Financial Repression on Growth in China

	Full Sample	1979–89	1990–99	2000–08
FREP	0.167*** (0.041)	0.787*** (0.132)	0.313*** (0.073)	–0.132*** (0.037)
INV	0.133*** (0.022)	0.068 (0.069)	0.191*** (0.047)	0.100*** (0.021)
TRADE	0.010 (0.008)	0.025 (0.034)	0.010 (0.014)	0.007 (0.012)
EDU	2.361 (0.539)	1.934 (6.445)	0.561 (0.627)	0.438 (0.745)
GOV	–0.189*** (0.055)	–0.225 (0.141)	–0.518*** (0.191)	–0.169** (0.083)
SOE	–0.039* (0.020)	–0.048*** (0.011)	–0.119*** (0.031)	–0.039* (0.023)
Time trend	0.002*** (0.0008)	0.008*** (0.002)	0.003*** (0.002)	0.002 (0.014)
Year-specific effect	YES	YES	YES	YES
Province-specific effect	YES	YES	YES	YES
Observations	750	275	250	225
R ²	0.179	0.138	0.326	0.187

* statistically significant at 10 per cent

** statistically significant at 5 per cent

*** statistically significant at 1 per cent

Source: Huang and Wang (2011).

Notes: Year-specific effect refers to certain years when there were special events such as the Asian financial crisis and the GFC. Numbers in parentheses beneath the coefficient estimates are related standard errors.

The second example is that repressive financial policies already contribute increasingly to macro-economic and financial risks. The first problem relates to the behaviour of the financial institutions. Many Chinese financial institutions have undertaken market-oriented reforms. Nevertheless, most of them still behave more like SOEs than market entities. For instance, the SOCBs went through a major transformation process during the past decade, including writing off non-performing loans, injection of public capital, introduction of foreign strategic investors and public listing. Despite adoption of a modern corporate structure, these SOCBs remain tightly controlled by the state. The senior executives of the banks, including their chairmen and presidents, are still appointed by the Chinese Communist Party (CCP). Important business and personnel decisions are still made by the party committees, not by boards of directors. A striking example is that when the financial institutions should have become cautious during the GFC, the Chinese banks all increased their lending aggressively to support the Government's policy. If the financial institutions continue to act on government instruction rather than market conditions then serious financial risks could emerge in the future.

The second problem is state intervention in capital allocation. For instance, bank lending still heavily favours the state sector. This has become an important constraint on the efficiency of capital allocation, as now the small and medium enterprises (SMEs) play a much greater role in driving Chinese growth. Since bank interest rates are generally depressed, there is a shortage of credit supply. For instance, the one-year base lending rate was 6.25 per cent in June 2011. At the same time, the lending rate in the curb market in Zhejiang province was at 24 per cent. SOEs now account for less than 30 per cent of industrial output, but they still take away more than half of the total loans. If we include borrowing by local government entities, the proportion might even be higher. The more dynamic SMEs, however, find it extremely difficult to obtain loans from the banks. In 2009, in Zhejiang province, where SME financing was better developed, only about 20 per cent of the SMEs obtained loans. Others had to meet their finance requirements through other channels, including borrowing from the curb market. This points to an important aspect of inefficiency in capital allocation.

The third problem includes the significantly distorted interest rates and exchange rates, which contribute to serious economic imbalances such as over-investment, under-consumption and large external account surpluses. Initially the Government utilised repressed interest rates and exchange rates to promote investment and exports. But now the investment share of GDP is already 48.5 per cent, while the current account surplus stayed at above 5 per cent of GDP in 2010. The real negative deposit rates encouraged speculative activities in asset markets in 2010. When the potential for stock and housing price increases

diminished, investors rushed to speculate on products such as cotton, garlic, beans, apples and sugar. Prices of these products skyrocketed one after the other. Again, the undervalued currency has been the main cause of massive 'hot money' inflows. This added significant liquidity to the domestic system and at the same time undermined the independence of monetary policy. All these factors risk the stability of macro-economic conditions and the sustainability of economic growth.

The fourth problem is declining effectiveness of capital account controls, which caused volatile cross-border capital flows and weakened monetary policy independence. Empirical analyses in this study confirmed that it was becoming increasingly difficult for the Government to enforce the capital account control measures. The result was that short-term cross-border capital flows became much bigger and more volatile. This could threaten the stability of the financial system. According to the 'Mundell trilemma', a country can achieve only two of the following three international economic policy objectives: free flow of capital, stable exchange rate and independent monetary policy. Weakening capital restrictions reduce the PBC's ability to control domestic liquidity conditions and interest rates. In a normal year, the PBC sterilises only about 80 per cent of the injected RMB liquidity for foreign exchange market intervention. This contributes to increasing inflation pressure.

And the third example is that many of the policy restrictions are no longer sustainable. One good illustration is that, while the authorities still maintain relatively strict short-term cross-border capital flows, the so-called hot-money flow is already a major phenomenon whenever there is fluctuation in economic and financial activities. This probably means the effectiveness of capital account control is weakening over time. Another illustration is the rapidly growing shadow banking activities, such as trust products and entrusted loans (Figure 10.2). Shadow banking businesses are backdoor liberalisation of interest rates. As the market becomes impatient with strict interest rate regulations, it dis-intermediates the banks and develops large volumes of non-credit financial products. All this suggests that continuation of the status quo is no longer an option.

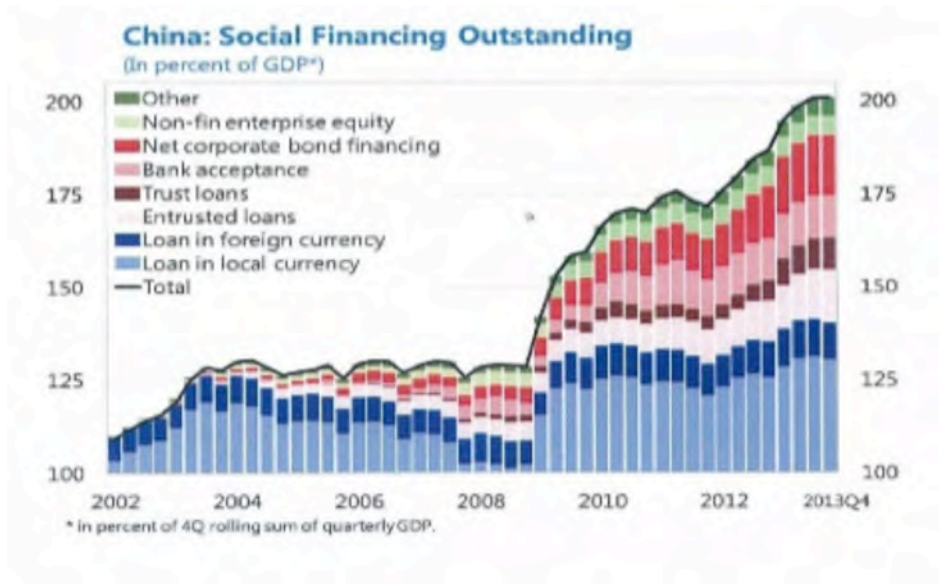


Figure 10.2 Total Social Financing in China

Source: IMF (2013).

What is likely to happen in the future?

There is another broad reason why financial liberalisation should accelerate now. In a recent study, Huang et al. (forthcoming) analysed the roles of financial liberalisation in economic growth at different stages of economic development. Applying a growth equation and 80-country dataset for 1980–2010, they found that the impact of financial repression on economic growth is insignificant in low-income economies, significantly negative in middle-income economies and significantly positive in high-income economies (Table 10.2).¹ These findings are similar to those of Huang and Wang (2011). In any case, today China is already a middle-income country, with per capita GDP of US\$6700. Therefore, it should probably accelerate financial liberalisation even if just to continue rapid economic growth and avoid the middle-income trap.

¹ The growth regression again uses real GDP growth as the dependent variable. The independent variables include financial repression (FREP), law and order (LAW), democracy (DEMC), initial level of income (LogGDP), size of the government (GOVN), education (EDU), inflation (CPI), fertility rate (LogFERTI), life expectancy (LogEXPECT), investment rate (INVR) and trade openness (OPEN) (Huang et al. forthcoming).

Table 10.2 Growth Equation Estimation for 80 Countries, 1980–2010

	Low-income		Middle-income		High-income	
	(1)	(2)	(3)	(4)	(5)	(6)
FREP	-0.0302 (0.0379)	0.0062 (0.0342)	-0.0803*** (0.0203)	-0.0789*** (0.0202)	0.0394*** (0.0148)	0.0390** (0.0150)
LAW		0.0945*** (0.0219)		0.0301** (0.0151)		0.0067 (0.0161)
DEMC		0.0101 (0.0186)		-0.0160 (0.0121)		0.0044 (0.0174)
LogGDPP	-0.0673*** (0.0193)	-0.0812*** (0.0178)	-0.1258*** (0.0143)	-0.1293*** (0.0143)	-0.1189*** (0.0163)	-0.1224*** (0.0186)
GOVN	0.0828 (0.1361)	-0.0618 (0.1233)	-0.4517*** (0.0821)	-0.4386*** (0.0816)	-0.3984*** (0.1072)	-0.3831*** (0.1126)
EDU	0.0130 (0.0099)	0.0049 (0.0088)	0.0165* (0.0085)	0.0150* (0.0085)	0.0199*** (0.0073)	0.0193** (0.0074)
CPI	-0.0338** (0.0158)	-0.0080 (0.0156)	-0.0025** (0.0010)	-0.0026** (0.0010)	-0.0648 (0.0733)	-0.0629 (0.0740)
LogFERTI	-0.0966** (0.0434)	-0.0478 (0.0428)	0.0184 (0.0250)	0.0257 (0.0251)	-0.0391** (0.0178)	-0.0386** (0.0183)
LogEXPECT	0.0359 (0.0732)	-0.0469 (0.0668)	-0.1445 (0.0935)	-0.1827* (0.0945)	-0.0286 (0.2367)	-0.0266 (0.2385)
INVR	0.1186 (0.0748)	0.0997 (0.0670)	0.1929*** (0.0494)	0.2004*** (0.0492)	0.2194*** (0.0615)	0.2215*** (0.0640)
OPEN	0.0002 (0.0006)	0.0010* (0.0006)	0.0005* (0.0003)	0.0006** (0.0003)	0.0010*** (0.0002)	0.0010*** (0.0002)
Constant	0.4794 (0.3390)	0.7533** (0.3035)	1.7030*** (0.3865)	1.8743*** (0.3911)	1.2671 (1.0771)	1.2813 (1.0862)
Year effect	YES	YES	YES	YES	YES	YES
Country effect	YES	YES	YES	YES	YES	YES
R2	0.511	0.636	0.606	0.618	0.655	0.656
Observations	103	103	242	242	158	158
Countries	21	21	47	47	24	24
Hausman test	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000

Source: Huang et al. (forthcoming).

Notes: Standard errors in parentheses. We only report fixed-effect results here as the Hausman test indicates the fixed effect is more suitable.

*** $p < 0.01$
 ** $p < 0.05$
 * $p < 0.1$

So what will happen to financial reform in the coming years? The comprehensive reform program lists key changes in the following 11 areas:

- opening to foreign and private financial institutions
- promoting reform of policy for financial institutions
- developing multi-layered capital markets
- perfecting insurance and compensation systems
- developing inclusive financial activities
- encouraging financial innovation
- establishing market-based interest rates, exchange rates and yield curves
- achieving capital account convertibility
- improving financial regulation
- establishing a deposit insurance system
- strengthening financial infrastructure.

According to PBC Deputy Governor, Yi Gang, these reforms fall within three broad areas: reducing entry barriers, liberalising market forces and improving financial infrastructure.² These are the three critical pillars for building a market-based financial system—both improving efficiency and controlling risk. Alternatively, we may view this comprehensive reform program as two important tasks: interest rate liberalisation domestically, and currency internationalisation externally.

Interest rate liberalisation has been an ongoing process. In the early days of reform, the PBC set all types of interest rates for financial institutions to follow strictly. Over time, the PBC gradually relaxed its grip. Today, both money market and bond market rates are freely determined by demand and supply. Although the PBC still sets base deposit and lending rates, commercial banks enjoy certain degrees of flexibility. There is no longer a ceiling on lending rates, although there are still floors. The deposit rates are still regulated with more strict ceilings. The floors for lending rates and the ceiling for deposit rates ensure the minimum interest rate spread for the commercial banks. Many economists argue that the most critical step for interest rate liberalisation is to lift ceilings for deposit rates.

Lifting ceilings for deposit rates could symbolically be the last step of interest rate liberalisation. This step alone, however, requires a large number of prerequisite conditions to be met. For instance, effective reforms of commercial banks are necessary in order to avoid reckless competition for

2 Discussion by Yi Gang at the Twentieth Anniversary of the China Center for Economic Research at Peking University, Beijing, 19 April 2014.

deposits by significantly raising deposit rates without carefully considering financial consequences. Commercial bank reforms require at least two important steps: enforcement of market discipline through bankruptcy and default, and introduction of a deposit insurance system to control systemic risk. Similarly, soft budget constraints for some institutions such as the SOEs and the local government investment vehicles (LGIVs) need to be hardened. Otherwise these institutions may accept ridiculously high interest rates in order to crowd out more productive private enterprises.

In the meantime, if the PBC's base interest rate regulation is to go then it needs a new instrument for its monetary policy. One of the potential candidates is the Shanghai Interbank Offered Rate (Shibor). The PBC could influence levels of Shibor by increasing or decreasing liquidity in this market, just the way the US Federal Reserve affects the Federal funds rate through open market operation. Currently, however, Shibor is still way too volatile. The market needs to introduce many more institutional participants and to substantially increase liquidity. In addition, China needs a well-developed government bond market to generate an efficient yield curve, serving as the benchmark rates for the market.

One interesting question is often raised in discussion: would China's interest rate rise or fall after interest rate liberalisation? The answer is likely to be complicated. In the short run, interest rates in the formal sector, such as the commercial banks, could rise. The fact that there is a large non-formal credit market is strong evidence that the interest rate in the formal sector is too low. Excess demand is pushed to the informal markets, such as informal lending and shadow banking, where interest rates are unusually high. Interest rate liberalisation could lead to convergence in these two markets. In the long run, whether the interest rate in China would rise or fall is dependent on two factors: growth potential (slower growth means lower interest rates) and capital flows (outflow implies higher domestic interest rates).

The second key theme is internationalisation of the renminbi. The Government apparently stepped up efforts to promote international use of the renminbi after the GFC. This was partly because many saw the subprime crisis as foreshadowing a dimming future for the US dollar. More importantly, many also believed that an internationalised renminbi would bring tremendous benefits to the Chinese economy, such as greater exchange rate stability and lower balance-of-payments risk.

The PBC first formulated its strategy for internationalising the renminbi in 2006 when it proposed a dual-track strategy: promoting international use of the renminbi in trade and investment settlement, and liberalising the capital account. Many officials also argue that currency internationalisation could be used as an instrument to force domestic reforms. In the official document,

however, the term internationalisation is never used. At the end of 1996, China realised current account convertibility. The comprehensive reform program approved recently specifically suggests achieving capital account convertibility as one of its key tasks.

The renminbi is, however, still a long way from becoming an international reserve currency. Many optimists tend to pay a lot of attention to China's already gigantic economy. The logic is simple: China is already a major world economy and, therefore, its currency should play some international role. A quick review of experiences of international currencies during the twentieth century suggests that the size of the economy may be an important favourable factor, but it is by no means a sufficient condition. We apply quantitative methods to identify determinants of international currencies' shares in global reserves and then use the results to predict the renminbi's potential share. We find that, if only GDP and trade weights are used then the renminbi's potential share could be as high as 10 per cent of global reserves at the end of 2011. If, however, policy and institutional factors such as capital account controls and economic freedom are considered, then the renminbi's potential share would only reach around 2 per cent (Figure 10.3). This suggests that the main obstacles to the renminbi becoming an international reserve currency are policy restrictions and institutional barriers.

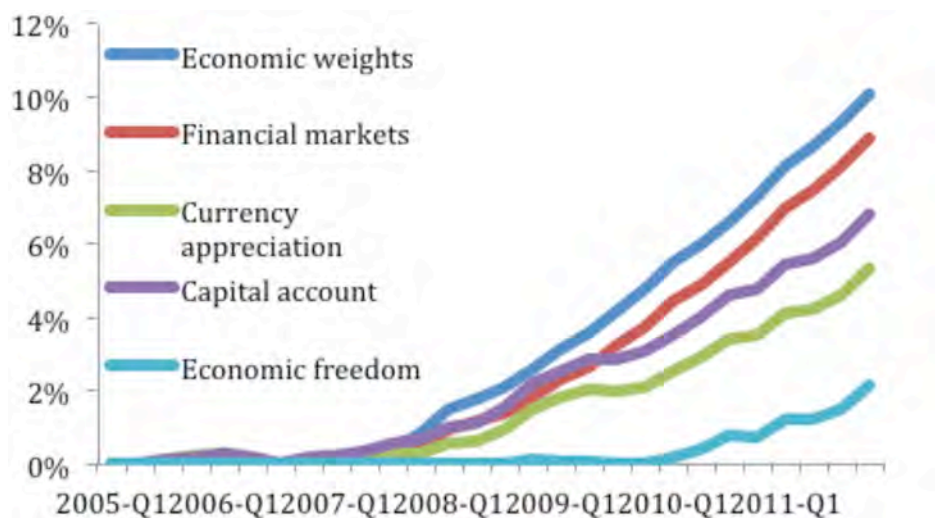


Figure 10.3 Predicted Shares of the Renminbi in Global Foreign Reserves

Source: Huang et al. (2014).

So what should China do to effectively internationalise the renminbi? It can certainly continue to push on the first track—that is, promoting use of the renminbi in international economic transactions, including establishment of

more offshore markets, issuance of more RMB-denominated assets overseas and use of the renminbi for trade and investment settlement. China may also adopt two additional strategies for this purpose. One is to add the renminbi to the special drawing rights (SDR) basket of the International Monetary Fund (IMF), which should significantly raise the international profile of the currency and make internationalisation efforts a lot easier. And the other is to introduce a new mechanism for intra-regional crossholding of reserve currencies in Asia.

For the purpose of currency internationalisation, however, the broadly defined second of the two-track strategy is probably more critical as it creates the foundation of a global reserve currency. We identify reforms in the following three areas for this purpose.

The first is to support sustainable growth of the Chinese economy. While economic weights are not sufficient conditions for a global reserve currency, any hopes for the renminbi to become an international currency could collapse if the Chinese economy suddenly stagnates, as happened to the Japanese economy in the 1990s. An imminent challenge for the Chinese economy now is to change the growth model, which may be characterised as a combination of strong growth and serious imbalances. The key is to go further with economic reforms. The new Government's economic policy framework, popularly termed as 'Likonomics', contains three important pillars—that is, no more major stimulus, de-leveraging to control financial risks and structural reforms. Government officials and policy advisors are working on reform programs for a large number of areas, including the financial system, fiscal policy, land use, administrative controls, factor prices, income inequality and the household registration system. Successful transformation of the growth model depends on the following reforms: liberalisation of interest rates, exchange rates and the capital account; changing local governments' role from directly engaging in production and investment to public goods provision; and breaking the monopoly power of the state sector.

The second is to create an open, large, efficient and liquid financial market. To serve as an international reserve currency, the renminbi needs to be supported by a financial market that is easily accessible to non-residents. One major step is to liberalise the capital account. Capital account liberalisation has been an ongoing process, with the capital account control index declining from 100 per cent in 1977 to 53 per cent in 2011. The Government now plans to realise basic convertibility by 2015 and full convertibility by 2020. There is, however, a major debate about whether this might be too aggressive and could trigger a financial crisis. The answer to this caution should be to keep a close eye on both the necessary conditions and the sequencing of liberalisation.

Nevertheless, capital account liberalisation is also a necessary step for currency internationalisation; however, the financial markets need to be open, liquid and efficient, and equipped with well-developed hedge instruments.

The third is to improve the credibility of China's economic and political systems. The essence of an international reserve currency is that international investors have long-term confidence in it. To support such confidence, China needs to improve its economic, legal and political systems. This is particularly important, since all other existing international reserve currencies are from developed economies that have well-developed economic and political systems. We suggest three preliminary steps for China: 1) an independent monetary policymaking mechanism; 2) a sound legal system that protects property rights and enforces bankruptcy laws; and 3) a political system that is more transparent and better represented.

Even if all these efforts are successful, we think internationalisation of the renminbi will be a long-term process. We think the renminbi will not become a global reserve currency in the coming decade or any time soon after that. But the renminbi's international roles may be extended steadily, perhaps first in the neighbourhood, then in the region and finally globally.

Concluding remarks

China's financial liberalisation has been going on for more than three decades. Its financial policies, however, remain highly repressive. Previous studies have found these policies do not prevent rapid economic growth. On the contrary, they probably helped China's economic growth by effectively translating saving into investment and by supporting financial stability. But there are at least three reasons reforms should accelerate now: the negative impact of financial repression on economic growth; growing macro-economic and financial risks as a result of repressive financial policies; and the inherent unsustainability of policy restrictions at China's stage of development. Chinese leaders devised a comprehensive reform program for the financial sector, which includes specific measures in 11 areas. There are two very broad themes. In the near term, interest rate liberalisation should dominate, while over time, currency internationalisation, including capital account convertibility, should take over.

While we believe financial liberalisation is critical not only for China's transition towards a market economy but also for its sustainable economic growth, global experiences also suggest that the consequences of financial liberalisation are highly uncertain. We conclude discussions by addressing one big issue of financial liberalisation and financial risk or crisis.

We believe China's leaders are serious about financial liberalisation. The new leaders have repeatedly argued that it is time to tolerate slow growth in order to push ahead with tough reforms. The Government's official growth target has been lowered from 8 per cent to 7.5 per cent. The Government, however, remains extremely nervous whenever growth momentum slows, even if only marginally below the target. The same is reflected in the Government's reluctance to allow default in the financial market. The worry is that default of some financial products could lead to repricing of these assets and, therefore, hurt growth momentum by worsening terms of financing. Another worry is that default could lead to the beginning of a meltdown of the financial system. Without default, however, it will be impossible to enforce market discipline and to reduce moral hazard problems.

Will China be able to avoid a financial crisis and, therefore, become an exception in the emerging-market world? Our answer is that it is possible but depends on how China implements reforms. Financial liberalisation is tricky—it improves the efficiency of capital allocation but at the same time also raises financial volatility. The key to avoiding major financial problems in the wake of liberalisation is to emphasise the prerequisite conditions and reform sequencing. If the capital account is opened up before effective improvement of the commercial banks and other financial institutions, and before elimination of misalignment of interest rates, then financial crisis could be a certainty. Therefore, while financial liberalisation should accelerate, it is crucial to follow the proper procedure.

International investors routinely predict a meltdown of the Chinese economy or its financial system every six months. They often point to risks of the property markets, commercial banks, shadow banking businesses and local government investment vehicles. While there are real risks in these areas, we don't believe they could cause a meltdown in the near term. The truth is that most of the institutions involved are either state-owned or directly related to the state. Therefore, the risk of financial crisis in China today might be crystalised by a liquidity squeeze but is unlikely to be caused by insolvency. The Government still has a sound fiscal system to contain financial risks in individual areas; but this could also be a source of major concern, as the Central Government's credibility is overdrawn. If this is not stopped quickly, it could eventually amount to a big problem.

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