Review of China Financial System

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Abstract

China financial system design is reviewed. Past academic and non-academic publish material is perused to formed an understanding of the present financial system. Discussion and recommendation suggested strengthening the present reform of financial system.

Introduction

While some report on China’s financial system reform had been objective, there had been overly pessimistic reports in the past (Lardy, 1998; Chang, 2001). The reform of China’s financial system has been gradual and cautious (Chow, 2011; Lin 2012) and as shown in Figure 1, after a period of fast economic growth, the economy will take a breather before moving north again.

Some research had suggested that instead of following the Anglo-Saxon market based model with widely held equity and an active market for corporate control China should adopt the German bank based financial system with a stable core of majority equity owners exercising directly control on management. (Corbett and Mayer 1992; Mayhew and Seabright, 1993).

At the moment China is going through a period of consolidation. (Walter & Howie, 2011; Mansharamani, 2011; World Bank, 2012) had voiced their concern as to the sustainability of China rapid economic growth. There is a growing consensus that China’s banking remains woefully dysfunctional despite almost 40 years of reforms (Goodstadt, 2012). But, China’s financial system has undergone tremendous and constant structural changes since 1979 (Bell and Chao, 2010).

According to (World Bank, 2012) report, China should complete its transition to a market economy through fiscal and financial sector reforms. Edmund Phelps from Columbia University said that China needed a brand new financial system that is not tied up to local government and therefore more flexible and able to respond to opportunities and demand of businesses.

The lack of a well-functioning financial system is one of the main weaknesses of transition and former centrally planned economies (Goodstadt, 2012).
The importance of well-functioning financial institutions in promoting economic growth (World Bank, 1989; King and Levine, 1993 a, b; North, 1990; Levine, 2002; Neal, 1990; Rousseau and Sylla, 2003; Goodstadt, 2012) and (Song and Thakor, 2012) discovered strong evidence that the development of financial market correspond positively to economic growth.

(Merton and Bodie, 2005), concluded that the design and implementation of a well-functioning financial system promote long-term economic growth. China’s longer-term economic goal involves moving to a more sustainable growth model appropriate for a maturing economy and one that is more innovative and less resource-intensive. It takes some macroeconomic rebalancing from foreign to domestic demand, of which the gradual shift from investment to consumption within domestic demand.

China may seems to be insulated from external markets does not mean it is crisis proof and from Figure 1, we can see that that external factors can disrupts economic growth (Walter & Howie, 2011). The (World Bank,2012) reported that China’s growth is in danger of decelerating rapidly and without warning. When calling for financial reform, the critics meant an ideal financial system.

The question is what is the design of a well-functioning financial system?

Unfortunately it does not exist as highlighted by (Allen, 1999) which raised the following questions: “Why do different countries have such different financial systems?” Do their economies have different needs, resources, and technologies that require different financial systems? Are different financial systems performing different functions or do they constitute different ways of doing the same thing? Can we say that one system is “better” than another?"

Thakor (1995) reviewed three dimensions of financial system design: (i) the permissible scope of activities for banks and other depository financial intermediaries, (ii) the regulations dictating the structure of the banking industry, and (iii) information disclosure requirements in the financial market.

The objectives of these paper is to firstly; understand the present system, discussed their strength and weakness and without bias argue the type of reform that would assist China economically in the future. This can only be done by acknowledging that the USA-UK market based model is not superior to the banking based financial system but both systems has its’ merits.

We perused past academic journals, newspaper articles and seminars in order to understand the entire situation without bias. We recommend that further research on the China economic miracle. Similar to (Allen, Qian, Zhang & Zhao, 2012), we discovered that the lack of rule of law has not hinder China’s economic progress. Professor Costas Markides from London School of Economics said “sometimes regulations and law may increase fraud because corporate figures may hide behind these laws as an excuse for committing these crimes” China may not have regulation and strong corporate governance but it does have harsh punishment for white collar crime.

The rest of this article is as follows. In Chapter 2, we define what is meant by a financial system so that we understand we are taking about the same issue. Chapter 3 is Literature review where we look at what other researchers had written about the various different financial system design and
implementation. In chapter 4 we take a look at the present financial system of China, chapter is discussion on what need to be reformed, in chapter 6, we provide our recommendation and chapter 7 is conclusion.

1 Definition and purpose of a financial system

The financial system allows the transfer of money between savers (and investors) and borrowers (Sullivan & Sheffrin, 2003). The financial system is made up of financial markets, financial institutions and financial instruments. Many business ideas cannot be implemented if they do not have access to capital. As for savers, they will always want better returns and if they are not rewarded for their savings or for taking extra risk for investment they will not be motivated to save. China economic miracle is greatly due to this large number of ordinary people depositing small amount of savings individually but collectively, it has made China the largest creditor nation.

"Financial systems are crucial to the allocation of resources in a modern economy. They channel household savings to the corporate sector and allocate investment funds among firms; they allow inter-temporal smoothing of consumption by households and expenditures by firms; and they enable households and firms to share risks. These functions are common to the financial systems of most developed economies. Yet the form of these financial systems varies widely" (Franklin & Gale, 2001).

Perhaps this could explain the rise of China corporations and businesses. China large pool of savers accumulated large amount of funds and the funds in turn helped finance China corporations. (Franklin & Gale, 2001) said that financial system varies widely therefore it to be expected that China financial system may be different from the Western model but what matters is that it works and contribute to the development of a country economy.

The key to financial system design is to understand the goals of the economy as a whole and to explore how different combinations of pieces of the system can best achieve those goals (Kaufman and Kroszner, 1997). The primary purpose of the financial system is to bridge the space between the savers and the investors. According to (Merton and Bodie, 2005), a good financial system is displayed in the quality of five key financial functions:

(a) Producing and processing information about possible investments and allocating capital based on these assessments
(b) Monitoring individuals and firms and exerting corporate governance after allocating capital;
(c) Facilitating the trading, diversification, and management of risk;
(d) Mobilizing and pooling savings;
(e) Easing the exchange of goods, services, and financial instrument.

Chakrabarti (2012) states that while the primary job of the financial system is to bridge the space between the savers and the investors, in doing so it fulfilled several other roles such providing
information, corporate governance and risk management.

(Čihák, Demirgüç-Kunt, Feyen & Levine, 2012) study documented cross-country differences and time series trends from 205 economies from 1960 to 2010. This paper introduces the Global Financial Development Database, an extensive dataset of financial system characteristics which includes measures of

(a) size of financial institutions and markets (financial depth)

(b) degree to which individuals can and do use financial services

c) efficiency of financial intermediaries and markets in intermediating resources and facilitating financial transactions (efficiency), and

d) stability of financial institutions and markets

These studies provide us with a benchmark to compare China's current financial system effectiveness. Perhaps by comparing the present financial system to these ideal systems, we can decide on what is the reform required in order for China to move forward. In the next chapter, we analyse the previous reform to the financial system and decide if they had achieved the goal set out previously.

3. Literature Review

There are two important branches in the literature that studies financial system of a country (Allen, 1999). One investigates the relationship between the legal environment and the financial system which was pioneered by (Laporta, Lopez-de-Silanes, Shleifer, and Vishny, 1997; 1998) and the second is concerned with the relationship between financial systems and economic growth (King and Levine, 1993a; 1993b; Levine, 1999). The particular focus of Levine (1999) is how the legal and regulatory environment affects financial intermediary development and whether there is a causal link between financial intermediary development and economic growth. He finds that greater priority given to creditors, greater enforcement of contracts, and better information disclosure lead to more developed intermediaries.

France, Germany, Japan and China follow the bank-based financial system and rely on financial intermediaries to finance businesses. Chakraborthy & Tridip (2003) studied bank-based versus market-based financial systems and concluded that bank monitoring involved agency problem, while market-based financial system requires less intervention.

Schmidt, Hackethal, and Tyrell (1999) studied the nature of the transformation of the financial systems of France, Germany, and the United Kingdom over time. It is often suggested that as European financial integration proceeds, these countries’ financial systems are converging and becoming more market-based with banks playing a less important role. Their findings did not support this theory, only in France has there been a persistent move away from banks toward financial markets.

Merton & Bodie (2005) proposes a functional approach to designing and managing the financial systems of countries.

4. China Financial System

Prior to 1979, China has a centrally planned economy, a Soviet-style mono-banking system the People’s Bank of China (PBOC) controlled almost four-fifths of all bank deposits and provided 93% of...
all loans (Lardy, 1998). Various other authors had perform studies on this area. The financial system has undergone on-going reformed since then.

Currently the present financial system is best described by (Allen, Qian, Zhang & Zhao, 2012). They discovered that:

1. The current financial system is dominated by a large banking sector. In recent years banks have made considerable progress in reducing the amount of non-performing loans and improving their efficiency. It is important that these efforts are continued.

2. The role of the stock market in allocating resources in the economy has been limited and ineffective. Further development of China’s stock market and other financial markets is the most important task. Third, the most successful part of the financial system, in terms of supporting the growth of the overall economy, is a non-standard sector that consists of alternative financing channels, governance mechanisms, and institutions. This sector should co-exist with banks and markets in the future in order to continue to support the growth of the Hybrid Sector (non-state, non-listed firms).

3. In order to sustain stable economic growth, China should aim to prevent and halt damaging financial crises, including a banking sector crisis, a real estate or stock market crash, and a “twin crisis” in the currency market and banking sector.

Keidel (2008) stated that China has a two-part financial system with a competitive market-based component and a public, government directed component. The market-based component is immature and subject to systemic weaknesses, while the government directed component, although not perfect, performs essential funding for infrastructure and large mega projects effectively. The author went on to say that critics claim that China’s financial system is inefficient, with banks considered technically insolvent but a realistic evaluation of the system’s resources and accomplishments, including investment rates of return and efficiency in generating sustained growth, can only conclude that China’s financial system is performing well and is likely to continue to do so.

China’s financial system is highly regulated and has recently begun to expand rapidly as monetary policy becomes integral to its overall economic policy. As a result, banks are becoming more important to China’s economy by providing increasingly more finance to enterprises for investment, seeking deposits from the public to mop up excess liquidity, and lending money to the government (Chow, 2007).

China’s financial system is one of the weakest links in the economy and it will affect future economic growth. World Bank (2012) again emphasized the need for financial reform. High saving and rapid growth have long diverted attention from deficiencies in the financial system. Without proper reform to support the next level of growth such as the development of an efficient capital market and less reliant on banking sector to raise capital for businesses, China is risking dismantling the growth they had accumulated in the last 30 years. This is a real challenge to sustain growth for China.

The features of China financial system can be summarized as follows:

1. Domination of banking sector

2. Stock markets have not been effective in allocating resources in the economy, in that they are highly speculative
3. Existence of alternative financing channels, such as informal financial intermediaries, internal financing and trade credits, and coalitions of various forms among firms, investors, and local governments

4. High level of savings and investments. Savings have not been allocated to their most productive uses, the huge increase in capital combined with the gains in productivity from moving labour out from low-productivity, subsistence agriculture have been enough to produce high growth

5. Weak legal system and lack of accounting standards enforcement

5. China financial System Reform

The on-going reformed of China's financial system will be necessary for the sustained economic growth. It is a critical to China’s effort to narrow social disparities and pursue balanced growth. Reforming the financial system would increase the rate of GDP growth and help spread China’s new wealth more evenly. If the reforms directed additional funds to private companies, the economy would generate significantly higher returns for the same level of investment and GDP would rise.

The reform should enhance the degree to which the financial systems

(a) enhance the quality of information about firms and hence the efficiency of resource allocation,

(b) exert sound corporate governance over the firms to which they funnel those resources,

(c) provide effective mechanisms for managing, pooling, and diversifying risk,

(d) mobilize savings from disparate savers so these resources can be allocated to the most promising projects in the economy, and

(e) facilitate trade

6. Recommendation

Based on various literatures that we had analysed, we would like to suggest reform to focus on the following areas:

a. To be less reliant on banking sector alone to provide funds to businesses. Based on People's Bank of China (PBOC) data, social financing amounted to 12.8 trillion yuan in 2011, of which new bank loans made up 58.3 percent while direct financing such as stocks and bonds accounted for only 10.6 percent and 3.4 percent, respectively (China Daily, Oct 2012) “By end-2011, the banking industry's total assets amounted to 113.3 trillion yuan, while those in the insurance, trust, securities and fund industries amounted to only 14.4 trillion yuan in aggregate. The proportion of non-bank financial institutions within China's financial system is far smaller than that in developed countries such as the US and Japan.

b. To provide more information to users of financial system. Grosfeld (1994) argued that in transition economies, priority should be given to stimulating information generation about investment opportunities, and ensuring substantial external evaluation of companies' potential. If banks are to become not only privileged creditors, but also shareholders of firms, the information needed for efficient restructuring may become the victim of excessive commitment.

c. Reform of SOE, state-owned enterprises (SOEs). Many SOE’s with low productivity, receive most of the available funds for investment in order to
maintain employment levels. Since the mid-1990s, SOE reform has been a priority area, with most practical measures focused on improving efficiency and to catching up with market-oriented changes that have taken place in other areas of the economy (OECD, 2009).

d. Development of alternative financing channels. (Allen, Qian and Qian, 2005, AQQ hereafter) find that the most successful part of the financial system, in terms of supporting the growth of the overall economy, is rather a sector of alternative financing channels, such as informal financial intermediaries, internal financing and trade credits, and coalitions of various forms among firms, investors, and local governments.

In summary reforms should involve the following: Increase information to investors; Monitoring and control of credit rating institutions; Diversification of loan portfolio; Encourage small banks to raise capital and minimization of the financial panic.

7. Conclusion

While China acknowledges it has to reform its present financial system, it is cautious not to “throw the baby with the bath water”. The Western financial system model is far from perfect and as (Allen & Qian, 2009) argued that some criticism from the West may not be valid for example China may not have strong rule of law but this did not hinder its financial system and development. As we witness in the USA, the formal creation of law is a long and tedious process and in a fast moving economy such law may become obsolete by the time it is passed by formal channel. Perhaps it is best to rely on common sense and judges to quickly resolve the conflict.

On the other hand there are areas such as the development of an efficient stock market which will affect the real economy if no reform is undertaken. China does not have many channels for savers to invest in and therefore over supply of savings caused bubble to appear in the limited investment vehicle such as real estate and the stock market. This is a valid issue must be address by the financial system reform.

While financial is needed for future economic growth but financial reform must not undo what is working for China at the moment. The challenge is to understand and identify what exactly that need reform. According to (Lin, 2012) China had employed decentralized trial-by-error exploration, method where reforms are carried out slowly at different stages in different economic zone. This is to avoid massive crisis in the event if policies do not work. While Western observers may get impatient with this method, it had worked well for China so far and therefore reform must be carried out patiently so that it will not cause great shock to the overall economy.

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