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Reform and Risk in the Chinese Financial System

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KEY POINTS

- China's traditional policy mix of low interest rates, an under-valued exchange rate, quantitative limits on bank lending, and capital account controls is coming under pressure both from more liberal policy and financial innovation.
- The Chinese financial system faces a number of risks including high local government debt of questionable quality, opaque wealth management products, and rapid credit growth.
- Progress is being made on making the financial system more market-based. Yet, some policy-makers continue to value a financial system that can also act as an additional tool for achieving broad policy objectives.

THE TRADITIONAL POLICY MIX IS UNDER PRESSURE

Traditionally, Chinese policy-makers have used an "unconventional" mix of policies designed to achieve a number of objectives:

The exchange rate was under-valued to support exporters.

- Interest rates were kept low to encourage investment.
- Monetary policy was implemented through quantitative controls on bank lending.
- Capital controls were maintained to achieve monetary policy independence.
- The banking system was subject to moral suasion and directed to support regional and sectoral economic development.

In recent years, the traditional policy mix has come under pressure. China has been enacting reforms, which are designed to improve the efficiency of the financial system. Medium-term economic policy, as enunciated in China's Financial 12th Five Year Plan (2011-15) foresees a greater role for markets and price signals. Monetary policy is to shift from using quantitative controls to interest rates and the exchange rate as policy tools. Interest rates are to be liberalized, a deposit insurance system is to be established, and the capital account is to be liberalized.

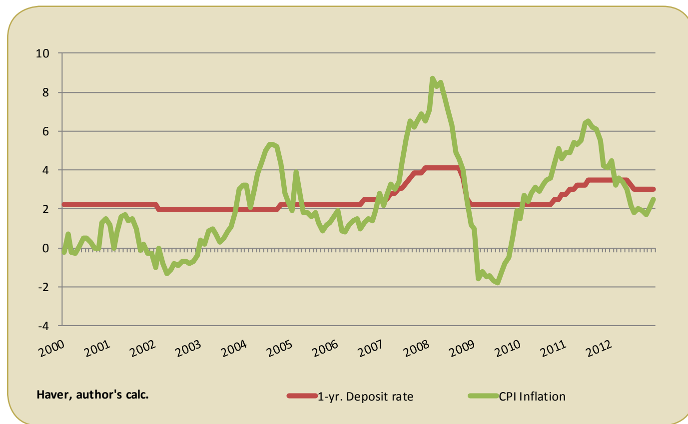
The impetus for reform comes from the changing nature of the Chinese economy. Over time, policy makers want to rotate demand from investment to consumption. They also want to de-emphasize industry and increase the role of high value-added services. In particular, they see a role for the development of world-class financial services. For example, in 2009, the State Council (China's cabinet) announced its plans to transform Shanghai into an international financial center by 2020. Moreover, policy makers are looking to internationalize the RMB (Chinese yuan). Initially, this means giving the Chinese currency a greater role in international trade and finance. Ultimately, it could mean that the RMB becomes a reserve currency.

While policy makers have taken top-down measures to liberalize the financial system, financial innovation and regulatory arbitrage are eating away at the effectiveness of the traditional policy mix. The development of a sizable shadow banking system, which has seen both deposit-taking and lending activities move off balance sheet, has created a dynamic tension with the authorities' reform plans. While de facto liberalization may be proceeding more rapidly than de jure reforms, we have not seen policy-makers roll back any of the previously instituted reforms. Indeed, financial sector

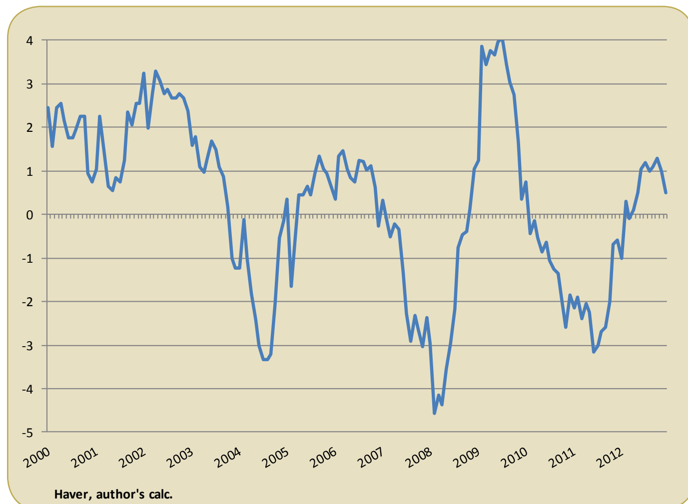
reform continues, albeit at a cautious and measured pace.

POLICY-MAKERS' GRADUAL *DE JURE* INTEREST RATE REFORMS

Graph 1: Deposit Rates and Inflation (%)



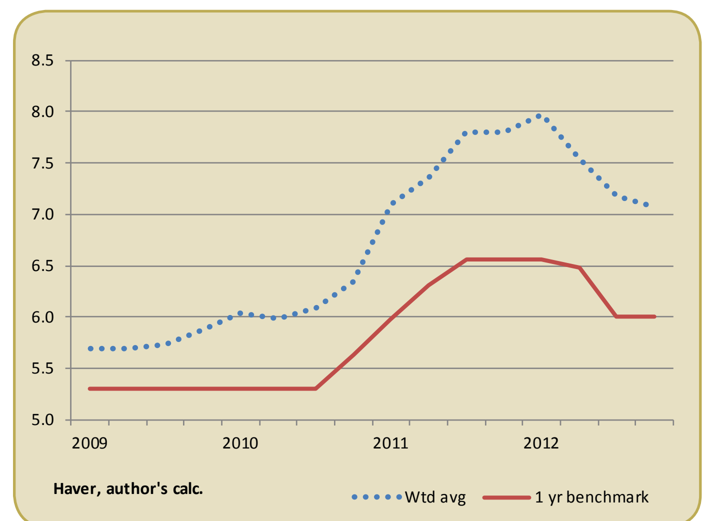
Graph 2: Real One-Year Deposit Rates (%)



In China, the household sector is the net lender and the corporate sector is the net borrower. The traditional policy mix achieved a low cost of capital for industry through financial repression: the yield on households' bank deposits often did not keep pace with inflation (Graph 1). The authorities appear to have a preference for interest rate stability, as rates only partially respond to changes in inflation. Between 2000 and 2012, real (CPI deflated) deposit rates only averaged 0.25 percent and they were actually negative 40 percent of the time (Graph 2). These low interest rates were a boon to the corporate sector.

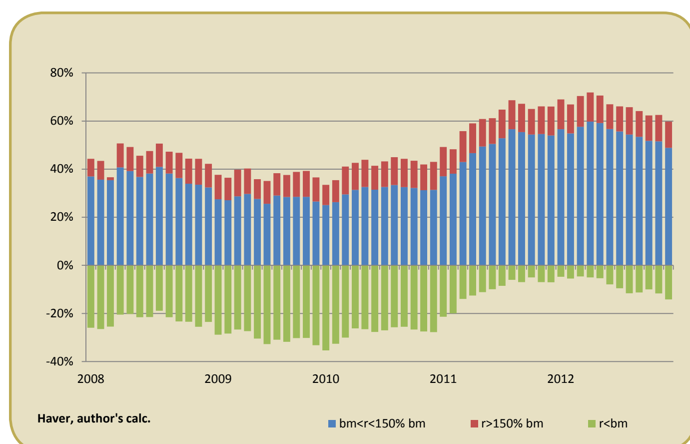
Early on in the reform process, banks had no flexibility in setting lending and deposit rates. Their posted rates were equal to government-set benchmarks. Over time, the authorities have given banks more scope to set rates. In 2004, the deposit rate floor and lending rate cap were removed. Banks were allowed to post lending rates 10 percent lower than benchmark, and there was no upper limit on how high they could price loans. Banks were given additional flexibility last year. They were allowed to offer deposit rates 10 percent higher than the benchmark, and lending rates as low as 70 percent of the benchmark.

Graph 3: Bank Lending Rates (%)



The banks appear to be able to use their limited flexibility to respond to changes in credit conditions. Graph 3 shows the one-year benchmark and the weighted average lending rates since 2009. The spread between these two rates was about 40 basis points in from early 2009 to mid-2010, a period during which the authorities loosened credit conditions in the aftermath of the 2008-09 Financial Crisis. In 2011, monetary policy shifted to containing inflation. Tighter credit conditions resulted in the spread peaking at close to 125 basis points in the first quarter of 2012. Subsequently, the spread has narrowed as policy, once again, has become supportive of growth.

Graph 4: Distribution of Bank Lending Rates



It appears that changes in the lending spread are the result of deliberate action by the banks. Graph 4 shows the distribution of the banks' loan book by the interest rate charged. In the first half of 2012, when credit conditions were tight, about 70 percent of the banks' loans were priced above the benchmark, including 12 percent that were priced 50 percent higher. Only 6 percent of the loans were priced below the benchmark. In comparison, during 2009, when credit conditions were loose, 38 percent of the loans were priced above the benchmark, and 30 percent were priced below the benchmark.

The authorities hope that market-based interest rates will lead to more efficient allocation of financial resources and force banks to improve competitiveness over the longer term. Chinese banks, which are for the most part state-owned, have traditionally lent to state-owned companies. Loan officers have traditionally relied more on the implicit guarantee of the government backing their loans rather than their own ability to conduct credit assessment. Yet the authorities are cautious about fully liberalizing interest rates – especially eliminating the ceiling on deposit rates. They are concerned that the weakest banks may offer the highest rates, imperiling financial stability. Indeed, after the cap on deposit rates was raised last June, smaller financial institutions increased their posted rates by the full 10 percent of the benchmark, while mid-sized banks took a more measured approach.[1]

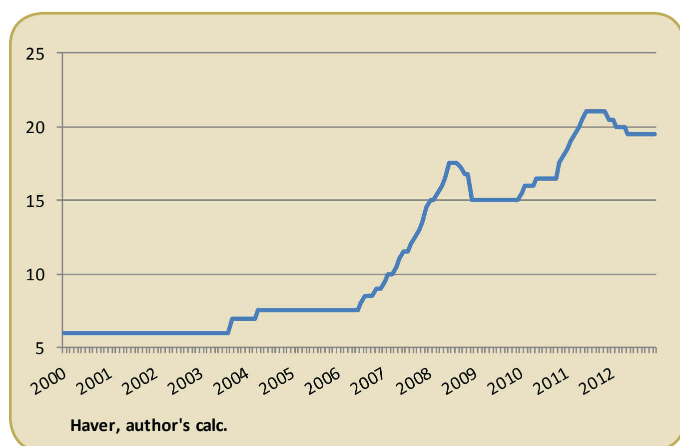
THE CREATION OF WEALTH MANAGEMENT PRODUCTS: *DE FACTO* INTEREST RATE LIBERALIZATION

The traditional policy mix depended on reserve requirements and window guidance to control the supply of bank loans, which has been the preeminent source of credit in the Chinese economy. In recent years, this has not been an easy task for the authorities as the rapid increase in foreign exchange reserves threatened to undermine monetary stability. To sterilize the foreign currency inflow, the required reserve ratio (RRR) rose from 7.5 percent of deposits

1 See Sheng Songcheng, "How to Promote the Gradual Reform of Interest Rates and Exchange Rates" China Economy Web, January 7, 2013 (Chinese only).

in early 2006 to just over 20 percent in mid-2011 (Graph 5). Even when policy loosened to support the economy in 2009 and again in 2012, the reduction in the RRR was modest. The current high RRR reflects the sizable monetary overhang, in terms of commercial bank deposits with the People's Bank of China (PBOC).

Graph 5: Required Reserve Ratio (%)



The central bank pays 1.62 percent on required reserves. While this rate is designed to equal the banks' average cost of funds and ensure that their profitability is not undermined by monetary operations, it is well below what the banks could earn if they were allowed to lend the funds out (Graph 3 above). Thus, banks have an incentive to move liabilities off balance sheet and avoid the very high RRR charge.

Table 1: A Comparison of Wealth Management Product Rates (annualized rate of return)

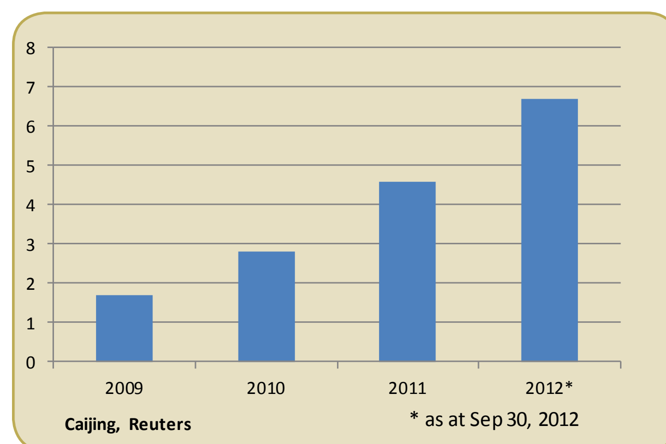
	Bank Deposit	Guaranteed WMP	Non-guaranteed WMP
Daily	0.40-0.44	2.00	2.50
3 month	2.85-3.14	3.70	4.80
6 month	3.05-3.36	2.40-3.50	4.90
1 year	3.25-3.58	4.00	5.00

Author's survey

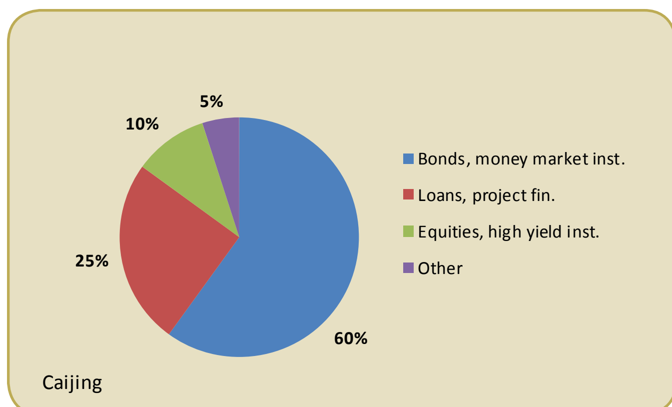
In order to circumvent the high opportunity cost of placing required reserves with the PBOC, the banks have created deposit-like instruments called wealth management products (WMPs). These instruments are sold at the banks' branches and offer yields 1 to 2 percentage points higher than traditional deposits of similar maturities. WMPs come in two varieties: guaranteed and non-guaranteed. The guaranteed variety must remain on the banks' balance sheets and it typically pays 1 percent less than the non-guaranteed variety. Table 1 shows that WMPs appear to be most attractive at the shortest maturity.

Clients are attracted by higher returns, ease of purchase, and the sense that the banks will stand behind the instruments offered at their branches. Graph 6 shows that WMPs have grown from RMB1.7 trillion in 2009 to RMB 6.7 trillion as of end-September 2012. This compares to close to RMB 80 trillion in traditional deposits at the commercial banks. Graph 7 shows the distribution of WMP investment, 60 percent of which are in bonds and money market instruments.

Graph 6: Stock of Wealth Management Products (RMB trillion)



Graph 7: Wealth Management Product Investments (June 30, 2012)



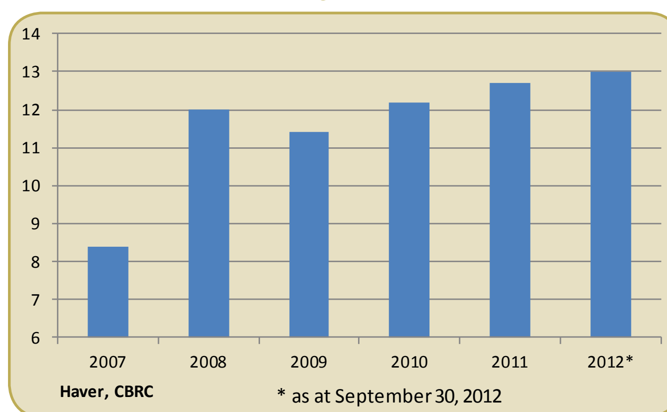
This interest "rate liberalization by stealth" gives households a higher return on their savings. It also begins giving WMP managers experience in assessing and pricing risk.[2]

THE BANKS' SHARE OF "TOTAL SOCIAL FINANCING" FALLS AS DISINTERMEDIATION INCREASES

Just as high reserve requirements encourage banks to accumulate off-balance sheet liabilities, high capital requirements encourage the banks to make off-balance sheet loans. While the statutory total risk-weighted capital ratio requirement is 8 percent, Chinese banks are encouraged to build up larger capital buffers. Graph 8 shows that, as at the end of September 2012, the banks' aggregate total risk–weighted capital ratio was 13 percent, up from 8.4 percent in 2007.

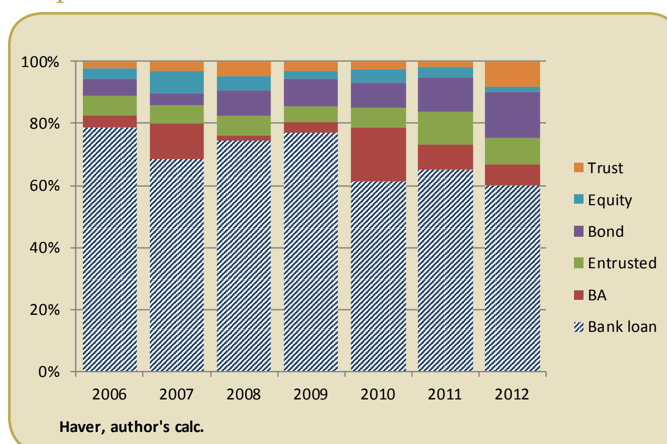
2 The rate paid on WMPs appears to be a market rate as banks are competing vigorously with each other for this market. If the rates paid on WMPs can be taken as the market benchmark, then we can gauge the degree of financial repression.

Graph 8: Total Risk-Weighted Capital Ratio (%)



On 15 April, 2011, the PBOC released its measure of total social financing (TSF), which is designed to be a broad gauge of credit to the private sector, and to take account of the growing trend of disintermediation. Graph 9 shows that in 2006-09, bank lending accounted for close to 80 percent of the annual net new flow of TSF and that, over time, the ratio has fallen to 60 percent. Traditional bank loans have been increasingly replaced by bond issuance, finance from trust companies, bankers' acceptances (BAs), and entrusted loans.[3]

Graph 9: Distribution of TSF Flows



3 Entrusted loans are where the bank acts as a trustee for the lender.

The broadening of traditional financial channels has meant that the PBOC's traditional monetary policy instrument, the control of the quantity of bank loans, has become less effective. In addition, the information content of the traditional monetary indicators (M1, M2 etc.) has been eroded, as liabilities have moved outside of the banking system. The challenge for the PBOC is to begin using a monetary policy instrument with which it can influence financial flows no matter what form they take. That instrument is interest rates. However, moving from quantity-based to price-based monetary control will require more integration between financial institutions and financial markets.

CAUTIOUS STEPS TOWARD CAPITAL ACCOUNT LIBERALIZATION

China completed the liberalization of its current account in late 1996, when policy makers had hoped to liberalize the capital account five- to ten-years later.[4] However, the outbreak of the Asian Crisis, which was partially caused by poorly sequenced capital account liberalization (i.e. excessive short-term foreign currency borrowing) caused them to take a more cautious approach.

China's capital account regime provides differential treatment for various types of capital flows. In an effort to kick-start economic development, China has treated direct investment inflows fairly liberally since the early 1990s.[5] Outward direct investment is being encouraged under the "Go Global" policy, but Chinese firms still need approvals from the State Administration for Foreign Exchange (SAFE), the National Development and Reform Commission, and the Ministry of Commerce before they can undertake major investments abroad.

In contrast, portfolio flows are managed more tightly. Since 2002, investment by foreigners is channelled through the Qualified Foreign Institutional Investors' (QFII) program. In April 2012, the quota available for QFII investments was increased from US$30 to 80 billion. While this is a large percentage increase, the allowable investment is still small compared to the US$2.4 trillion market cap of the Shanghai "A share" market.[6] As of end-November 2012, 165 foreign institutions were approved for an aggregate QFII quota of US$36 billion (Graph 10).

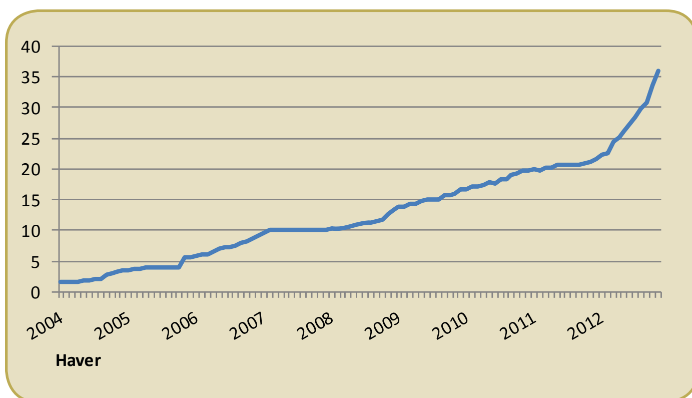
In 2006, a parallel program called Qualified Domestic Institutional Investor (QDII) was established, which provides Chinese nationals a limited amount of investment in foreign financial markets. As of end-November 2012, 106 domestic institutions were approved for US$87 billion in overseas investment (Graph 11). About 60 percent of the aggregate quota is held by securities companies, with insurance companies holding another quarter. Banks and trusts hold the remaining 15 percent.

4 See Yiping Huang, Xun Wang and Daili Wang "Liberalization of China's Capital Account", Paper prepared for the NYU Conference on China's Capital Markets, 31 May 2011, New York University, New York

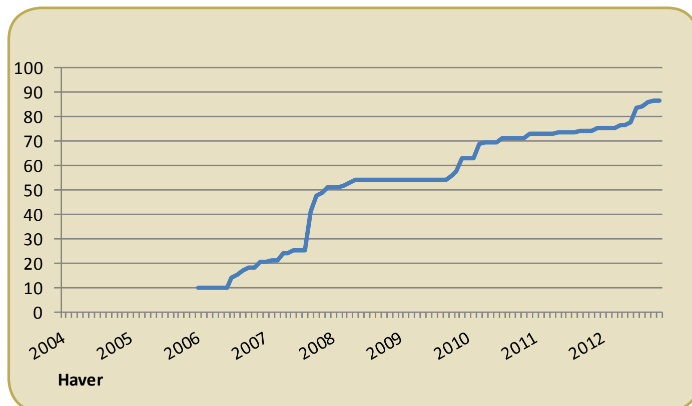
5 FDI in manufacturing is fairly open, while service and extractive industries remain protected. China's openness to FDI in manufacturing contrasts with the more protective attitude taken by Japan and Korea during their takeoff stages.

6 Foreign nationals only have limited participation in the RMB-denominated "A share" market. A "B share" market exists in Shanghai and Shenzhen which trades in foreign currency and is open to foreign investment. However, the market is small – with a market cap of only US$12 billion – and its shares are fairly illiquid.

Graph 10: QFII: Amount Approved (US$ bn)



Graph 11: QDII: Amount Approved (US$ bn)



Foreign non-financial firms are permitted to borrow abroad as long as their foreign debt does not exceed the difference between their investment scale and their capital.[7] Foreign financial institutions seeking to borrow or lend are subject to quotas set by SAFE. Chinese firms also need SAFE approval in order to borrow abroad.

On February 23, 2012 the PBOC published a report titled "The Time is Right to Open the Capital Account" by Sheng Songcheng, Director General of the Bank's Statistics Department.[8] The report argued that the risks to the banking sector, capital markets, and Chinese foreign reserves from capital account liberalization are now manageable. The government need not wait until all market conditions are fully mature – including complete interest rate and exchange rate liberalization and RMB internationalization – in order to liberalize the capital account. Moreover, it noted that China's capital controls were becoming increasingly ineffective.

The report contended that the Chinese economy is currently in a good position to reap the benefits of capital account liberalization:

- Chinese enterprises will have more foreign investment opportunities, giving them access to advanced technology, resources, and new markets, thereby boosting their competitiveness.
- The internationalization of the RMB and the development of Hong Kong as an offshore RMB center will be accelerated.
- China's economic restructuring will be facilitated as low-value added activities will be transferred to countries with lower labour costs.

The report proposed that capital account opening be carried out in three steps:

- In the short run (1-3 years), controls on direct investment should be relaxed in order to facilitate enterprises' "go abroad" strategy.

7 See Ming Zhang, "The Liberalization of the Current Account in China: Retrospect and Prospect" Research Center for International Finance Working Paper 2103W01, January 10, 2013.

8 The full text report in Chinese is available at http://news.pedaily.cn/201202/20120224296871.shtml

- In the medium run (3-5 years), controls on commercial lending should be loosened to accelerate the progress of RMB internationalization.

- In the long run (5-10 years), controls on portfolio capital inflows should be liberalized, followed by controls on portfolio outflows. Quantitative controls should be gradually replaced by price-based monetary management.

At a recent forum, PBOC Governor Zhou was quoted as saying that capital account convertibility does not mean the end of all restrictions or a fully free-floating currency. He said that the authorities will still have rules to ensure the transparency of cross-border financial transactions, enforce prudential behaviour of financial institutions, and prevent money laundering and tax avoidance.[9] This suggests that the PBOC is still committed to effective, medium-term liberalization.

RMB INTERNATIONALIZATION: MEET THE NEXT GLOBAL CURRENCY

In contrast with the measured approach they have taken toward capital account liberalization, the Chinese authorities have been engaged in a rapid, proactive process to internationalize its currency. Currency internationalization has typically been a market-driven response to regulatory constraints and perceptions of the stability of existing international currencies. There is no historical precedent for a government's taking the lead in internationalizing its currency.[10] There are a number of reasons behind China's policy-driven approach:

1. *Reduce currency risk*

   Using the US dollar for trade exposes Chinese firms, its financial institutions, and the official sector to currency risk.

   Chinese exporters typically incur production costs in RMB but receive payments in US dollars. Importers pay for their goods in US dollars yet sell them in the Chinese market for RMB. Both importers and exporters are exposed to currency fluctuations, which can be costly and difficult to hedge. Settling foreign trade in RMB would benefit Chinese companies by reducing exchange rate risk as well as eliminating the cost of purchasing foreign exchange.

   Moreover, China runs balance of payments surpluses. It finances these surpluses by lending to the rest of the world. Currently, these loans are made via increased international reserves, which are denominated in foreign currency. If these IOUs to the rest of the world were denominated in RMB, then China would eliminate a major source of risk on its national balance sheet.

2. *Maintain trade finance*

   During crises, there is typically a strong demand for high quality US dollar assets, typically in the form of government securities, and there is less of an appetite to hold riskier instruments. As US dollar liquidity tightens, trade finance can dry up. The shortage of trade finance was very evident in 2008-09 and it had a detrimental effect on China's ability to export. Chinese financial institutions

9 See "Full RMB Convertibility Ruled Out", China Daily, December 12, 2012.
10 See RMB internationalization and China's financial development, Robert McCauley, BIS Quarterly Review, December 2011.

– whose funding base is in RMB – only have a limited ability to provide US dollar trade finance before they incur sizable currency risks. However, to the extent that trade can be settled in RMB, Chinese banks' ability to fund trade increases. This would allow them to stabilize trade and production on the Mainland.

3. *Create high value-added service jobs in the financial sector*

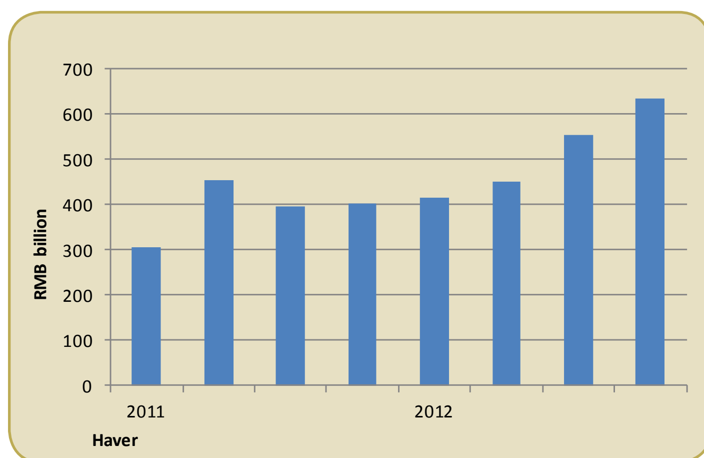
   Internationalizing the RMB essentially means deepening the process of using Chinese financial markets as a platform for lending to and borrowing from the rest of the world. This requires improving the sophistication of Chinese financial markets and would necessitate creating high value-added service jobs in the financial sector. Such a program is consistent with the 12th Five Year Plan's objective of raising the share of services in GDP as well as the government's goal of transforming Shanghai into an international financial center by 2020.

4. *Raise China's financial profile*

   In the longer term, use of the RMB as a regional currency would strengthen China's influence in Asia. A more internationalized RMB would also contribute to increasing China's clout in international institutions, allowing China to play a bigger role in the global financial order.

Graph 12 shows that the value of goods trade denominated in RMB reached RMB 636 billion in 2012Q4, about 10 percent of China's total trade in goods in the quarter. This is incredible growth, given that the RMB cross-border trade settlement pilot was just launched in July 2009 and, at the time, only covered 300 companies in 5 major cities in Guangdong Province.[11]

Graph 12: Goods Trade in RMB



Most of the RMB trade transactions have been in payment for other countries' exports to the Mainland. As the Chinese pay RMB to their foreign suppliers, a large pool of Chinese currency has been created abroad. The majority of China's RMB trade settlement has been conducted through Hong Kong banks so far, since Hong Kong was China's first designated offshore market.

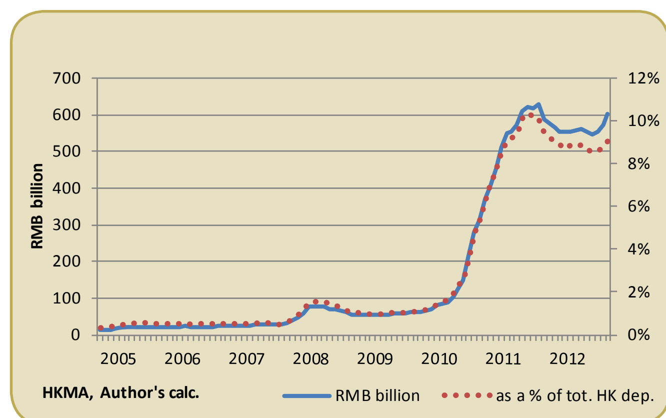
Driven by RMB trade settlement, RMB deposits in Hong Kong increased dramatically from RMB 63 billion in December 2009 to RMB 571 billion in December 2012 (Graph 13).[12] They now account for

11 The trade settlement program has since been rolled out nationally.

12 In an attempt to benefit from the appreciation of the RMB, many Hong Kong individuals have also accumulated deposits in RMB since 2004, when Hong Kong banks were allowed to provide RMB deposits, exchange remittance, and credit card services.

about 9 percent of Hong Kong's total bank deposits, up from around 1 percent in January 2010.[13]

Graph 13: RMB Deposits in HK



RMB deposits peaked in September 2011, and subsequently declined modestly. For much of 2012, there was an expectation that the Chinese currency would depreciate and this somewhat reduced depositors' appetite to hold RMB. Deposits may have also been reduced by new investment opportunities on the Mainland. In general, offshore deposits are only to flow back on shore if they are being used for trade. However, in August 2011, the government launched the RMB QFII program (RQFII), which allowed the investment of offshore RMB back into the Mainland via designated Chinese financial institutions. The initial quota was set at RMB 20 billion and was expanded to RMB 70 billion in April 2012 and to RMB 270 billion in November 2012. In March 2013, the government allowed financial institutions in Hong Kong to participate in the RQFII program.

The existence of a large pool of RMB in Hong Kong has given rise to the dim sum bond market. Dim sum bonds are RMB-denominated obligations that trade in Hong Kong. CNH 69 billion in dim sum bonds were issued in January-November 2012.[14] While this is down from the CNH 154 billion issues in the same period in 2011, it is more than double the CNH 35 billion issued in all of 2010. The fall-off in issuance in 2012 is attributed to the lower investor interest due to the perception that the RMB will depreciate. However, given the boom in Mainland bond issuance last year, potential issuers may have decided to stay at home. The credit quality of the dim sum market is improving. Fitch notes that only 17 percent of the deals between January and October 2011 had international credit ratings. However, 72 percent of the issues in the first 10 months of 2012 were rated by an international agency.[15] This is a sign of market maturation.

LIBERALIZING CROSS-BORDER BANKING: THE QIANHAI PILOT PROJECT

In July 2012, the State Council announced a pilot project in Qianhai, Guangdong Province that will further liberalize the capital account and reinforce the offshore RMB market.[16] The authorities are planning to establish a finance/logistics/IT service center in Qianhai at a cost of US$45 billion. It is hoped that Qianhai's GDP will reach US$24 billion by 2020.[17]

The authorities have established special rules that will liberalize capital movements in support of Qianhai's development. In particular, enterprises in Qianhai will

13 Source: HKMA

14 RMB in the Hong Kong offshore market are identified as "CNH" to differentiate them from onshore RMB or "CNY".

15 See Fitch, "Focus on Credit Quality Not Currency", October 31, 2012.

16 Qianhai is a special economic zone city in Guangdong Province, just west of Shenzhen.

17 Euromoney, "Meet China's Newest Special Economic Zone: Qianhai" July 25, 2012.

be allowed to borrow RMB either from Hong Kong banks or by issuing RMB-denominated bonds in Hong Kong. In addition, Qianhai banks will be able to lend RMB for projects abroad.

Initially, at least, loans from Hong Kong to Qianhai will be subject to quotas. Caijing puts the initial quota in the RMB 30-50 billion range.[18]

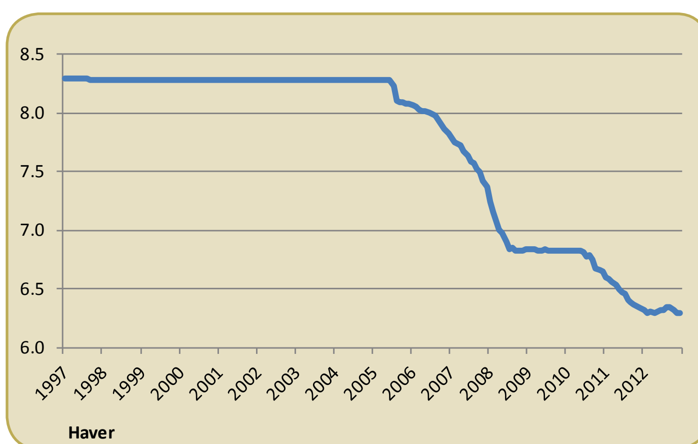
EXCHANGE RATE REFORM: FROM PEGGING TO THE DOLLAR TO PEGGING TO A BASKET

The 12th Five Year Plan foresees a rotation of demand from foreign to domestic sources and the exchange rate is the key price for achieving this transformation. To the extent that the exchange rate is under-valued, exports appear to be more profitable in domestic currency terms and capacity is put in place to export. A fairly valued exchange rate does not unduly encourage exports. The challenge Chinese policy makers have faced is in bringing the exchange rate to fair value without destabilizing China's large export sector, a task complicated by the significant uncertainties caused by the 2008-09 Financial Crisis.

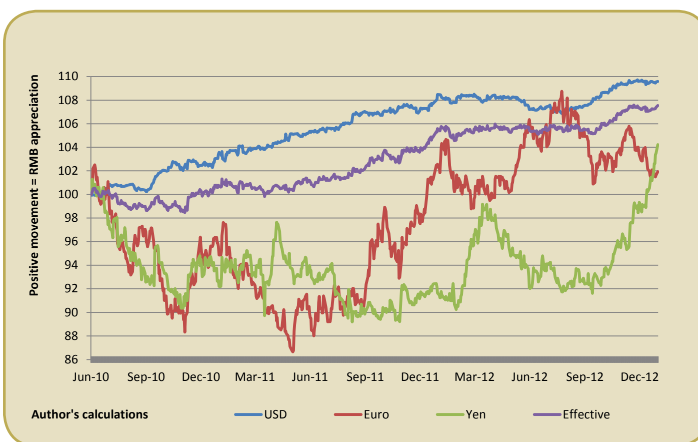
In recent years, exchange rate policy has followed a path of alternating periods of stability and flexibility. Over time, the RMB has appreciated in a controlled manner. The trade surplus in 2009-11 averaged 2.7 percent of GDP, down from 6.9 percent of GDP in 2006-08, suggesting that progress is being made in bringing the RMB to fair value.

Since 1995, the RMB had pegged to the US dollar at a rate of close to 8.3 to 1. In June 2005, it was de-pegged from the dollar and it appreciated by 20 percent until August 2008 when it was re-pegged against to the dollar at 6.8 to 1 (Graph 14). In July 2010, the RMB was de-pegged once more. By December 2012, it has appreciated by an additional 9 percent.

Graph 14: RMB per US$



Graph 15: RMB Indices (June 1, 2010=100)



Officially, the authorities are managing the RMB against a basket of currencies. Unfortunately, neither the composition of the basket nor the desired path of the RMB versus the basket has been announced publicly.

18 Caijing, "Ceiling of First Cross-Border RMB Loan at RMB 50 billion Yuan in Pilot Zone" December 31, 2012.

It appears to us that, since the RMB was de-pegged from the dollar in July 2010, the authorities are implicitly targeting a basket of 70 percent dollars, 20 percent Euros and 10 percent yen. In particular, they manage the RMB/dollar bilateral rate so as to smooth the "effective rate" while limiting the depreciation of the RMB against the dollar (Graph 15). We would note that for the periods of June 2010-June 2011 and January 2012-September 2012, the standard deviation of the effective rate was half that of the bilateral US rate.

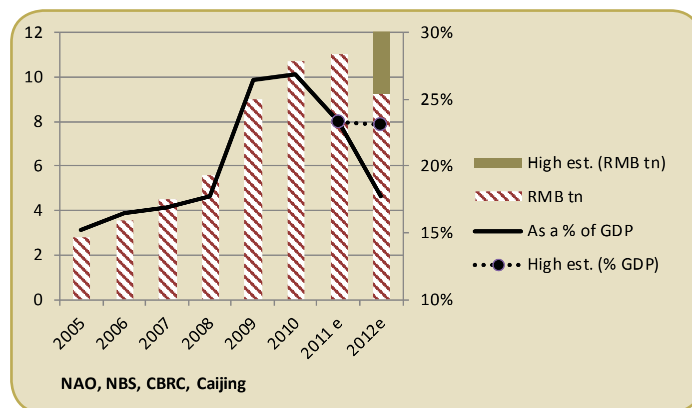
NO SHORTAGE OF RISKS IN THE FINANCIAL SYSTEM

Local government debt is a looming credit risk

Following the massive counter-cyclical spending undertaken in 2009, local government debt rose rapidly. The central government is seriously concerned about this increase in indebtedness and the ability to repay loans. However, definitive, up to date information on the quantity and the quality of local government borrowing is hard to find.[19]

In mid-2011, the National Audit Office (NAO) released its comprehensive audit of local government finances, which had been mandated by the State Council. It found that local government debt totalled RMB 10.7 trillion, or 27 percent of end-2010 GDP. According to NAO report, 26 percent of the local financing platforms were losing money. This was consistent with the China Banking Regulatory Commission's (CBRC) view that approximately one quarter of the local government debts were assumed by unqualified borrowers, with insufficient financial guarantees.[20] While the central government is trying to contain debt growth by managing the availability of financing to local governments, we have not seen a comprehensive picture of local government debt since the NAO audit. Recently, CBRC Chairman Shang Fulin indicated that local government debt had fallen to RMB 9.25 trillion.[21] However, estimates by the private sector put the amount closer to RMB 12 trillion.[22] This suggests that, by the end of 2012, local government debt was between 18 and 23 percent of GDP (Graph 16).

Graph 16: Local Government Debt



With local government debt in this range, we estimate that China's consolidated gross general government debt would be between 60 and 65 percent of GDP.[23] Graph 17 shows that indebtedness at this level would

19 In most cases, local governments are not permitted to borrow directly. They typically set up corporations, local government financing platforms, which are charged with undertaking specific projects, say building a highway. These special purpose vehicles are able to secure bank loans or issue bonds.

20 See "Only 23% of local government debt has obvious risks: MOF expert", China Economic Times, December 7, 2010 (Chinese) and "Survey results on LGFV debt released", China Securities Journal, October 14, 2010 (Chinese).

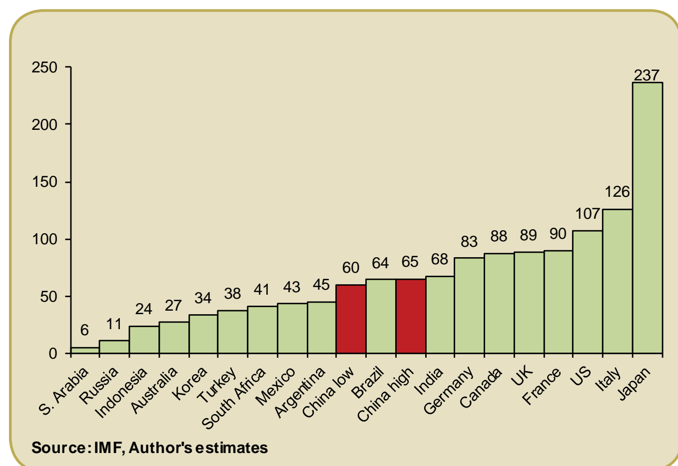
21 China Daily, "Local debt at 9.25t yuan, says CBRC chief", November 8, 2012.

22 Caijing, "Managing Local Government Debt", January 7, 2013 (Chinese).

23 Explicit central government debt is about 22 percent of GDP. We assume that "fiscal skeletons" comprised of railway debt, policy bank debt, and bonds to support asset management companies are an additional 20 percent of GDP.

place China in the middle of the G20 countries.[24]

Graph 17: 2012 Gross General Government Debt to GDP Ratios (%)



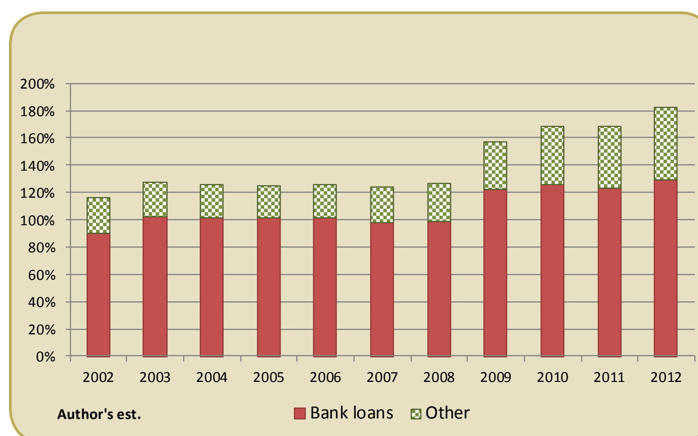
While China is rather indebted for an emerging market country, its relatively fast rate of GDP growth and low external indebtedness are positive factors.

Rapid credit growth could mean higher non-performing loans

Credit has grown very rapidly in recent years. Graph 18 presents the ratio of the stock of TSF to GDP. [25] Between 2003-08, this ratio was fairly stable as the broad measure of credit was growing at the same pace as GDP. In 2009, the ratio increased sharply as the authorities enacted a massive counter-cyclical stimulus program. After stabilizing in 2010-11, the ratio shot up again in 2012. At year-end, the stock of TSF had grown to 183 percent of GDP, up from 169 percent in 2011.

Many observers are concerned that the sharp increase in credit to the private sector will lead to a decrease in asset quality and funding pressures.[26]

Graph 18: Stock of TSF as a % of GDP



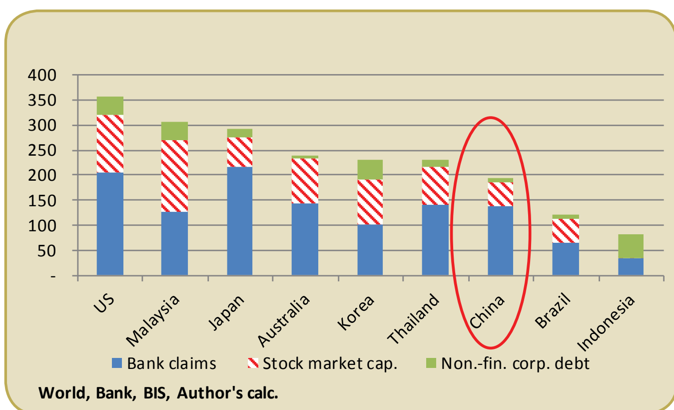
We believe that the authorities are concerned about rapid lending credit growth and credit quality and it is likely that they will take measures to stabilize the TSF/GDP ratio in 2013. Note that while private sector borrowing has increased quickly in recent years, when compared to other countries, the Chinese private sector does not seem to be especially highly indebted. Graph 19 presents the ratio of credit to the private sector to GDP for China and other selected countries by adding up bank claims, stock market capitalization and the bonded debt of non-financial corporations. China's private sector debt level is relatively low because its household sector borrows very little. We estimate that household debt is only around 20 percent of GDP.

24 Data taken from the IMF's October 2012 fiscal monitor. The Chinese measure is our estimate (the IMF only includes explicit central government debt).

25 Note that the authorities only publish flow numbers for TSF. The stock number is our estimate.

26 See, for example, Fitch Ratings, "Chinese Banks: Credit Growth Accelerates in Q312, but Continued Aggressive Expansion Has Limits", November 8, 2012.

Graph 19: Private Sector Debt as a % of GDP (2011)



Opaque WMPs

While the advent of WMPs has been a good way to increase the return on savings and broaden the potential channels of finance, these instruments are subject to liquidity and credit risks. In addition, WMPs purchasers are not fully aware of the investment risks that they are taking. Unlike mutual funds, which are marketed as stock, bond or balanced, WMPs are sold with little information as to where the investors' funds are going.

Maturity transformation is always a process that financial intermediation needs to manage carefully, but the duration of WMPs seems to be especially short, with 65 percent of the WMPs having maturities of 3 months or less.[27] It is very likely that WMPs are funding much longer-term projects. In order to minimize liquidity risk, we understand that managers often pool their liabilities and do not dedicate particular WMP funds against particular assets. In this way, maturing WMPs which are not rolled over can be paid out of the pool, or out of new funds which enter the pool. This pooling of liabilities led Xiao Gang, former Chairman of the Bank of China's Board, to call WMPs a Ponzi scheme.[28]

The CBRC frowns on pooling liabilities.[29] Moreover, the recent failure of particular products at Huaxia Bank and CITIC Bank appear to indicate that pooling, if it is being used, was imperfect at best.

THE ROAD AHEAD FOR REFORM: CAUGHT BETWEEN TWO VISIONS

Data published by the CBRC show that, despite challenging economic conditions, Chinese banks have performed very well. Return on equity in 2008-2010 averaged 18.9 percent, compared to only 6.3 percent for global banks.[30] Reported non-performing loans are only 1 percent of total loans. While this figure might under-state the true amount of problem credits, Chinese banks have over-provided by three times: loan loss provisions account for close to 3 percent of total loans. In addition, the banks have core and total capital ratios of 10.6 percent and 13.3 percent of risk-weighted assets respectively; rates of capitalization that compare well internationally. Importantly, China has been implementing the Basel III capital adequacy standards since the beginning of this year. The Bank for International Settlements notes that only 11 major countries published the final set of Basel III regulations

27 Caijing, "China's Shadow Banking Revisited: Size, Implications, Risks, and Reforms" December 5, 2012.

28 Xiao Gang, "Regulating shadow banking", China Daily, October 12, 2012.

29 Caijing, "China Banking Regulator to Ban Financing Assets From Access into Wealth Management Assets Pool" July 11, 2011.

30 Global bank average taken from Deloitte "Bridging the Profitability Gap" April 2012. Between 1980 and 2007, global banks' return on equity was 16 percent.

effective from January 1, 2013.[31]

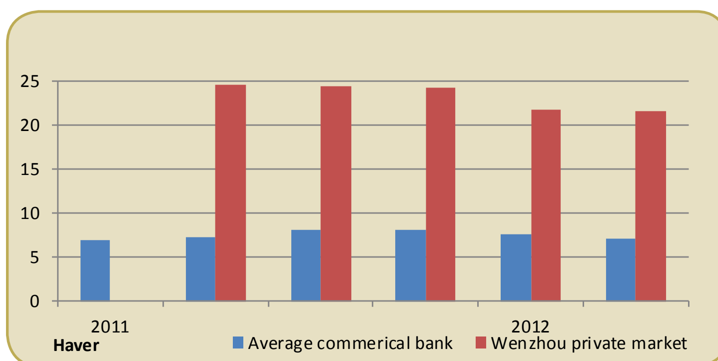
Notwithstanding the banks' solid performance, large segments of the economy do not have access to formal finance. The key role of the financial system is to ensure that credit gets allocated to its most efficient use. This does not appear to be happening in China. The private sector is much more productive than the state-owned sector, yet it is very difficult for private firms to borrow from banks or access formal capital markets.

Chinese financial firms prefer lending to state-owned firms that are large, have significant assets that can be used as collateral and, importantly, appear to be backed by a government that will ensure the repayment of borrowed funds. In addition, financial markets have, until recently, been closed to private firms that are looking to raise funds.

Private firms often turn to grey market, private lending to satisfy their financing needs. The largest private financial market is in Wenzhou, Zhejiang Province. Graph 20 illustrates the segmentation of the formal and informal financial markets. While formal bank lending rates are in the 8 percent range, informal lending rates exceed 20 percent. Even though private lending implies greater risk, it appears that efficiencies can be realized by integrating these markets.

While many Chinese policy-makers see the value in market-based finance, others continue to value the financial system as an additional policy tool. For example, financial firms are told not to lend to highly polluting firms or to those in industries with excess capacity. Indeed, some would say that China's ability to direct the banks to fund infrastructure projects during the Financial Crisis – so as to help stabilize growth – shows the importance of the government having these policy levers. They say that a market-based system would not have provided the needed finance.

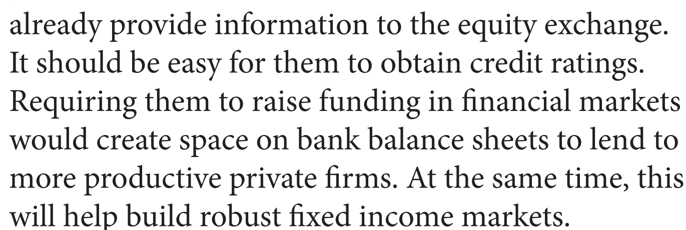
Graph 20: Lending Interest Rates (%)



Notwithstanding the conservative stance of some policy-makers, the rapid growth of direct finance in recent years is encouraging. For example, in 2012, RMB 2.4 trillion in bonds was outstanding under the medium-term notes program, which allows non-financial firms to raise funds in the interbank bond market. This is an 83 percent increase from the outstanding stock in 2010. Nevertheless, the system remains dominated by banks. In 2012, the banks made RMB 8.2 trillion in new loans. Only RMB 2.2 trillion was raised in bond markets and RMB 0.3 trillion in new stock was issued.

Deep financial markets are a good way to broaden financial access while increasing transparency. To accelerate the process, the government should require that listed state-owned companies raise capital in financial markets, rather than by borrowing from banks. These enterprises are well-known firms that

31 The countries are Australia, Canada, China, Hong Kong SAR, India, Japan, Mexico, Saudi Arabia, Singapore, South Africa and Switzerland.See Bank for International Settlements, "Implementation of the Basel III Framework" 14 December 2012.



already provide information to the equity exchange. It should be easy for them to obtain credit ratings. Requiring them to raise funding in financial markets would create space on bank balance sheets to lend to more productive private firms. At the same time, this will help build robust fixed income markets.

Local governments should be given greater freedom to fund their operations in capital markets rather than relying on borrowing from banks. If local governments and their financing vehicles issued bonds, it would be a step forward in enhancing the transparency of their fiscal operations.

The desire to grow financial services both domestically and internationally provides policy-makers with a powerful incentive to continue financial reform. It remains to be seen how much progress will be made, and the extent to which authorities will try to retain the traditional policy mix.

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