Asia Pathways
The blog of the Asian Development Bank Institute
ADBInstitute

FINANCE SECTOR DEVELOPMENT

Financial development and stability in the People's Republic of China: Evaluating the policy challenges

By Damian Tobin and Ulrich Volz. Posted SEPTEMBER 5, 2018

The People's Republic of China (PRC) has come a long way in developing its financial system, and it has done so at a speed that has been breathtaking. The country's "big four" banks are now the four largest banks in the world by assets, while another 14 PRC banks make it into the top 100 largest banks. The PRC last year surpassed the euro area to become the world's largest banking system by assets, and PRC banks are now major sources of dollar-denominated lending, not least as part of the country's One Belt One Road initiative. The PRC bond market is the third largest after the United States and Japan. The PRC has also become the world's leading nation in the area of fintech, with the biggest market for digital payment and online lending. Moreover, the PRC's efforts to promote the renminbi as an international currency have already resulted in its inclusion in the International Monetary Fund's special drawing rights basket, where it joined the dollar, the euro, the yen, and the pound sterling in 2016.

As we show in our recent study on the PRC's financial system, the country's policy makers have made significant progress in restructuring and reorganizing the finance sector since the late 1990s. Financial regulation is now much less fragmented, and there has been a steady decline in the share of banking assets of the large state-owned banks. Policy-led restructuring and consolidation of the urban and rural credit cooperatives, the entrance of the Postal Savings Bank of China, and a more conducive funding environment for city commercial banks have resulted in a more diverse financial system. Equity market reform has seen a transition from one-third to two-thirds privatization, while efforts to improve governance and accessibility have been buoyed by the PRC's inclusion in the Morgan Stanley Composite Index. Incremental bond market liberalization has made it easier for foreign financial institutions to participate in the onshore bond market. The PRC's efforts to contain the growth of foreign liabilities, while promoting a moderate increase in the overseas holdings of domestic financial assets, have also allowed it to avoid the balance-of-payments problems faced by many transition economies.

Despite progress in the above areas and the rapid development of capital markets since the 1990s, the PRC's financial system has become increasingly complex and leveraged, giving cause for serious concern about financial stability. Crucially, while the importance of nonbank financial institutions has continued to grow, banks not only have become important players in bond and equity markets, but also are closely linked with the rapid growth of off-balance sheet finance. Through a combination of interbank funding activities, wealth management products and shadow banking/gray capital market activities, large-state owned banks have become important sources of liquidity provision to both smaller commercial banks and a range of nonbank financial institutions. An unintended consequence of this is that the PRC's state-run financial system has become ever more intricate and interconnected.

The PRC now faces major challenges in terms of financial stability emanating from its enormous level of domestic debt and the enormous size of its shadow financial system. An optimal scenario for PRC policymakers is a managed unwinding of counter party obligations involving the restructuring and diversification of corporate debt alongside the creation of a more diverse financial system. Thus far, policy has focused on debt-for-equity swaps with indebted state enterprises. Debt-for-equity swaps imply that state banks will in the absence of broader financial market reform carry the risk of these restructurings on their balance sheets. This is likely to further constrain their ability to allocate credit to productive uses in the corporate sector. Debt-for-equity restructuring also increases the urgency of corporate governance reform in equity markets. Weak governance continues to present a significant limitation on restructuring as banks face significant governance obstacles in monitoring repayment. In the absence of further reform, equity markets themselves also appear poorly placed to absorb significant amounts of debt.

A further challenge is to improve the financing conditions of private corporations, especially small and medium-sized enterprises (SMEs). While a recent report by the World Bank and the People's Bank of China on financial inclusion has praised the PRC's remarkable progress in financial inclusion over the last 15 years, for the time being a large share of private corporations have little chance of obtaining credit through the formal financial system and therefore have to rely on alternative ways of financing. Tightening up on shadow financing is crucial for financial stability, but it starves off private companies from credit. The much-needed deleveraging process appears to be hurting the private sector much more than state-owned companies. Fintech solutions such as peer-to-peer lending have flourished and provided SMEs with a welcome alternative to conventional bank lending, but online lending platforms have not been without problems either.

Another major challenge, which has received growing attention of PRC financial authorities, is the alignment of the financial system with sustainable development. While progress has been made since 2012 when the China Banking Regulatory Commission first issued Green Credit Guidelines, the vast majority of lending and investment does not sufficiently consider environmental and climate risk. These risks are among the greatest systemic medium- and long-term challenges facing the PRC economy—and the finance sector ought to play a leading role in mitigating them.

Overall, the PRC has come a long way in developing its financial system, which has played a crucial role in supporting the economy's investment-driven growth model. However, some of the very factors that have helped this rapid development are now proving to be a liability for the future. The problems discussed above have been well known to the financial authorities, but because of vested interests and the need to provide liquidity to keep growth humming, reforms have been difficult and slow to implement. On the upside, despite a multitude of problems in the formal and informal finance sector and the stupendous growth in credit and debt, the system is reasonably stable. As long as the authorities maintain the current level of capital controls and debt remains largely denominated in domestic currency, the system can be managed. Striving for full integration into the global financial system before the domestic financial system has been fixed would be a recipe for crisis—for the PRC and the world economy.

About the Author
Damian Tobin is a lecturer in Chinese business and management at the School of Finance and Management, SOAS University of London.
View all posts by Damian Tobin →

Economics
Education
Energy
Environment
Finance sector development
Gender
Governance and public sector management
Health
Industry and trade
Information and Communications Technology
Infrastructure
Miscellaneous
Population
Poverty
Private sector development
Regional cooperation and integration
Sanitation
Social development and protection
Transport
Urban development
Video Blog
Water

Recent Posts

Economic impacts of the COVID-19 pandemic and oil price collapse
SMEs in global value chains: Catalysts for dynamic and inclusive economic growth
How should ASEAN and ASEAN+3 respond to the COVID-19 crisis?
The tip of the iceberg for COVID-19 cases in developing Asia?
Global stimulus to fight the COVID-19 pandemic

Recent Comments

N SRIDHARAN on Global stimulus to fight the COVID-19 pandemic
Shiladitya Chatterjee on How should ASEAN and ASEAN+3 respond to the COVID-19 crisis?
John Confidus on Characterizing financial cycles: Are emerging markets different?
Mahendra on Improve handwashing access to combat COVID-19
Tori on Some knowledge economy lessons from the Republic of Korea for Africa

Archives

Archives Select Month

About the Author
Ulrich Volz is head of the Department of Economics and reader in economics at SOAS University of London, senior research fellow at the German Development Institute, and honorary professor of economics at the University of Leipzig.
View all posts by Ulrich Volz →

banks, Damian Tobin, financial system, People's Republic of China, PRC, Ulrich Volz

← Land trust laws as a solution to the land acquisition dilemma for infrastructure development in Asia
The costs of being overweight and obese in Asia and the Pacific →

No comments yet.

Leave a Reply

Name (required)

Email (will not be published) (required)

Website

By using this form you agree with the storage and handling of your data by this website. *

I'm not a robot
reCAPTCHA
Privacy - Terms

Submit Comment

CONTACT US

ASIAN DEVELOPMENT BANK INSTITUTE

Kasumigaseki Building 8F
3-2-5, Kasumigaseki, Chiyoda-ku,
Tokyo 100-6008, Japan

Tel: + 81-3-3593-5500
Fax: +81-3-3593-5571
Email: asia_pathways@adbi.org