China's Path to Financial Reform

Looking Beyond the Market

By Adam S. Hersh October 2014

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Introduction and summary

Last year, China's political leaders set forth an ambitious and unfolding agenda for financial reform as part of a broader national economic strategy of structural rebalancing toward more domestic demand and innovation, as well as a more environmentally friendly and more equitable economy.

These goals are not new for China but rather have persisted across decades of China's five-year plans. What is new is China's political leadership, and new leaders have offered a sweeping vision that sets an ambitious agenda to advance the next wave of reform in China's long evolution from a centrally planned economy that began in 1978. In the November 2013 18th Party Congress Third Plenum Decision—which is at once both a governing policy document and a political statement similar to the State of the Union address—the party's Central Committee called for reforms across virtually all aspects of society and pledged that the economy should embrace "a decisive role for the market."[1] Nearly one year later, the scope and intention of these reforms are starting to come into focus.

Central to the reform agenda, and at the heart of its unbalanced economy, is China's state-dominated financial system. An economy's financial institutions are fundamental to its economic success, facilitating the investments that yield the higher productivity and innovation that lead to economic growth and rising living standards. At the most basic level, financial institutions do two things that determine the quantity and quality of investment: They provide a means for collecting savings and selecting the projects in which to invest those savings, and they provide corporate governance and legal systems to make sure those investments are being effectively used.

Unfortunately, China's financial institutions are falling short on both these fronts, and the pervasive role of the state in these core functions creates considerable structural inertia that is likely to keep things this way for China's foreseeable future. State-owned banks control 57 percent of China's banking-sector assets, and state-owned enterprises account for more than 90 percent of the capital raised in China's

corporate bond market.[2] The legacy financial institutions inherited by China's leaders create "distortions [in] the system at every level" that pose daunting challenges for reform.[3] What's more, even as the state may be seen to pull back, because of its compulsive power over those people and businesses within the country, Beijing still has substantial freedom to set policies that affect how virtually all other social institutions function.[4]

To understand the challenges China faces in approaching financial reform, this report first considers China's position with respect to the international financial trilemma. Economic theory suggests that a country can attain at most two of the following three economic policy goals: macroeconomic policy autonomy; a stable, fixed exchange rate; and open, deregulated international capital flows.[5]

China presently forgoes the third option—free capital movement—and instead opts to have the ability to conduct its economic development strategy and maintain a fixed exchange rate for its currency, the renminbi, or RMB, which provides financial stability and promotes exports. In many ways, this formulation of the trilemma provided the foundation for China's historic economic transformation. But it also created costs and now constrains China's future economic development and limits its ability to escape the middle-income trap.[6] Realizing these problems, the Chinese government last year pledged to open the domestic economy to international capital flows and to shift toward market-determined interest rates and other financial prices—but gradually and with significant limitations and constraints.

Given the trilemma, by choosing to adopt the third option, economic theory suggests China will also need to choose to give up either independent monetary policy or a fixed exchange rate. Leaders and top economic policymakers have set clear intentions to open China's capital account and to halt direct policy interventions in setting interest rates, the exchange rate, and prices for other assets and financial services. But Beijing established that changes will take place gradually over the next decade, and policymakers do not yet have a clear path to that end.[7]

A decisive role for the market in China's financial system will be difficult to achieve given the pervasive reach of China's one-party political structure and extensive state ownership across the economy's financial and nonfinancial sectors. As Nobel Prize-winning economist Joseph Stiglitz writes, "Market Socialists were misled into thinking that they could get all the advantages of the market economy simply by using the price system."[8] The ubiquity of the party-state's roots throughout the economy creates a decision-making mechanism that exists in parallel to market

mechanisms for deciding investments' worth. These competing nonmarket institutions disrupt market-price discovery by corrupting the economy's micro-level choices about which investment projects to choose and on what terms financial resources will flow.

In other words, Stiglitz's observation is that a market-based financial system needs more than just interest and exchange rates that float with supply and demand, as nonmarket mechanisms will skew not only interest rates but also who gets to borrow, lend, and control the investments that amount to fully half of China's gross domestic product, or GDP.[9] To work effectively, a market-based financial system also requires open, transparent public and corporate governance systems and robust prudential regulations to referee competition and to keep the system from crashing. Instituting these and broader changes are necessary to address structural problems in China's financial system that stand in the way of economic rebalancing and attaining China's next stage of economic growth. Skipping over these steps will pose problems for China.

Capital account opening and interest rate liberalization without corporate governance and regulatory reforms in China's state and private sectors will not lead to market-determined interest rates in either bank lending or China's corporate bond markets. Rather than reflecting supply and demand conditions, decisions about how much to lend, how much to borrow, and the perceived risk of an investment are made through discrete units of China's existing state-owned financial and nonfinancial enterprises.

For China's exchange rate, too, it is not clear that marketization will bring the desired effects of economic rebalancing. In fact, capital account opening is likely to move China's exchange rate in the wrong direction—depreciating against the U.S. dollar rather than appreciating toward a balanced level—even if monetary authorities were to refrain from using their resources and ongoing capacity to manage China's exchange rate. Increasing capital flows into and out of China's economy will strain the financial system's ability to channel capital into productive investments. It will also limit policymakers' ability to manage systemic and macroeconomic stability, exposing China and the global economy to real risk of banking and financial crises—like so many other developing countries.

Whether China is ready for such a market financial system, leaders have chosen to move ahead with financial liberalization and capital account opening. The question now is how and at what pace China will do this. This report provides a survey of the challenges in China's financial system and explores China's ambitious and

unfolding agenda for financial reform and structural rebalancing toward an economy that is more domestic-demand driven, fueled by innovation, more environmentally sustainable, and more equitable.

The report concludes by offering a series of steps both Chinese policymakers and global leaders can take to shepherd China along the path to the economic rebalancing and reform needed for China to develop and integrate further into the world economy. These recommendations include:

- Building China's foundation for inclusive growth
- Prioritizing corporate governance reform
- Rebalancing global exchange rates
- Setting a high standard for China's reform efforts and global commercial norms

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