REFORM AND DEVELOPMENT OF CHINA'S FINANCIAL SYSTEM
Abstract

Zhang Chenghui
Development Research Center, State Council, Beijing

This paper discusses the development of China's financial sector, the present structure of the financial sector, the next steps in the reform of the financial sector and the impact of the Southeast Asian currency crisis and the reversion of Hong Kong on China's financial sector.

Financial Sector Development in China

China's present financial system evolved from the highly centralized one formed after 1949 to meet the demands of the planned economy. In the traditional financial system, the central bank had no independence because the only objective of the system was to fulfill the financial requirements of economic growth. As China's economy became more market-oriented since 1979, reforms have been adopted in the financial sector.

Evaluation of China's Financial System

The main characteristics of China's present financial system are:

1. Banks are the main source of finance. Banking assets (including assets of the urban and rural credit cooperatives) account for over 90 percent of the gross assets of financial institutions. Despite rapid development, non-bank financial institutions still have a smaller impact than banks have on the economy.
2. Government plans and policies largely determine the money supply.
3. Financial controls are rigid.
4. The state monopolizes banking operations. The four state-owned banks hold 87 percent of financial assets. The state allows only a small number of non-state commercial banks.
5. The financial market is still immature.

Financial System Support for Economic Development

China is experiencing both a transition to a new economic system and the take-off of the economy. In this period, the allocation of funds through the banking system has the following characteristics.

1. The increasing number and expanding scale of commercial banks have provided a large amount of funds for economic development and sped monetization of the economy.
2. The long-standing policy of low bank interest rates has supported enterprise investment. Real interest rates were negative for eight of the seventeen years from 1980 to 1996 and the average annual real interest rate was negative for this period. China's financial system, dominated by banks and lacking a developed direct finance system, offered limited investment channels for the savings of enterprises and individuals so the state adopted a low interest rate policy to foster rapid economic development.
3. Since the present financial system is more or less a planned one, the allocation of funds is biased toward the state pillar industries, priority sectors, and state-owned enterprises.

Evaluation of the Financial System

Generally speaking, the present financial system is riskier than the traditional one. It also performs better, but it still lags far behind systems in developed countries. The market is expanding and market participants are more competitive and more capable of dealing with emergencies. Financial structure and macroeconomic regulation have not caught up with this situation, creating financial risk. The aim of China's financial system is to foster economic development, while the structure of the system itself is still in the process of development. The rapid change in the structure and business scope of financial institutions inevitably produces problems in internal control and external supervision, which lead to further moral risk. Internally, most Chinese financial institutions have problems in corporate governance; people, rather than regulations, exercise control. Externally, strict financial supervision limits market competition, inevitably causing inefficiency and systemic risk.

Prospects for Reform of China's Financial System

The next steps in financial reform in China should be:

- To restructure the central and state-owned banks to locate their branches according to economic, rather than administrative, regions. These banks are actually making major adjustments in their branch locations and management systems.

- To speed up the commercialization of state-owned banks.

- To take strict preventive measures against financial crises including integrating formal and informal finance, reducing non-performing assets of state-owned banks, tightening financial controls, promoting the transition from direct control to indirect regulatory control, and cultivating and developing the capital market.

Influence of Japan's Big Bang

Japan's Big Bang financial reform is likely to 1) attract Japanese capital to promote the Chinese economy 2) increase competitive pressure on Chinese financial institutions; and 3) provide an object lesson on financial reform. However, China's on-going financial system reform differs in essence from Japan's reform because China's financial sector is far behind Japan's and its socio-economic conditions are vastly different. Rather than promoting financial liberalization, China has been tightening some controls in order to reduce financial risk. Meanwhile, it is exploring new financial commodities and further opening up its financial markets.

The Southeast Asia Crisis and Regional Financial Systems

The financial crisis that swept Southeast Asia since July 1997 shows that developing countries are involved in the emerging integrated regional or global market, whether they are prepared or not. Only through strengthening financial structures and systems, improving the operating mechanism of financial institutions, is it possible for developing countries to limit their losses in the global market games.

Although it was not affected by the recent crisis despite many serious problems including an unsound banking system, a heavy load of non-performing loans, an undeveloped market structure, and inefficient supervision, China must be alert to financial crisis. In the short run, it should be prudent in opening up the capital market although opening up is inevitable in the long run. After developing market mechanisms and financial systems, reforming commercial bank operations, and raising supervisory efficiency, China will open up further and strengthen its ties with international financial circles so as to finally melt into the regional and global financial market.

The Financial Status of Hong Kong

Since the return of Hong Kong, the Chinese central government has implemented the policies of "one country, two systems" and "Hong Kong people administering Hong Kong" to give the government of the special-administrative-region a free hand in the economy. These policies support Hong Kong's position as an international financial center, the stability of the Hong Kong dollar, and the economic development of Hong Kong. The central government adhered to these policies during the recent crisis. The continued growth of China's domestic economy also provides strong backing to Hong Kong.