The Chinese Financial System: An Overview

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Overview

• China’s financial system is translucent, neither fully opaque nor fully transparent; we must be humble about what we can know
• Chinese finance does a bad job of channeling funds to the best users: privately-owned SMEs
• This is a big driver of the growth of shadow banking, which will continue, although with increasing regulation
• Continuing reforms will encourage capital markets and insurance
• Implicit guarantees are prevalent throughout the system and could prove to be quite dangerous
Overview (continued)

• The Big Four banks are likely to be relative losers; unless a major crisis develops, in which case they would be relative winners, but absolute losers.

• Key reforms are very likely to happen, although slower than hoped and with many transitional compromises
  » Shanghai Free Trade Zone
  » Third Plenum

Overview (continued)

• There is a reasonable Bear case on China as a whole, but I do not subscribe to it

• Other risks exist
  » Housing crisis
  » Western monetary tightening
  » Resurgence of the Euro Crisis
  » Political unrest
The Party-State as Senior Partner

- The Chinese Communist Party has the leading role in both constitutional theory and practice
- The government is closely allied with, and ultimately subordinate to, the Party
- The large majority of key decision-makers in China are in the Party and need to consider their network of Party supporters and opponents in their choices
- There remains much more of a formal State role than in the West, through ownership stakes and quite interventionist economic policies
- The informal Party-State role adds considerably to this. For example, key bank executives are chosen by the Organization Department of the Party

Capital Market (in trillion USD$)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Bank Credit</th>
<th>Stock</th>
<th>Fixed Income</th>
<th>Insurance</th>
<th>Asset Management Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Size (China)</td>
<td>13.7</td>
<td>3.7</td>
<td>3.4</td>
<td>12</td>
<td>0.4</td>
</tr>
<tr>
<td>Size (US)</td>
<td>7.6</td>
<td>18.7</td>
<td>36</td>
<td>46</td>
<td>36</td>
</tr>
<tr>
<td>% GDP (China)</td>
<td>126%</td>
<td>44%</td>
<td>41%</td>
<td>14%</td>
<td>5%</td>
</tr>
<tr>
<td>% GDP (US)</td>
<td>49%</td>
<td>118%</td>
<td>240%</td>
<td>32%</td>
<td>230%</td>
</tr>
</tbody>
</table>

Note: All values above computed for end of year 2012, except for the values for Chinese Bank Credit, which are up to date through Q1 2013.
Finance caters to big SOEs

• Almost everyone would prefer to lend to the big State-Owned Enterprises (SOEs)
  » Implicit guarantees by the State
  » Sometimes quite profitable business models
  » No risk of getting fired for lending to SOEs
  » Party/Social connections encourage it
  » More direct persuasion sometimes occurs

• In practice, the big banks dominate such lending, although smaller banks get some share of the business

Shadow banks fill the gap

• Privately owned Small and Medium-sized Enterprises (SMEs) are the entrepreneurial heart of Chinese exports

• They end up going to whatever source they can find for funding, which means the shadow banks
  » Trust companies and wealth management products
  » Guarantee companies
  » Pawn brokers
  » Informal lenders

• The Party-State is trying to push banks to do a better job of SME lending, but it has limited success

• As a result, the authorities tolerate the shadow banks despite their lesser control and their fears about them
Capital markets and insurers will grow

- The authorities recognize there are many advantages to the Western approach of large capital markets to better allocate funding and insurers to provide social protections and to bring professional investment management
- They are moving steadily, but not rapidly, to encourage these developments
  - Concerns about transitional issues
  - Desire to retain considerable control over funding sources

Corporate debt issuance surged to new highs in Q3
Bond sales by nonfinancial corporations, by type
Implicit guarantees are a major risk

- It sometimes seems that everything is assumed to be guaranteed by the Central Government in one way or another, except private SMEs
  - State banks are clearly implicitly protected
  - SOEs are generally implicitly protected
  - Local government borrowings are usually seen as protected
  - Deposits are clearly implicitly protected
  - Trusts are usually assumed to be guaranteed by their associated banks or the State
  - Wealth management products are generally assumed to be guaranteed

Big Four banks are in relative decline

- The big, state-owned banks (with minority private ownership) still dominate, but are a smaller and smaller share of the market
- Moves towards shadow banking, capital markets, and insurance are all likely to reduce their roles
- Increased Western competition over time should decrease their relative importance
- Reforms to deposit and lending rate restrictions endanger their core profits
- A slow move towards a greater private role in the economy endangers their base of SOE lending
Key reforms are likely to happen

- I do believe the new team at the top of the Party-State will accelerate reforms and the Third Plenum confirms this.
- That said, they will not fully buy into all of the liberal proposals, they will need to make compromises, and they will be cautious about transitional arrangements.
- Some of the key reforms related to finance are:
  » Elimination of deposit and lending restrictions
  » Cessation of informal and formal lending quotas
  » Lessened informal pressures on who to lend to
  » Foreign exchange rate reforms
  » Capital movement reforms
  » Explicit deposit insurance, with premiums
There is a reasonable Bear case ...

- Michael Pettis and others (such as Jim Chanos) argue that medium-term Chinese growth will be much slower (3%?) and may temporarily crash to zero
- Over-investment, excessive focus on exports, and under-consumption are considered to have reached an unsustainable point
- The Party-State is viewed as incapable of dealing with the required strong change in emphasis because of entrenched interests and inexperience in this type of transition

... but I believe it is wrong

- The Party has proven extremely adept at doing what has to be done to maintain the growth they consider essential to the maintenance of their control and the growth of China's power in the long-term
- The past 30 years of challenges have been surmounted
- The leaders are very smart and quite pragmatic
- There are ways to adjust more slowly and with less overall negative impact than the bears believe
Other risks exist as well

- Potential for a housing crisis
- Difficulties in adjusting to Fed tapering and the medium-term transition away from extremely loose Western monetary policies
- A resurgence in the Euro Crisis
- Some form of political crisis in China
China: Growth of Mortgage Lending

Sources: CEIC and DRI staff calculations.