Financial Reforms in China

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I. Financial instability in China

As China enters the post-WTO era, its financial market is opening more rapidly and widely to the outside world. In the face of unstable and complex factors, its financial stability is facing new challenges. The following factors could potentially contribute to financial instability in China:

(I) Huge amount of forex reserve makes it increasingly difficult to maintain a prudent monetary policy

In recent years, China's forex reserve has been breaking records almost daily. In 2004, China's forex reserve stood at US$ 609.9 billion. At the end of 2007, China's forex reserve exceeded US$1.5 trillion, becoming the largest in the world. As far as financial stability is concerned, an exorbitant forex reserve has increased the cost of hedging on the part of the People's Bank of China (PBOC) and weakened its independence and the effectiveness of monetary policy control. Firstly, under the current system of centrally controlled exchange settlement and sales, PBOC is responsible for the purchase of all of China's forex, and the growth of China's forex reserve has increased PBOC's capacity for forex purchase and the size of its money issuance base. The enlarged monetary base will increase money supply. To contain money supply and relieve inflationary pressure, PBOC first issued bank notes to withdraw excessive liquidity from commercial banks. In the face of huge amount of note issuance, PBOC resorted to raising the ratio of reserve requirement of deposits. In 2007 the ratio is raised 10 times, from 8% to 14.5%; and in 2008, it is raised 5 times so far. Despite such a frequency, the prospect of inflation in 2008 does not seem to be promising.

(II) Flexible exchange rate reform has led to RMB appreciation

Reforms to make the exchange rate more flexible have led to a marked trend of RMB appreciation. In terms of financial stability, the prospect of strong RMB appreciation lures an enormous amount of international financial capital to China. With the country's accession to the WTO in 2001, and the implementation of the QFII system and the lowering of the capital market entrance threshold; in particular, financial capital (in banking, securities, funds and insurance) will gradually replace industrial capital to become China's primary form of foreign capital. China is prudently opening its security market to overseas capital. As opening-up accelerates, China will become more involved in international financial markets. Although the influx of foreign financial capital may stimulate a market boom for a period of time, the ensuing instability cannot be overlooked; once the prospect of RMB appreciation weakens, foreign capital will swiftly withdraw from China. Such an exodus of capital could have a devastating effect on the securities market and confront the regulatory authorities with the tremendous pressure of intense market fluctuations.

(III) Financial opening and the impact of foreign financial institutions

As China further opens up its financial system, the potential risks to China's finance industry will gradually emerge. With the opening-up of more businesses and areas to international financial capital, foreign banking institutions will pose a real challenge to their Chinese counterparts in liability, asset and intermediary businesses. Internal management risks of Chinese commercial banks and the moral hazards of employees will prove to be a new test for China's financial stability. Moreover, the financial sector opening and the tendency for global merged financial operations will also challenge China's current divided industry businesses and divided regulatory framework: one bank, three commissions (PBOC and banking, securities and insurance regulatory commissions)", as foreign financial institutions continue to diversify their businesses, regulatory gaps still emerge due to the overlapping functions of some authorities or the lack of mutual communication. Consequently, some unstable factors may be magnified.

II. Further reforms are needed

In the post-WTO era, China cannot rely on quick fixes or emergency measures, such as CB note and reserve requirement manipulations, to maintain financial stability. Instead, China should intensify financial reform and establish a strong legal system for the sound development of the finance industry, thereby making it more competitive but less vulnerable to financial risks.

(I) Further reforms to improve the financial system

Over the past twenty years, China's financial system has undergone many reforms, with tangible results. These reforms have however only been preliminary, superficial and relatively simple. There is still a long way to go to accomplish more profound, complex and substantial reforms. In this sense, an arduous and challenging task lies ahead to fully reform the financial system with the following emphases:

1) Further improve the financial macro-control mechanism to ensure continuity and stability in monetary policy, continuously strengthen the institutional development of the financial market, and set up more straightforward channels for turning savings into investments.

2) Intensify reform of state-owned and non-state-owned commercial banks' organizational structure, management regime, operational mechanism, business pattern, ownership, etc., and continuously improve risk management and internal control.

3) Speed up reform of the rural finance system, clarify ownership relations, improve the legal governance structure, and prevent and resolve the risks to rural credit unions.

4) Steadily promote the reform and development of securities and insurance sectors, increase the proportion of direct financing of enterprises, and fervently protect the legitimate rights and interests of investors.

The ultimate purpose of further reform is to create a comprehensive financial organisational structure consisting of various entities with allocated functions; a highly efficient, secure and stable financial market system; a financial control and regulatory system compatible with the current finance industry; and a financial assurance system that values people and protects investors.

(II) Enhance vitality of the finance industry through intensified competition

Effective competition lays the premise for the sound operation of the finance industry and serves as an important means to promote its efficiency. Over twenty years of reform, China's financial institutions have been growing in both number and variety. The finance industry has been forced to improve, and as such has been able to play an increasingly prominent role in the economy. However, the monopoly of the finance industry, especially in the banking sector, has not been substantially broken down. As a result, the function and effects of the competition mechanism have not yet been brought into full play. The emergence of a wide variety of financial institutions has indeed created competition. Nonetheless, this competition is far from complete in any real sense. The six main obstacles are outlined below:

1) Access barriers to the finance industry are still high and thus competition from potential incomers is weakened and even restricted. In particular, it remains difficult to register new financial institutions, and foreign capital has to exceed a certain threshold before it can enter the finance industry, while private capital still cannot access the financial industry.

2) There are still relatively rigid regulations in place for pricing, deposits and loan interest rates, as well as various other forms of financial service pricing regulations, which have reduced the opportunity for competition among financial institutions.

3) The uniform operation of the finance industry, especially the banking sector, still heavily relies on traditional sources of revenue stemming from the interest rate difference between savings deposits and loan issuance. Due to the lack of intermediary businesses and other services, competition in the finance industry is rather restrained.

4) China's financial institutions are still controlled, to different degrees, by all levels of government, the full deployment of competition is impeded by state protection, government intervention, underdeveloped legal regulations and a lack of innovative momentum. In the post-WTO era, it is imperative that China builds an effective financial competition mechanism if it wants to empower its banking sector with more strength, efficiency and competence. To do so we must further reform the financial organisational structure, transform the current ownership relations of financial institutions in accordance with the need to develop a market-based economy, and stimulate competition.

Specifically, we should further transform state-owned commercial banks into stockholding companies, steadily develop small and medium sized banks of various ownerships, and develop them into modern financial enterprises with adequate capital, stringent internal control, safe operation and energetic innovation.

(III) Comprehensive regulations to ensure financial stability

For such a high-risk industry as finance, it is essential to reinforce regulation and supervision to resolve risks and maintain stability. Recent years have witnessed new developments in the improvement and reform of China's financial regulatory system. In light of international experiences, the government has improved financial regulatory methods and adopted some preventive measures and solutions to both potential and already exposed financial risks. In spite of these efforts we must recognize that defects still exist in China's financial regulatory system. For example, there is no overall regulatory policy framework, and various financial regulatory agencies cannot effectively coordinate with each other. Much attention is paid to market access while continuous supervision is overlooked.

While placing emphasis on regulatory compliance and external supervision, the authorities have neglected risk monitoring, internal corporate control and the rule of law. These problems cannot afford to be ignored. In terms of global trends, financial regulation and supervision is witnessing a transformation from four aspects: from the regulation of individual operations to the regulation of joint operations, from institutional regulation to functional regulation, from partial regulation to overall regulation, and from insular regulation to open regulation.

The level of China's financial regulation should be improved as soon as possible to better and more effectively prevent and resolve financial risks, safeguard financial stability, and create stable conditions for financial development. Therefore, it is necessary to streamline and improve existing laws and regulations in light of the financial market situation, and in particular to step up legislative efforts with regard to market access, business practices, competition, market withdrawal, financial networks and electronic development.

Meanwhile, financial regulatory concepts should be updated, regulatory content should be clarified, and innovation carried out to shift the regulatory focus from compliance to the supervision of operational risks and functions, from mere monitoring to putting an equal emphasis on nurturing core competences, and from external regulation to all-round regulation that also supervises internal corporate control. In addition, China also needs to establish a system to disclose financial information, unify regulatory standards, and develop the independent supervision of financial institutions.