

Optimal Financial Structure and Financial Reform: a Perspective from China*

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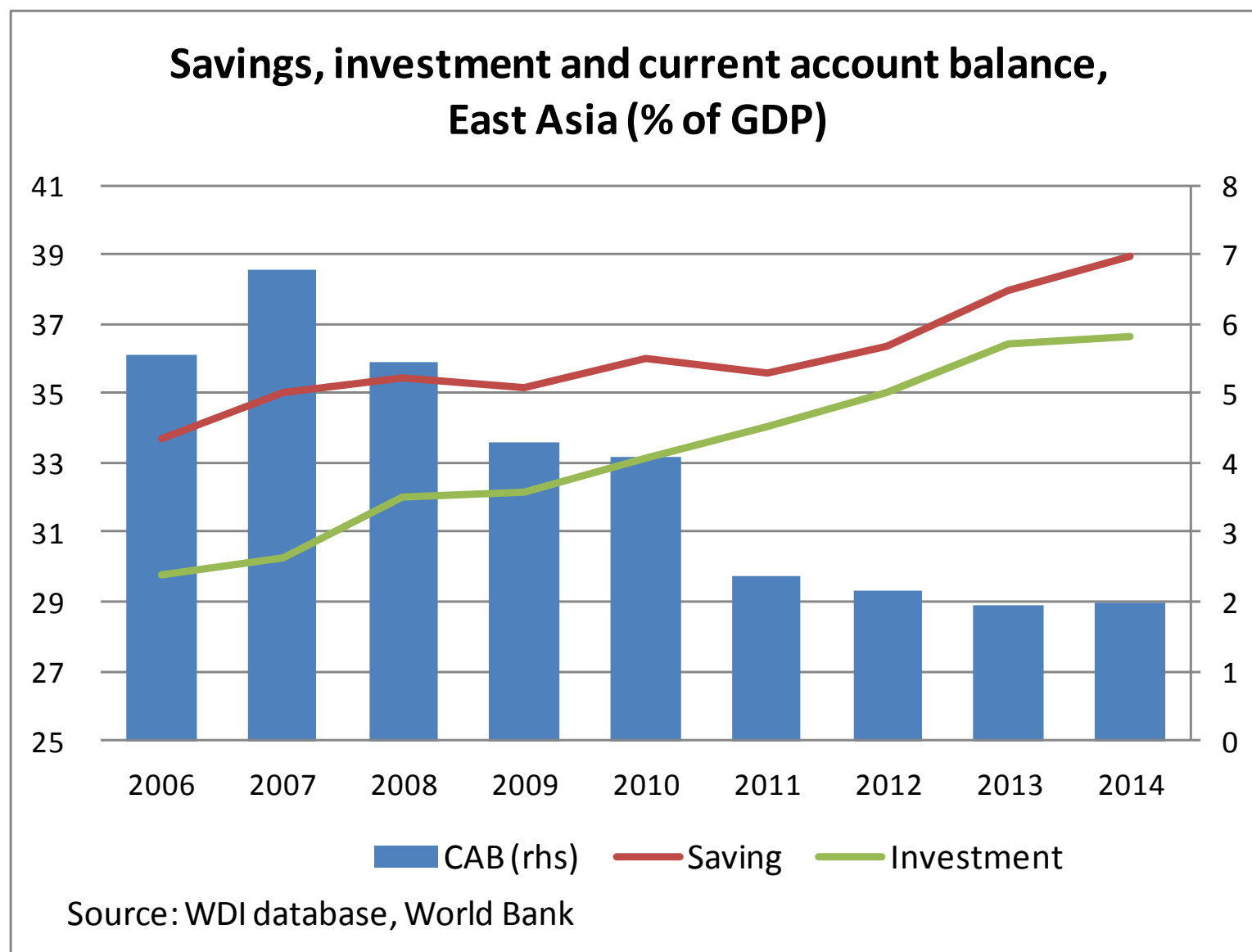
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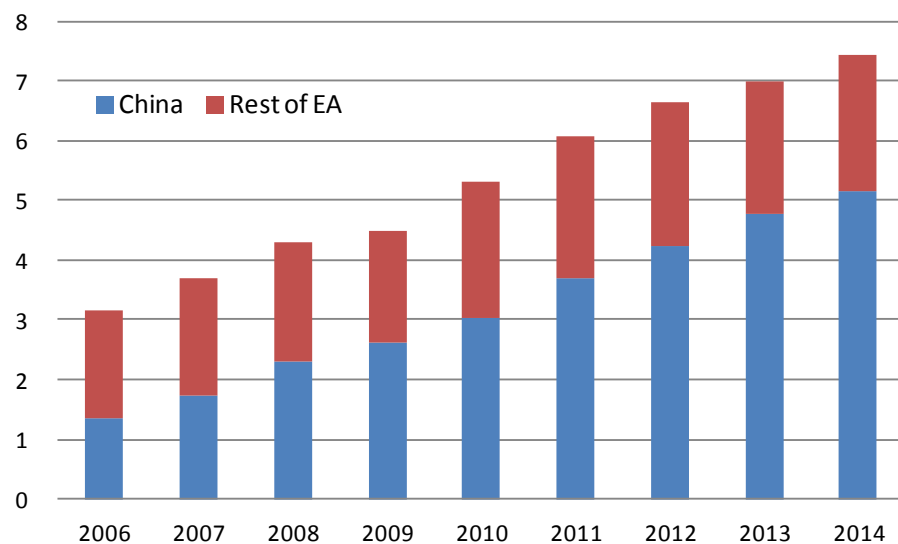
* The views expressed in the presentation are those of the author and should not be attributed to China Investment Corporation.

Asia boasts high savings and investment rates...



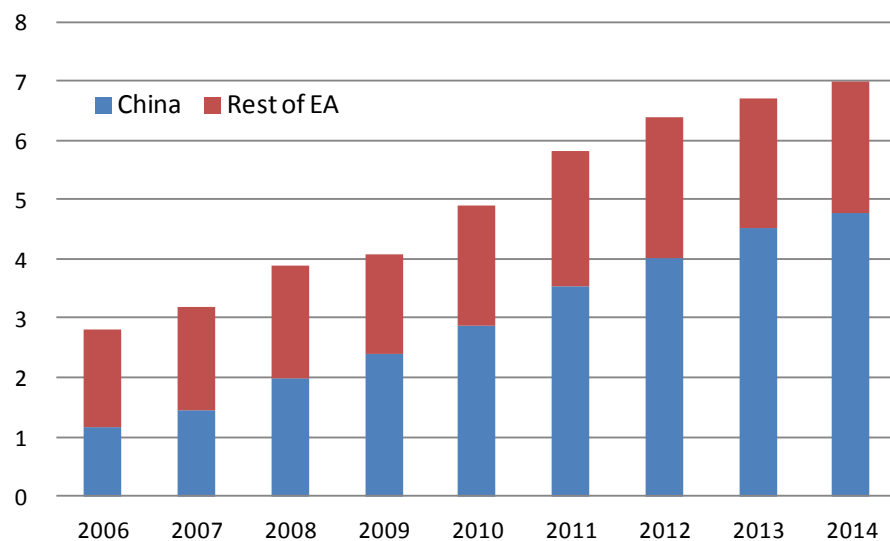
...largely driven by China.

Gross domestic savings, East Asia (tn US\$)



Source: WDI database, World Bank

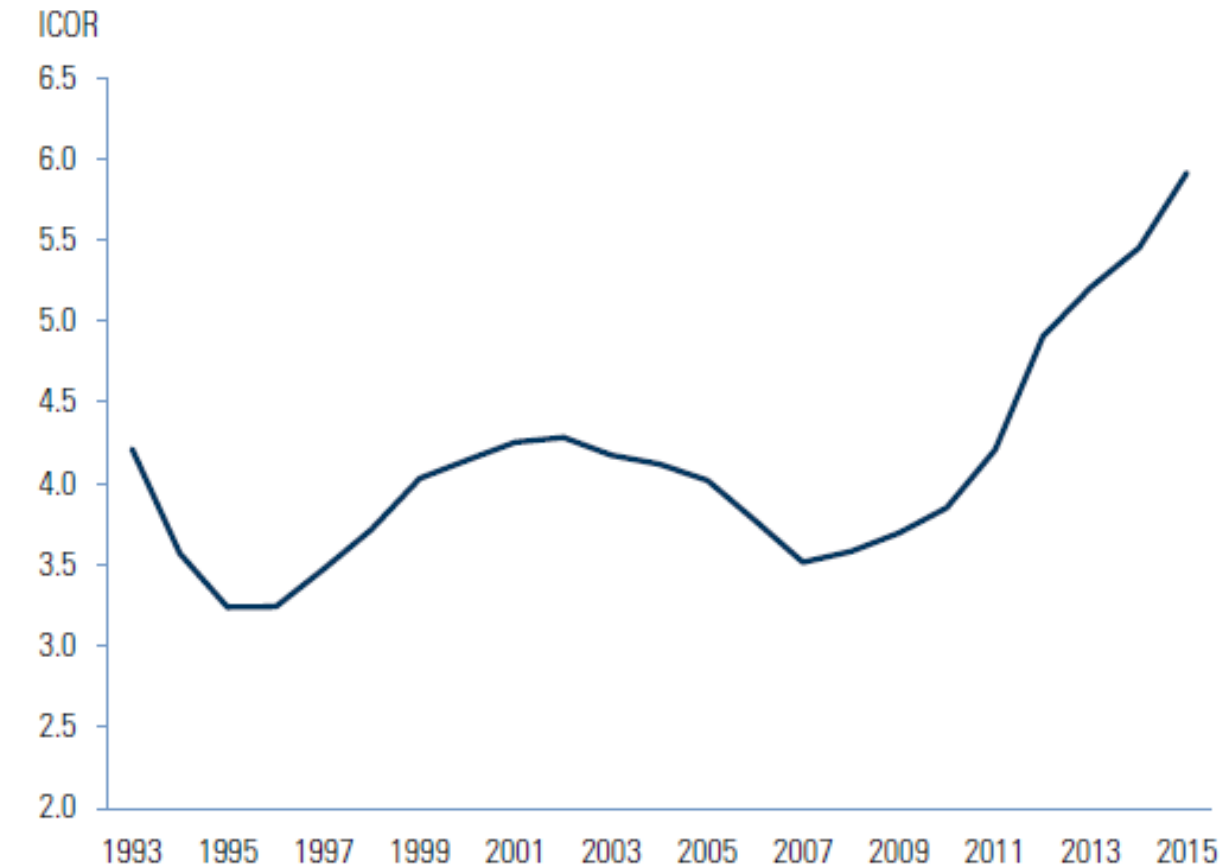
Gross capital formation, East Asia (tn US\$)



Source: WDI database, World Bank

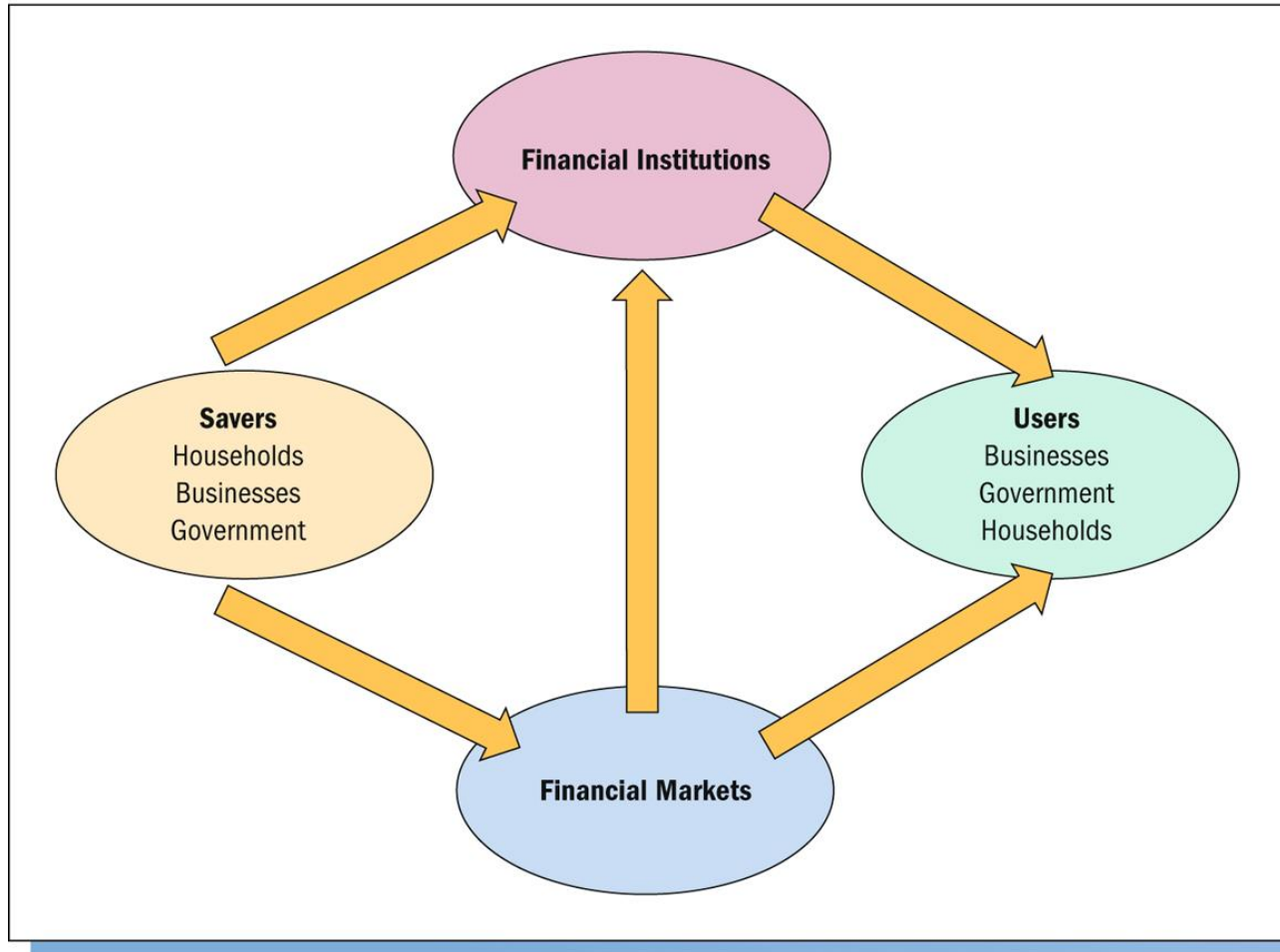
Sharply rising ICOR may suggest deterioration of investment efficiency in China...

China's Incremental Capital-Output Ratio

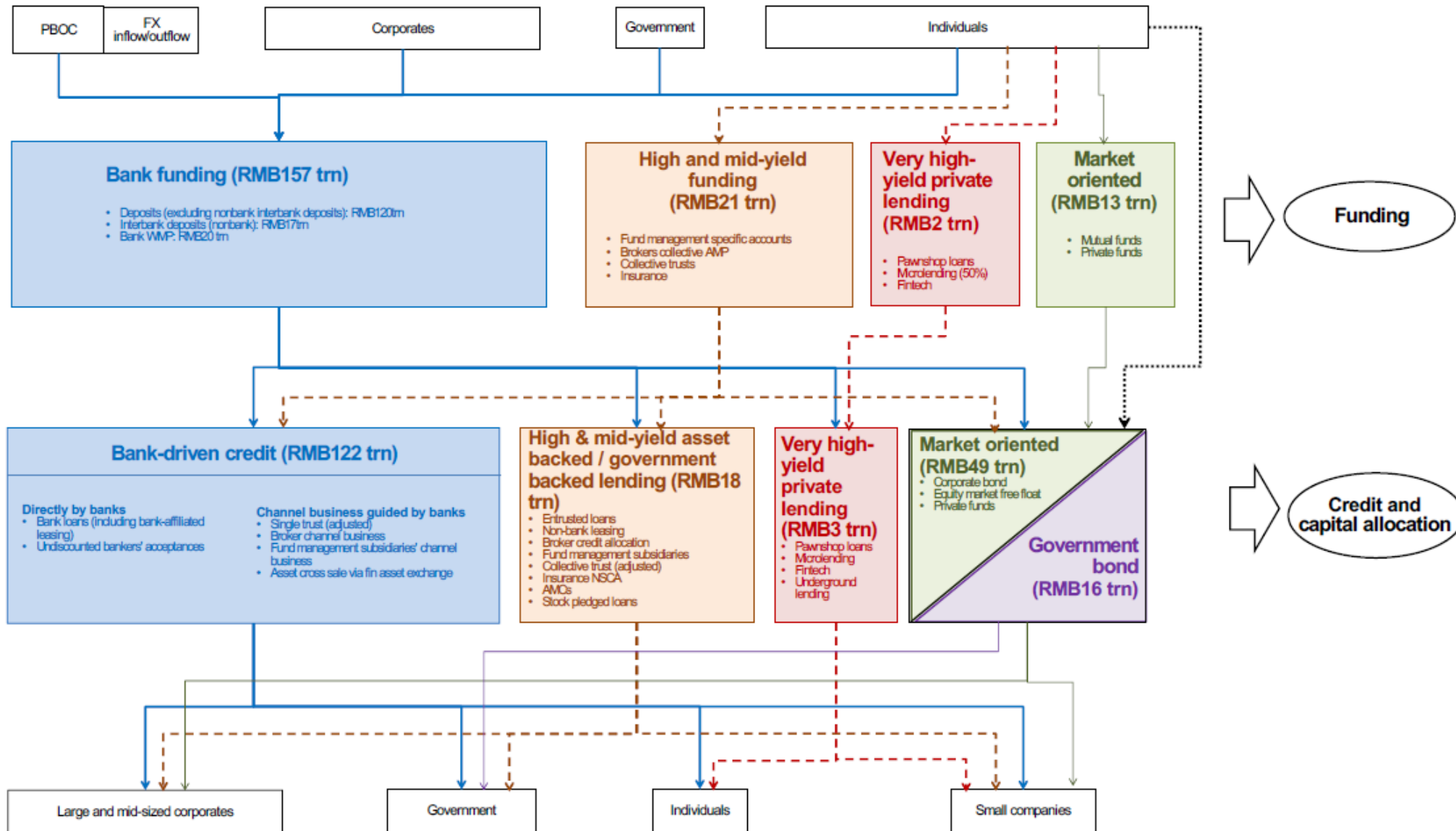


Source: GSAM

...which may lie in its flawed financial system

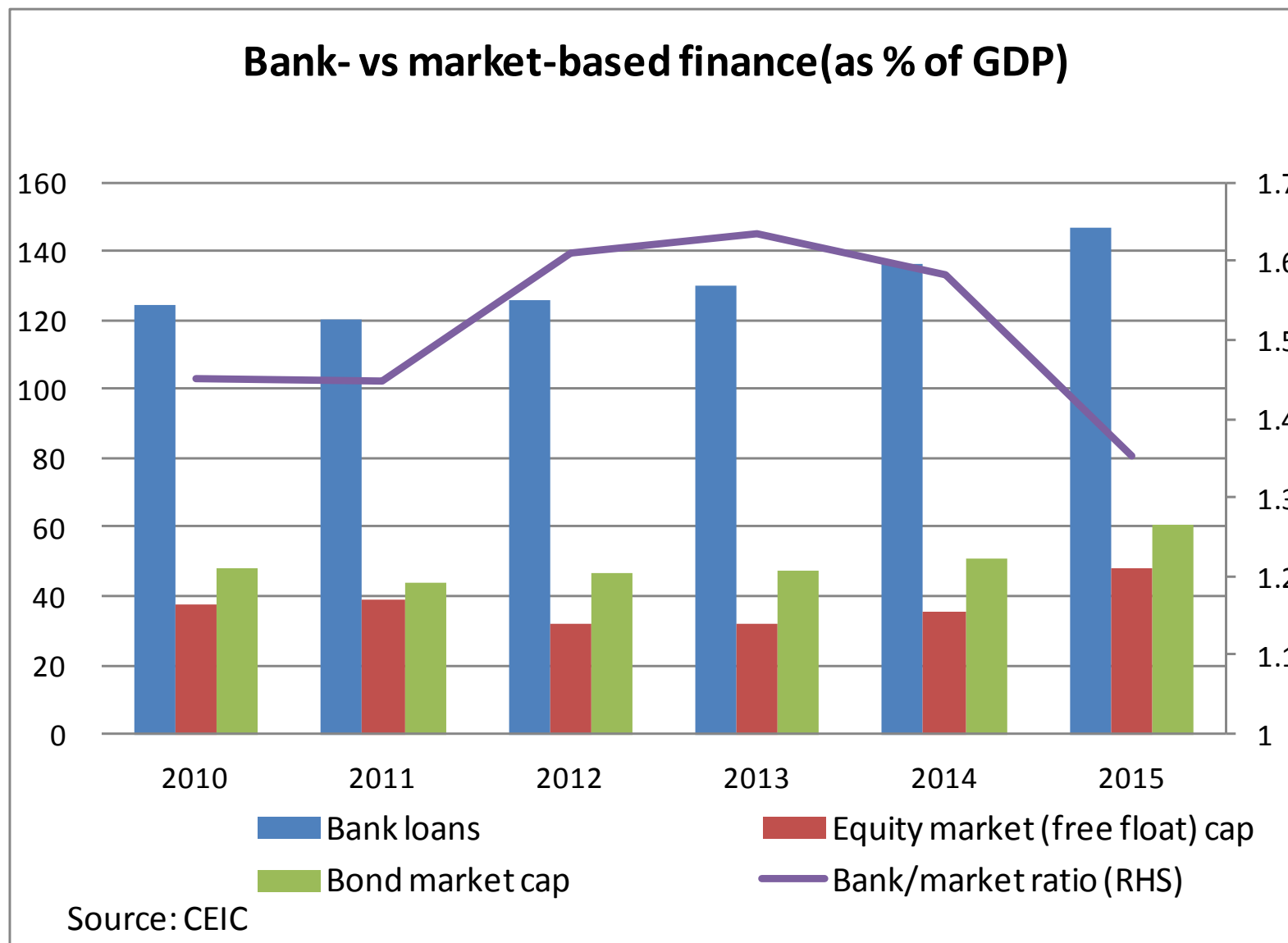


An overview of China's financial system



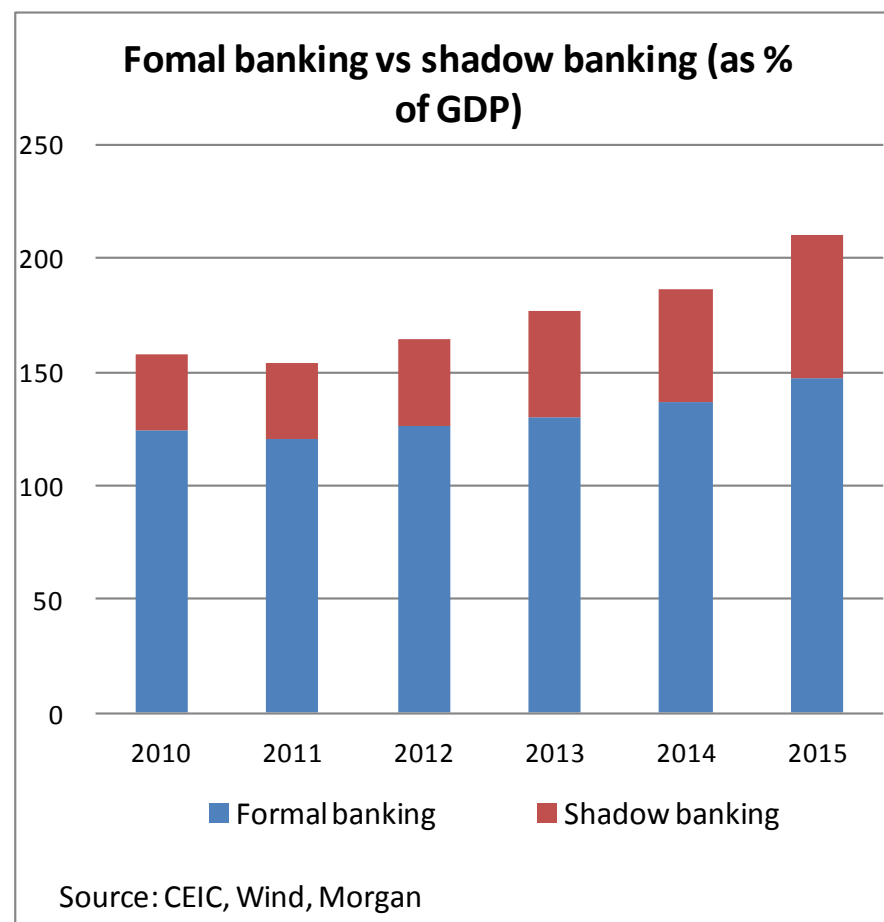
Source: Morgan Stanley

Heavily bank-based



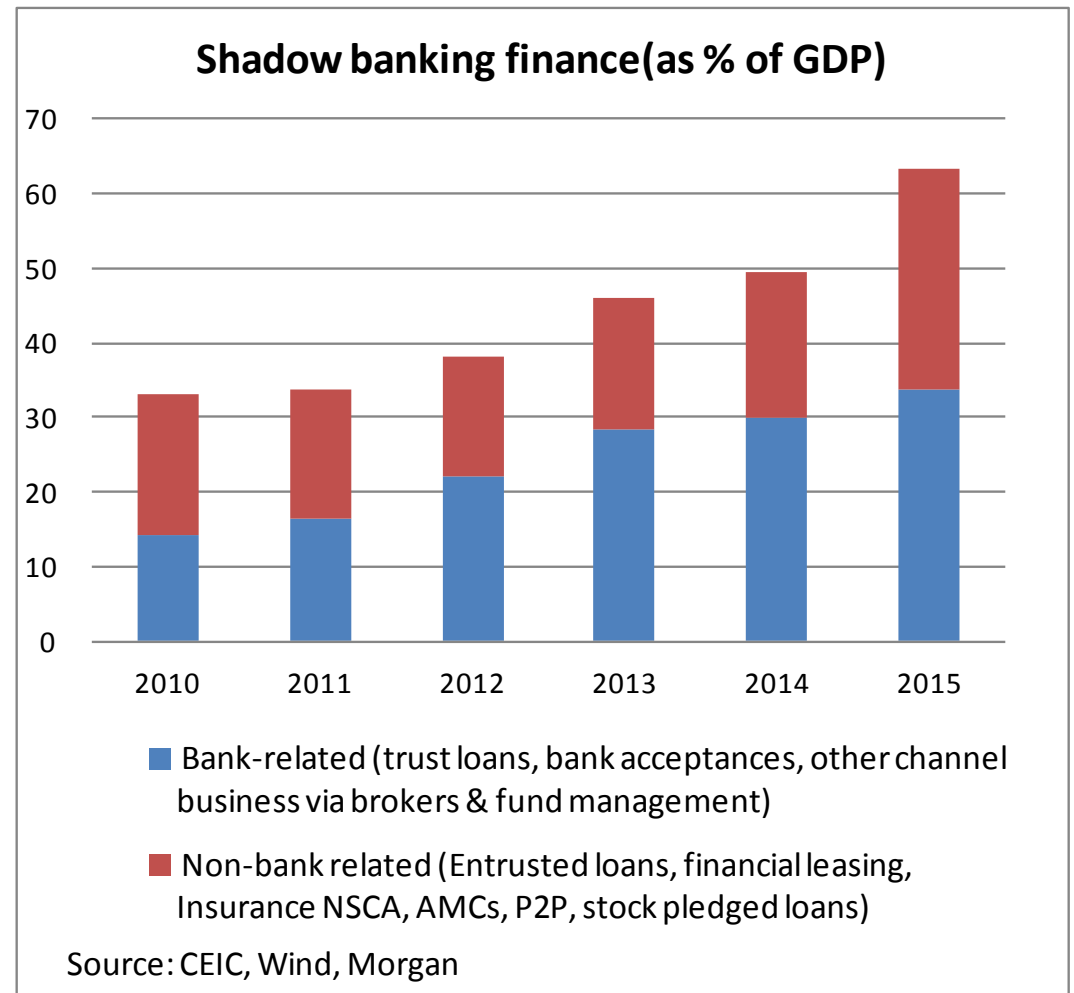
Shadow banking system is rapidly expanding...

- Natural results of financial repression and regulation arbitrage
 - Interest rate controls, high rate of reserve requirement and the 75% loan-to-deposit ratio imposed on formal banking system
 - Window guidance to limit credit supply to certain sectors, such as LGFVs, property developers and equity leverage
 - Rising demand for financial intermediate services by both savers and borrowers, especially private corporations and SMEs.



... while carrying dense connections with formal banking system

- Many of the shadow banking activities are in fact operated by banks.
- They provide credit assets via the channels business at many types of nonbank financial firm, and then fund through either interbank markets or the sale of WMPs.
- These nonbank financial channels can gain scale rapidly through working with large banks.



Formal banking system is state-dominated

Year 2014	Number of banks	Assets (bn RMB)	as % of industry assets
Large commercial banks	5	71,014	42%
Shareholding commercial banks	12	31,380	19%
City commercial banks	133	18,084	11%
Rural commercial banks	665	11,527	7%
Rural cooperative banks	89	957	1%
Rural credit cooperatives	1,596	8,831	5%
Policy banks	3	15,614	9%
Foreign banks	41	2,792	2%
Other	1,218	7,098	4%
Total	3,762	167,298	100%

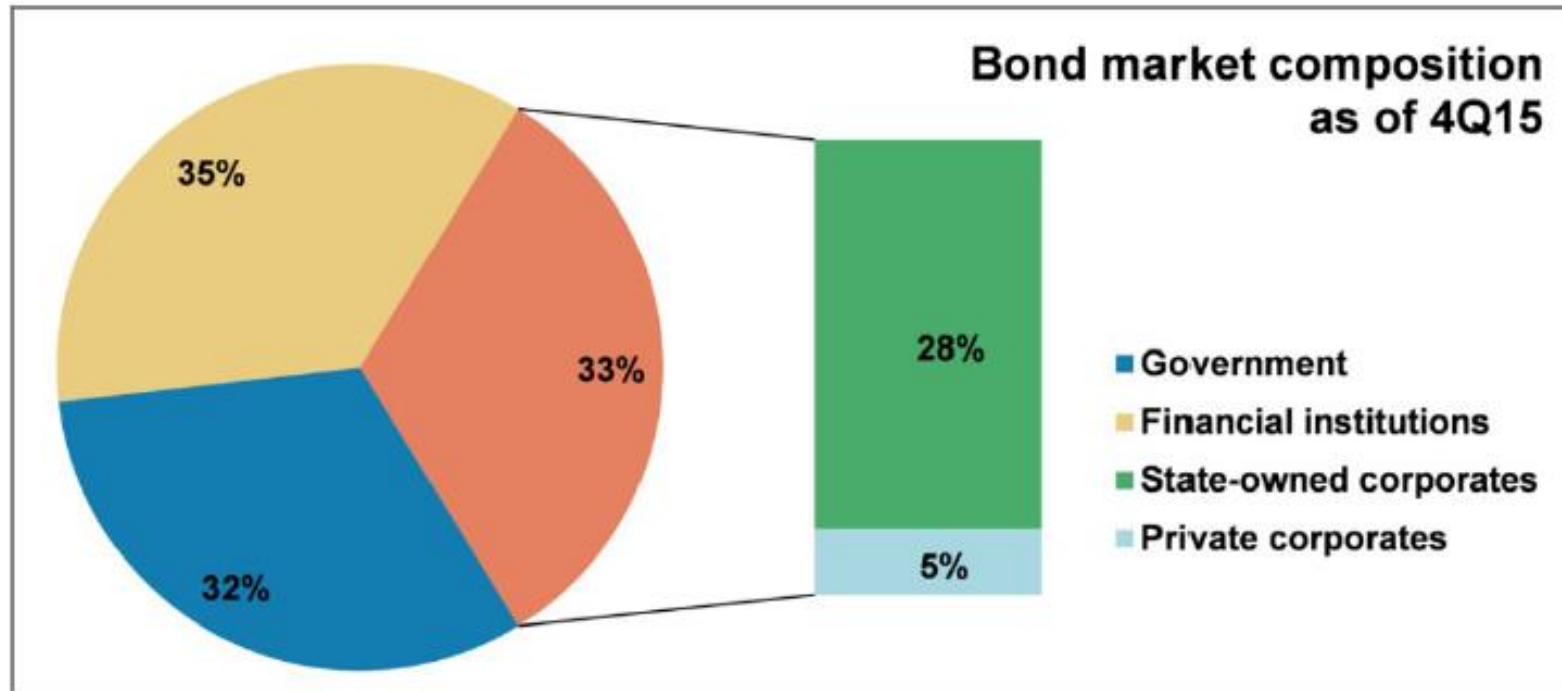
Bond markets

- China has the third largest bond market in the world, which is still small compared with China's economic size.
- Fragmented by two markets and three approvers.
 - Market: Interbank market and the exchange market
 - Approvers: enterprise bond – NDRC; “*corporate bond*” - CSRC
- Banks are the key holders of bonds, contributing to weak liquidity of China's bond market.
 - Banks held around 56% of total bond balance in 2015.

International comparison of turnover ration of bond markets

	US	Japan	Germany	China
Government bond	9.8	1.4	4.4	0.4
Corporate bond	0.7	0.1		0.3

SOE dominates the issuance of corporate bond



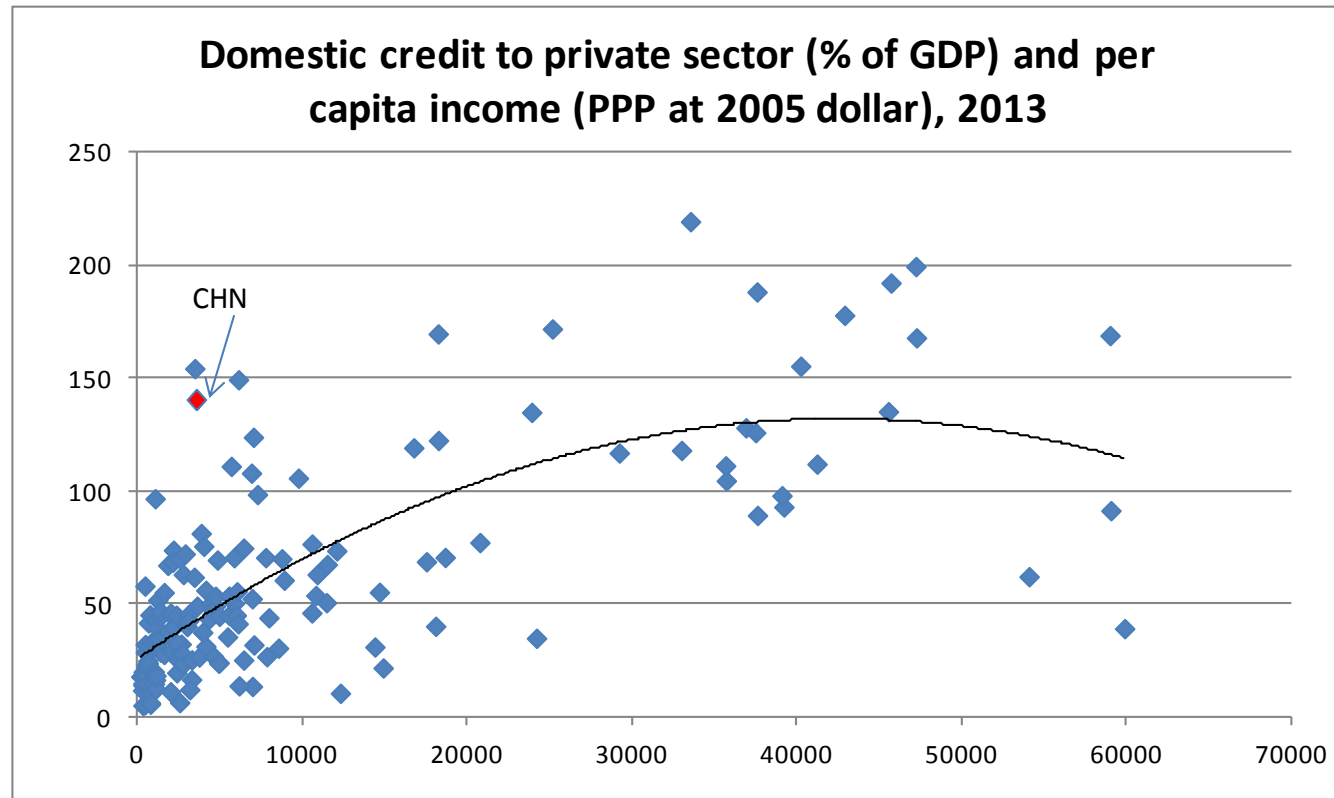
Equity markets

- Highly volatile
- Highly liquid, driven by more trade-oriented retail investors, whom are reported to account for 85% of trading volume
- But some of them may have been scared off by recent volatility and sharp corrections.



An over-banked China's financial system?

- The traditional over-banked financial system in China may reflect the government's intention to control the economy using state-dominated bank system, and has been consistent with relatively weak institutional and regulatory environment in China.



Towards an optimal financial structure

- Current financial system may have become a binding constraint for China's economic transition and growth
 - The bank-based financial system has led to high economy-wide leverage, rendering the economy vulnerable to negative growth shocks
 - State-dominated banking system fails to provide financial services to SMEs, hindering economic growth and inclusiveness.
 - Developing an innovation-driven economy requires capital markets to share and diversify risks.
 - With rising of households wealth and opening-up of capital account, limited capital market investment opportunities lead to risk of sustained capital outflows.
- An optimal financial system should provide a mix of bank-based and market-based financing which matches the industrial structure and the characteristics of firms of its underlying economy (Lin et al, 2009).

Financial reform

- The recently published 13th Five-Year Plan reaffirms the government's aim to grow capital markets and increase the share of direct financing in total external finance,...
- ...although the path to this aim is not specified.
- An optimal financial structure could be nurtured under sound legal and institutional environment. Without appropriate legal and institutional reform, to pursue a pre-specified target of financial structure might be risky.
 - The 2014-15 stock bull market and its subsequent plunge in 2015 summer serve as a good warning.
- An immediate risk is the policy temptation to speed up the capital account liberalization to foster financial development and liquidity (Eichengreen, 2015).
 - PBoC opened bond market to foreign institutional investors in Feb 2015.
 - CSRC seeks the inclusion of A share into MSCI.

Thanks for your attention!