China Business & Finance

How to fix China's financial system

Allocate capital to the more productive, employment-generating sectors

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China's party congress in the autumn will determine the contours of government leadership and policies for the next five years. With most reforms and policy changes on hold ahead of this pivotal event, a major financial work conference last week was a sign of the government's economic reform and intentions.

It seemed encouraging that the top leadership understands the importance of financial industry reforms but the lack of any substantive outcomes is troubling. With financial risks increasing even as the sector becomes more important to the economy, fundamental reforms, rather than tinkering, are needed. China's leadership seems unwilling to tackle this head on, raising the odds of dire consequences.

China saves about half of its annual output. The financial system that intermediates these resources is dominated by an inept banking system. So these resources have been misallocated to inefficient investment that features rapidly diminishing productivity, little job creation and enormous waste. Worse, the dependency on credit-financed investment to boost growth has led to mounting risks, as potential bad loans pile up.

Fixing the financial system is not just about managing risks and avoiding disaster, but also about allocating capital to the more productive, dynamic and employment-generating parts of the economy.

First, cut the link between stocks and flows. The bulk of outstanding loans in the banking system represent loans to state-owned enterprises. Keeping these loans, many of which may never be repaid in full, on their books means banks continue lending to old customers to prevent them going bankrupt.

The belief that the state will provide full insurance to the banking system is difficult to shake

Then change the incentives for banks to make loan decisions based on commercial considerations. Bankers are rational. They are currently responding to distorted incentives — loans to large state enterprises are safer, even if those enterprises lose money, because the government stands behind them.

Solving these two problems means recognising and removing bad loans from bank balance sheets as well as reforming state enterprises, which would include weaning them off bank credit.

In addition, market discipline needs to improve. The government has put in place an explicit deposit insurance system, hoping that markets would assess banks based on the riskiness of their balance sheets. But the widespread belief that the state still provides implicit full insurance to the banking system — and even to other financial products — has been difficult to shake. The government must not protect weak banks or unregulated saving products.

Next, the government must foster competition. It has freed up deposit and lending rates, ostensibly so banks can compete and price in the risk of lending to private and smaller firms. In practice, the central bank still sets the benchmark rates. The banking regulator looks askance at deviations, squelching the benefits of market-determined rates. This must be fixed, along with freeing up restrictions on entry of new banks.

Broader institutional reform is also necessary. This means improving governance in financial and non-financial businesses, better auditing and accounting standards, and more corporate and government transparency.

Regulatory reforms are crucial as well. The weekend conference hinted at coordinating multiple regulatory agencies through a super regulator. As China’s financial system becomes larger and more complex, systemic risks need to be monitored carefully.

But wholesale changes to the regulatory structure are neither necessary nor sufficient to

ensure financial stability and a well functioning system. It is more important to ensure that regulators have the technical ability and political will to enforce regulations.

China has had success with reforms when they come with a specific goal that can garner broad political and popular support. For financial sector development, this goal exists: boosting employment growth, as articulated on many occasions by China's leaders.

Financial reforms must ensure more credit flows to the services sector and to small and medium-sized companies, and shift growth away from dependence on capital-intensive heavy industry. China has to get finance right.

Otherwise, it will face escalating risks, slower growth and an increasingly unbalanced economy. The stakes are high not just for China but, given its sheer size and importance to the global economy, to the rest of the world as well.

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