China's Financial-Sector Challenge

A Commentary
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China's massive underemployment problem - an army of surplus labour estimated at 200m people — has been characterised as the underlying imbalance in the world economy. Some argue that China's salvation can only come from the dynamic foreign-financed export sector because the domestic financial sector is moribund and irremediable. China's exchange rate policy is seen as essential to this approach.

However, the exchange rate is not the only determinant of the growth in exports. World Trade Organisation accession, rapid productivity growth and good infrastructure have played key roles as well. More importantly, at this stage of its development, China could not continue thriving on a predominantly export-oriented growth strategy. Given the country's size, development of domestic demand will be essential to long-term stable and sustainable growth of output and employment. This, in turn, will depend critically on reforming and further developing the financial sector.

In China, national savings amount to almost half of gross domestic product. For a developing economy, high saving has the benefit of providing cheap and abundant capital that can help generate strong growth. For want of other financial investment opportunities, however, most Chinese savings end up as deposits in state-owned banks, which have done a poor job of intermediating the funds. This money has helped fuel a recent investment boom, with gross investment now amounting to about 45 per cent of GDP. Much of this has been concentrated in a few sectors — such as steel, cement and carmaking — where it may not always be productive and could cause a build-up of excess capacity.

Thus, even as China has become the world's manufacturing workshop, the financial system has been accruing unproductive assets by continuing to support old domestic-oriented companies. This growth strategy is like filling a bucket that has a big hole in the bottom. Fixing the banking system would help plug the leak.

The Chinese government clearly views this as a crucial reform priority. Incentive systems are gradually being changed and the recent liberalisation of lending rates will eventually help banks make more commercially oriented lending decisions. The government has also long argued that such domestic reforms are essential for stable and robust long-term growth and are far more important than exchange-rate flexibility.

But financial-sector restructuring cannot be divorced from other policies. For instance, maintaining a fixed exchange rate reduces the independence of China's monetary policy. In the face of capital inflows and pressures for appreciation, the government is forced to keep interest rates low. This implies cheap, subsidised capital to banks and companies. The government then has little choice but to use administrative measures such as moral suasion to control growth in lending and investment. This is not consistent with training the banking system or state enterprises to respond to market incentives.

With investment growth at unsustainably high levels, less repressed interest rates would give banks strong incentives to assess risk more carefully and price loans based on commercial considerations. This would impose a higher cost of capital on weaker companies, thus reducing their profits and making it harder to justify lending to state enterprises that are only marginally viable. This could also help reorient lending towards relatively efficient private sector enterprises.

But would such measures depress domestic demand? And worse, would a decline in investment reduce China's long-term growth prospects? We think not. First, if the efficiency of investment improves and thus provides a higher expected return on saving, the fraction of income that is saved by individuals, who may be targeting a particular level of post-retirement saving, could fall. Second, if more careful investments reduce the risk of boom-bust cycles, households would have less need for precautionary savings. Moreover, a high investment rate is hardly the way to economic nirvana if such investment is misdirected with scant regard for commercial principles.

Given the importance of China's banking sector within the financial landscape, restructuring the banks is a key priority. But development of the broader financial sector, including equity and bond markets, is crucial as well. This would provide much-needed competition to the banks, giving savers a wider range of investment and borrowing opportunities and giving companies alternative sources of funding.

There is, unfortunately, no clear template for financial-sector development and reform. And there are numerous risks associated with developing these markets, which will require careful supervision. In tackling these challenges, it would help Chinese policymakers to do away with the constraint of maintaining a fixed exchange rate and the distortions that this requires.