

China's Financial Markets: An Overview was chaired by Charles Calomiris, the Henry Kaufman Professor of Financial Institutions and Academic Director of the Jerome A. Chazen Institute of International Business at Columbia Business School. The panelists included

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Summary

Researching China's financial markets can be challenging as the task involves a moving target. Tremendous change continues to take place. Despite the inherent difficulties, three main themes emerge: First, China's pronounced credit and investment cycles have significantly impacted economic growth and reform. Second, the state still plays the central role in the intermediation of capital and the Chinese economy. Third, reform of both financial markets and of state owned enterprises has been very closely intertwined. This is likely to be the case moving forward as well, which could impose some constraints on the pace of financial reform.

Historical Overview of the Financial Markets

In reviewing key stages of China's reform over the last 25 years, it's striking that real GDP growth has averaged more than 9 percent per year. Yet, there also have been pronounced fluctuations around that mean, driven to a great extent by China's investment boom and bust cycles.

The first cycle began in the early 1980s and generated macroeconomic imbalances including rapid inflation and the creation of excess capacity across a wide range of sectors. When the state sharply curtailed bank lending, investments stopped growing and started declining, and GDP growth quickly dropped off.

The second credit cycle, through the 1990s, was even more pronounced since there had been a surge in investment leading to an inflationary boom even more dramatic than the one in the '80s. The authorities again had to curtail bank lending using a mix of sharp interest rate increases and administrative controls on lending volume.

In both of the above cases, the decline in the rate of economic growth and in investments forced a number of enterprises that had overextended themselves during the boom into financial distress. Estimates suggest that roughly 40 percent of the loans extended during the '90s investment boom became nonperforming in the period of slower growth that followed.

The third investment driven boom began in the early years of the current decade. Some observers believe that current real GDP growth actually exceeds the official statistics and nominal GDP growth could be as high as 13–20 percent.

As in the earlier investment driven booms, officials have been decrying the creation of excess capacity and have imposed limits on bank lending and investment. There is concern that investment will decline once again, that growth may slow substantially in the coming years and that at least some highly leveraged firms and sectors will come under financial pressure as the overhang of excess investment is slowly absorbed. Already profits and output prices in some sectors are trending downward, even as officially recorded economic growth remains robust.

This environment of declining investment, slowing growth and increasing levels of financial distress may create a challenging macroeconomic context in which to enact further financial reform.

Structure of Chinese Financial Markets: Banks

In the last 25 years, the landscape has shifted from one approximating a Soviet-style monobanking system to one including a much more complicated set of players, many of which are heavily influenced by market considerations. Bank lending continues to be the dominant source of external financing; banks directly owned by the state dominate the banking sector. The four largest state-owned banks account for more than 50 percent of total banking system assets.

Joint stock commercial banks, a number of which are listed on China's equity exchanges, account for about 14 percent. These are much more market oriented in their outlook than the state-owned commercial banks or the policy banks. And yet government influence over senior appointments in these institutions also remains large.

Policy banks account for around 10 percent of banking system assets. The remaining players include city commercial banks, real credit cooperatives, finance companies, urban credit cooperatives and foreign banks—each holding a very small fraction of total system assets.

Key Challenges

Since state-owned banks constitute such a large fraction of the total banking system assets, it's important to look at reforms as they pertain to these establishments. Two major waves of bank reforms have been initiated in the last 10 years. The first was in the late 1990s. It established recognition on the part of the state that directing the lending of

the banks into SOEs to support government policy objectives had generated an unacceptably high level of nonperforming loans in the banking system and was creating the risk of an outright financial crisis in China. The government instituted a set of what can be seen as drastic policies designed to make these financial institutions operate on a more commercial basis.

First, new policy banks were created to take on the direct responsibility for lending. They supported government policy objectives, lifting this burden off the state-owned commercial banks. Second, the government established four asset management companies and transferred a huge chunk of the nonperforming bank loans into them. This transfer took place at asset valuations that were quite favorable to the state-owned banks and was certainly a boon to their balance sheets. Third, the government injected about \$33 billion in capital into the four largest state-owned commercial banks. Fourth, banks were strongly directed to reduce their nonperforming loan ratios.

In the years immediately following these reforms, the state-owned commercial banks appeared to have reoriented their activities along more commercial lines, closed unprofitable branches, restructured their operations, complied with more strict reporting requirements and reduced nonperforming loans. Banks also sifted lending toward consumers, causing a surge in mortgage and auto lending. In the early 1990s and again in the early part of this decade, loan growth exploded and helped to drive the investment to GDP ratio to unprecedented heights.

One of the challenges confronting the authorities is the reality that the economic returns the asset management companies are deriving from their asset disposal activities may not be enough to cover the interest payments they need to make on the financial injection they got from the government to establish themselves in the first instance.

It's also likely that there was a breakdown of lending standards, and while loan growth has slowed considerably, there is well-founded fear that some substantial fraction of the new loans disbursed during the period of rapid lending growth may become nonperforming.

Structure of Chinese Financial Markets: Equity Markets

Even before the establishment of official stock exchanges, government economists debated the merits of using stock markets to improve the efficiency of SOEs. As early as 1985, a process of improving SOEs was sketched out and to some extent implemented.

The idea was to legally convert SOEs into shareholding enterprises, allocate shares to various government branches, sell some to private investors in order to raise funds for enterprise restructuring, invite the scrutiny of shareholders to discipline management and use equity prices as a mechanism to allocate capital to the most efficient firms. Enterprises would be run by professional managers, not government cadres, and state shares would be vested in holding companies, not regulatory agencies, in an effort to curb temptation on the part of regulatory agencies to intervene on behalf of their client firms.

Key Challenges

The reality that has emerged is perhaps less elegant than what was originally envisioned. The existence of multiple classes of shares in the Chinese equity markets, distinguished by who is allowed to buy and hold them, complicates things. And only firms approved by the state have been able to sell shares of any kind.

As of December 2005, the majority of shares in listed companies on Chinese stock exchanges are nontraded shares that can be legally held only by the state itself or by organizations with legal-person status. In practice, legal-person status has been granted mostly to affiliates and arms of the state.

For most of the history of Chinese equity markets, Chinese citizens have only been allowed to purchase so-called A shares, which are traded on the domestic equity exchanges in Shanghai and Zhejiang. The best-performing SOEs, meanwhile, have been listed on foreign markets such as Hong Kong, Tokyo and London.

The price indices for the country's two major domestic equity markets declined by more than 40 percent and 50 percent, respectively, from mid-2001 through mid-2005. In 2003 and 2004, China's stock markets were the worst-performing equity markets of significant size in the world. And the collapse has been so pronounced that the total market value of Chinese public companies has fallen since 2000, even though 513 new listings came into existence during that period.

Another problem is that under different classes of stock entitling the shareholder to the same claim on the financial resources of the company, the same right to exercise influence over management moves in completely different ways. In 2002, the H shares for China Eastern Airlines suggested a market valuation that was about 80 percent below the market valuation suggested by the price of the A shares, even though H and A shares are basically equivalent in terms of rights. Hence, Chinese equity markets cannot really give us an answer to the simple question What is a Chinese company worth? because the answers that we would get from these segmented, noninteracting pieces of the Chinese equity market are quite different.

The dismal performance of the Chinese equity markets highlights one of the unfortunate ironies of China today. The hard work of the Chinese people has generated an admirable and large savings rate. Yet the returns generated from these savings in the formal financial sector are rather meager. At least \$1.4 trillion of Chinese savings is sitting unproductively in banks earning a nominal rate of interest that was below the rate of inflation in 2004. Not only have returns on equity markets and equity market investment been low, but yields on Chinese government bonds are fairly low, and there's a very limited corporate bond market.

Much of the savings has found its way into real estate purchases spurring fears of a real estate bubble, particularly in the booming coastal areas. There's evidence of a large, informal credit market that funds private enterprises and many of these lenders have operated at the boundaries of legality. So the system is also subject to instability.

Meanwhile, due to China's one-child policy, China's population is projected to age faster than any society ever has in the coming decades. China faces the prospect of having to provide for vast numbers of elderly citizens without the enormous stock of wealth Japan, Western Europe or North America can draw upon. Raising investment returns could be key to avoiding a pension crisis.

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