

Deepening financial reform in China

Remarks by

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I am extremely pleased to be back in this beautiful, captivating land to participate in the China Financial Summit 2014, devoted to the theme of financial reform and economic growth. I would like to thank our hosts for the honor of accompanying such distinguished speakers and sharing some views with you on the implications of financial reform.

China's economic miracle

For more than three decades, China has experienced a remarkable increase in income and living standards. Average annual GDP growth has been about 10 percent, and since 2010 China has become the second-largest economy in the world.

This progress has had a global impact. Many nations have benefited from China's momentum, through the effects of greater international trade and investment. Also, world economic growth has been enhanced, and per capita income disparities have substantially narrowed.¹

China's outstanding economic performance has been the result of sweeping reforms starting in the late 1970s. Transformations have included property rights granted to farmers, the opening of many economic sectors to foreign direct investment (FDI), the ability to run a private business, the privatization of some state-owned enterprises, the liberalization of goods prices, and the reduction of barriers to international trade.

¹ See Sala-i-Martin, X., (2006), "The world distribution of income: falling poverty and ... convergence, period," *The Quarterly Journal of Economics*, CXXI (2).

Tremendous output expansion has gone hand in hand with urbanization, as well as augmented employment and investment. But most notably, it has been backed by consistently growing total factor productivity. Efficiency has benefited greatly from the adoption of technologies and know-how from leading advanced economies.²

As occurs in any economic development process, China may be facing diminishing returns from already implemented liberalization policies. Unexploited opportunities are suggested by the relatively low size of consumption and the service sector in China's economy in comparison with many nations.

Hence, the sustainability of high growth rates and further widening of benefits to society would seem to require more structural changes. In particular, inefficiencies prevailing in several markets may be too costly to allow for continued high rates of economic expansion.

To take hold of these opportunities, the plan for reform announced by China's government last November aims to make the economy more efficient and market oriented. The reform agenda is ambitious, involving a great number of issues. The following are just a few that stand out: the protection of property rights, the deregulation of nonpublic enterprises, further liberalization of prices, financial reform, a revision of government's role in the economy, urban and rural development, and additional areas opened to FDI.

² See Kehoe, T.J. and Ruhl, K.J. (2010), "Why have economic reforms in Mexico not generated growth?", *Journal of Economic Literature*, 48(4).

The potential for success is high in light of China's proven ability to implement necessary and difficult reforms in the past. Given China's importance to the global economy, the world is following this process with fixed attention.

The implications of financial development

The incorporation of financial reform in China's transformation plan is highly appropriate considering its potential benefits. China can take further advantage of common knowledge regarding financial development, such as the following points, which can be gleaned from years of world experience.

First, functioning financial markets are a necessary condition for a prosperous economy. Many studies based on cross-country, individual-country, and industry levels confirm that greater financial deepening tends to bring about higher rates of economic expansion.³

Second, the market is a cost-effective mechanism for channeling savings to financing. Market functioning, in turn, requires competition, with the free entry and exit of for-profit players, as well as the possibility of the failure of institutions which are no

³ For a review of the literature on the relationship between growth and financial markets, see Levine, R. (2005), "Finance and growth: Theory and evidence," in Aghion, P. and S. Durlauf (eds.), *Handbook of Economic Growth*, Volume 1, Part A. Amsterdam, North-Holland Elsevier, pp. 865-934; and Zhang, J., et al. (2012), "Financial development and economic growth: Recent evidence from China," *Journal of Comparative Economics*, 40(3).

longer viable, provided that the stability of the financial system is preserved. Markets also require flexible prices, which of course, include interest and exchange rates.⁴

Third, productivity may be enhanced by opening an economy to foreign investment and the free movement of capital. It is better for financial institutions to be well-developed and adequately regulated and supervised before the capital account is fully freed.

Flexible exchange rates and currency convertibility allow for independent monetary policy. Furthermore, economies with flexible interest and exchange rates are able to accommodate external shocks more easily than those under rigid price regimes, where adjustment relies heavily on quantity changes, including higher unemployment.

Fourth, financial markets frequently suffer from imperfections, such as asymmetric information, adverse selection, and moral hazard, which can translate into negative externalities to the rest of the economy. The financial system is based on trust and the management of risk. When risk is not appropriately priced, contagion may arise and trust may be jeopardized.

⁴ The advantages and disadvantages of fixed vs. flexible exchange rates have fueled a long-standing debate. For a seminal reference on the benefits of flexible exchange rates, see Friedman, M. (1953), "The Case for Flexible Exchange Rates," in Friedman M., *Essays in Positive Economics*. Chicago, University of Chicago Press, pp. 157-203.

These limitations make adequate regulation and supervision absolutely necessary. While the rules of the game should provide the correct incentives to market participants, by reducing moral hazard for example, prudential policies should aim at preventing systemic crises.

Fifth, we are continually learning about how financial systems should best develop. Specifically, successful financial liberalization depends greatly on how well and in what order it is implemented. Neither can it be considered a panacea. History teaches us that financial crises have been recurrent, and that many of them have resulted from poor policies, a fact to which the recent global financial debacle bears witness.

China's financial challenges

China has made significant progress in fostering its financial system. Key advances include bank restructuring, increased foreign participation in financial institutions, the listing of banks on domestic and foreign stock markets, the development of debt, stock, and derivatives markets, the liberalization of lending interest rates, the initial opening of the capital account, and a stronger regulatory and supervisory framework.

These measures have allowed China's financial system to become one of the largest in the world. This is reflected by indicators such as the ratio of financial assets relative to GDP, the number of financial intermediaries, the capitalization value of the stock

markets, and the fact that some of the major banks in the world in terms of market value are Chinese.⁵

This advancement is obviously impressive, especially given the daunting complexity of the system. The next step is to increase quality and efficiency. Indeed, China's financial system could yield greater benefits by becoming more market oriented, in the spirit of the reform plan.

Well-known avenues for transformation would include further interest rate liberalization, credit allocation according to business criteria, transparent local government finances, competitive capital markets, currency convertibility, flexible exchange rates, and additional opening of the capital account. These reforms can enhance long-term economic potential.

In the short term, China faces significant challenges to sustained economic momentum, given the presence of apparent financial imbalances, which, to a large extent, stem from stimulus policies implemented in the aftermath of the global crisis.

In particular, during recent years, credit has been growing rapidly, financing significant investment projects. The unregulated shadow-banking sector has been taking on a growing role. With rapid credit growth since 2008, China's total financing

⁵ For an overview of China's financial system, see Elliott, D.J. and K. Yan (2013), "The Chinese Financial System: An Introduction and Overview," *John L. Thornton China Center at Brookings Monograph Series*, No. 6, July.

stock relative to GDP has risen about 70 percentage points, to reach approximately 200 percent in 2013.⁶

Credit and debt trends may need to slow, and some deleveraging and cooling in certain sectors of the economy may be unavoidable, as for example, in the real-estate market. Economic measures such as tightening financial conditions may facilitate the adjustment.

Furthermore, nontraditional finance could pose a systemic threat to financial stability in part because banks remain closely linked to the shadow-banking sector. Prudential policies may be called for.

China's authorities are conscious of these and other short- and long-term financial challenges, as shown by efforts to adjust to recent economic developments. In the past, reforms have been gradual and ordered, and results have been encouraging. This feature does not need to be changed. Smooth implementation and adequate sequencing of reforms will continue to be essential for China to gain further from financial modernization.

⁶ Data refers to social financing stock as a percentage of GDP from the fourth quarter of 2008 to the first quarter of 2013. See IMF (2013), "People's Republic of China, 2013 Article IV Consultation," *IMF Country Report* No. 13/211, p. 10, July.

The Mexican experience

I would now like to comment on experiences from my own country, Mexico. The health of the Mexican financial system seems to be largely a result of policies inspired by the hardship and trauma caused by domestic financial crises. Specifically, the disarray that emerged in 1982 and in 1995 due to a perverse mix of fiscal, monetary, and bank policies, led the country to implement corrective measures to achieve sustainable financial growth.

The Mexican financial system is bank centric. Most of its assets are owned by banks that compete among themselves and exhibit strong balance sheets by international standards. The system also includes other intermediaries, such as mutual funds, pension funds, insurance companies and nonbank banks, as well as efficient bond and equity markets for government and private issuers.⁷

Several sound policies have led to financial improvement in Mexico. First and foremost, we learned the hard way that no financial system functions properly within an unstable nominal framework characterized by high inflation and weak public finances.

Mexico's central bank has had autonomy for 20 years. Monetary policy adheres to an inflation-targeting regime and uses an interest rate as its key policy instrument. The

⁷ For the structure and recent development of the financial system and its intermediaries, see Banco de México (2013), *Reporte sobre el Sistema Financiero*, September.

control of inflation at low levels for more than a decade has been backed by stable and well-managed public debt.

The credibility of monetary and fiscal policies, in turn, helps explain the rapid formation of a complete yield curve for sovereign bonds in local currency during the first years of this century, and issuances of public debt in international markets for maturities as long as 100 years.

Second, the modernization of bank regulation and supervision has been a continuous work in progress. We lifted restrictions on deposit terms, amounts, and interest rates, and eliminated both mandatory credit allocation and deposit reserve requirements in the late 1980s and early 1990s.

Unfortunately, this was done without first imposing more adequate bank regulations amid all these changes, along with appropriate supervision. Financial liberalization triggered the beginning of excessive, low-quality credit growth. Also, after a 10-year period of bank nationalization, the banks were reprivatized, further inflating the credit boom.

Third, the need to recapitalize the banks after the ensuing credit bust in the mid-1990s led to the abolition of restrictions on FDI in the banking sector. At the same time, a deposit insurance corporation was founded to provide deposit insurance to savers up to a certain limit.

Accounting, disclosure, corporate governance, capital, currency mismatch regulations, and provisioning requirements were further enhanced in the second half of the 1990s. Moreover, in the early years of this millennium, the legal framework for protecting creditor property rights was strengthened and credit bureaus were formed.

Banks' business models have also become more suitable in the wake of the lessons learned by managers from crises and the transfer of technical skills from other countries. Prudential regulation has received a careful overhaul based on experience from the most recent global turmoil.

Fourth, the public defined-benefit pension system was replaced by a privately funded defined-contribution system, in which workers hold individual retirement accounts operated by specialized private asset managers. This has had the double effect of nourishing deeper capital markets while making the pension system sustainable in the long run.

Fifth, the lack of obstacles to free international capital movement, especially since the early 1990s, has been combined since 1995 with a flexible exchange rate regime, which has served as a buffer in turbulent times. Indeed, the resilience of the Mexican financial system was tested by the recent global crisis. Despite real and financial shocks to the economy, financial markets operated with no disruptions and with sufficient liquidity during the most volatile period, while banks remained solvent.

Furthermore, the international financial bonanza since 2010 resulted in substantial portfolio capital inflows directed to Mexico's equity and fixed-income assets. Especially noteworthy have been increasing holdings of peso-denominated government bonds by nonresidents, a trend that has only recently slowed.

Given the possibility of future bouts of heightened global risk aversion, sudden stops or even reversals of capital flows cannot be ruled out. The authorities remain vigilant to the need for measures to make the Mexican financial system more resilient in such an event.

In the long run, Mexico faces two significant and interrelated challenges to financial development: greater deepening and wider inclusion. Mexico is one of the emerging economies with the lowest ratios of credit to the private sector relative to GDP, and with less favorable coverage of financial services geographically and across different income strata.

The relatively compact Mexican financial system finds its roots in previous domestic crises and a history of high and volatile inflation and financial repression. Fortunately, the deepening process was renewed during the last decade, as a result of a sounder policy framework.

To further facilitate this process, the authorities have allowed new forms of bank delivery channels such as retail commission agents, and simplified the requirements

for opening bank deposit and phone banking accounts. Finally, Mexico's ongoing, multi-tiered financial reform includes measures to tackle some obstacles to competition and permit the more expedient repossession of loan collateral. Financial expansion will necessarily take time if it is to be sustainable.⁸

Final remarks

China's decades-long reform program has been responsible for nothing short of an economic miracle, which has improved living conditions not only for the country itself, but to a large degree the world over.

Where China's financial development is concerned, reforms with the potential to fuel growth for many years have recently been outlined. The importance of structural reforms that undergird a solid financial system cannot be understated for any country. In China's case, the order in which measures are implemented is of key significance, as is facing short-term challenges, and devising a well-thought-out medium-term plan.

Without a doubt, China is pursuing these objectives with innovative and timely solutions, as the nation has done for many years. This course of action should allow its citizens to look forward to greater standards of living, and future generations to enjoy more prosperous lives.

⁸ For a review of Mexico's financial deepening and ongoing financial reform, see Sánchez, M. (2014), "Mexico's banking system: opportunities from reform," presented at *BNP Paribas Economic Forum*, March.