An Overview of China's Financial System and Current Challenges

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In the past few decades, Asia has seen unprecedented growth, and the development of Asian capital markets, notably China's, played a critical role in realizing that growth.

China's financial system is fast growing, and many exciting reforms are still underway: interest rate liberalization, IPO reform in the stock market, RMB internationalization, and capital account liberalization, among others. By size, China's financial market is already the second largest in the world.

Against this backdrop, **Professor Wei Xiong** – Professor of Finance and Economics at Princeton University – delivered a talk titled "An Overview of China's Financial System and Current Challenges" as part of ABFER's webinar series – Capital Market Development: China and Asia.

To begin with, Professor Xiong remarked that after 40 years of successful market reform, many people, especially those outside China, expected China's financial system to become similar to typical western systems. However, it has become increasingly clear that developing a laissez fair system, similar to systems in western countries such as the US, is not necessarily an end goal for China. In fact, a key structural difference likely to persist between China's and western financial systems is that China prefers to combine markets with heavy governmental interventions – a difference that implies different market dynamics and warrants a conceptual framework unique to China.

Providing an overview of China's financial system, he pointed out that the banking system is still at the core of China's financial system. By 2018, banking institutions contributed 76% of aggregate financing to the real economy and owned a staggering 97% of the total assets in China's financial system.

In addition, the banking system provides the main channel for China's monetary policy that follows the so-called quantitative monetary policy system, which aims to grow aggregate financing to the real economy instead of targeting interest rates.

Importantly, the financial system, especially the banking system, has provided a powerful tool to support the government's broad financial policies, which often combine physical and monetary policies to implement particular policy agenda, such as the huge post-crisis stimulus in 2008 or developing the country's western region.

Furthermore, the Professor noted that there is a full set of interest rates in China, many of which are already entirely driven by market forces. However, two key interest rates – the bank deposit rates and bank lending rates – are yet to be fully liberalized, despite the central bank's efforts to do so.

China has also made great attempts to open up its capital markets. It has successfully enlisted RMB into IMF's SDR reserve currency basket with a weight of 11%, which puts it only behind the US dollar and the Euro and ahead of the Japanese Yen and British Pound – a landmark for RMB's internationalization process.

China also has a very dynamic stock market. The Professor noted that, at present, the IPO process is the central point for further reform. The mechanical IPO process might have led to the underperformance of China's stock market, which clearly lacked behind the country's spectacular economic growth.

Talking about risks in China's financial system, the Professor emphasized that although a combination of rising leverage and rising housing prices across China is concerning, its financial system is well equipped to avert a 2008-like financial crisis. He remarked that in a western laissez-faire system, financial crises are like pandemics: during booms, institutions compete to take on leverage, ignoring the externality on the system while, during busts, each runs for the exit, exacerbating the crisis. Since in a laissez-faire system, a government lacks the authority to impose restrictions on taking more leverage or stopping institutions from running for the door, it is very challenging to handle negative systemic externalities.

In contrast, China has a very different institutional foundation. Rising leverage in China is directly related to its quantitative monetary policy. In fact, China's monetary target is M2, which is directly associated with leverage in the country, making rising leverage a direct outcome of monetary policy. However, the government and the central bank have substantially larger capability to forestall firesales and maintain the banking system's stability than a typical western country. Moreover, the housing boom is also directly rooted to local governments. Hence, China's credit and housing booms need to be viewed differently from similar scenarios in a western system because of the heavy governmental presence in its financial system.

Lastly, the Professor shed light on how governmental interventions impact financial systems. His research on China's stock market showed that governmental intervention helps stabilize financial systems because unregulated markets can be highly volatile and can even break down when noise trader risk is too high. However, active government intervention may also render noise in government policy an important factor in asset price dynamics and cause investors to speculate on government noise rather than fundamentals – possibly amplifying the effects of policy errors on market dynamics. To prevent government noise from becoming the key focus of financial market information discovery, the Professor highlighted an important upper bound in the government's intervention intensity.