

An Overview of China's Financial System and Current Challenges

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Summary

China's financial system is quickly growing and still under reform

- The second largest in the world
- Interest rate liberalization
- IPO reform in the stock market
- RMB internationalization and capital account liberalization

The system combines markets and **strong government interventions**

- Sharply different from western systems, despite China's successful reforms to incorporate many market elements
- This structural difference implies very different market dynamics
 - The real estate boom and the rising leverage
 - Need a different conceptual framework



Outline

1. An overview of China's financial system
2. The fundamental difference of China's financial system from the typical western system
3. Challenges to academic researches

Handbook of China's Financial System

Princeton University Press



Wei Xiong



Handbook of China's Financial System

- ▶ **Foreword**

- ▶ *Darrell Duffie*

- ▶ **Introduction**

- ▶ *Marlene Amstad, Guofeng Sun and Wei Xiong*

Part I: Banking and Monetary Policy

- 1. Banking Institutions and Regulations**

- ▶ *Guofeng Sun*

- 2. Monetary Policy Framework and Transmission Mechanism**

- ▶ *Yiping Huang, Tingting Ge and Chu Wang*

- 3. Monetary Policy Instruments**

- ▶ *Tao Wang*

- 4. China's Interest Rate Liberalization**

- ▶ *Jun Ma and Xiaobei He*

Part 2: Bond and Money Markets

- 5. Chinese Bond Markets and Interbank Market**

- ▶ *Marlene Amstad and Zhiguo He*



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Part 3: Financial System and the Real Economy

6. Macroeconomic Effects of China's Financial Policies

➤ *Kaiji Chen, and Tao Zha*

7. China's Real Estate Market

➤ *Chang Liu and Wei Xiong*

8. Infrastructure Financing

➤ *Zhiwei Zhang and Yi Xiong*

Part 4: Ongoing Reforms

9. RMB Internationalization: Past, Present and Prospect

➤ *Kai Guo, Ningxin Jiang, Fan Qi, and Yue Zhao*

10. China's Capital Account Liberalization

➤ *Yanliang Miao and Tuo Deng*



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Part 5: Stock Market

11. The Development of the Chinese Stock Market

➤ *Franklin Allen, Jun "QJ" Qian, Chenyu Shan and Julie L. Zhu*

12. Corporate Governance in China

➤ *Cong Wang*

13. The Accounting System in China

➤ *Tianyu Zhang*

Part 6: Asset Management

14. Investments Funds in China

➤ *Wenxi Jiang*

15. China's Venture Capital Market

➤ *Zhaojun Huang and Xuan Tian*



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Part 7: Pension System

16. The Chinese Pension System

► *Hanming Fang and Jin Feng*

Part 8: New Developments

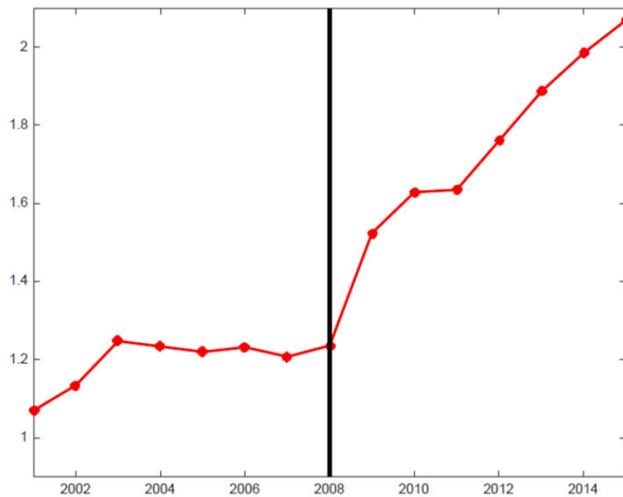
17. Fintech Development

► *Bohui Zhang*

The Current Progress

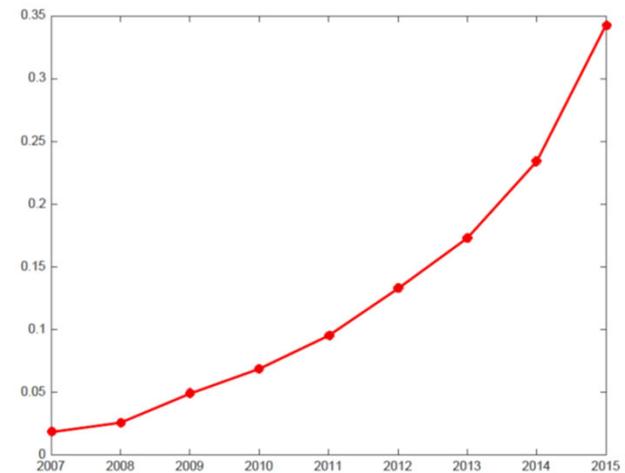
- ▶ Many progresses have been made relative to 1980s
 - ▶ A highly developed system
- ▶ Still substantial differences from western systems
 - ▶ Restrictions and controls remain, to certain extent, on some key markets, such as IPOs, interest rates, capital flows
 - ▶ Some of the restrictions are part of the transitional dual-track reform process, some are structural
- ▶ The Chinese economic model: enabling state (有为政府) and effective markets (有效市场)
 - ▶ The goal of the reforms is not a laissez-faire economy
 - ▶ Delicate balance between two powerful forces
- ▶ Important and persistent influences by the state on the financial system
 - ▶ Intensive government interventions
 - ▶ The mandates of the financial system to support the government agenda and the government system

Rising Leverage



Note: The outstanding debt is backed out from “social financing statistics” provided by NBS, which measures lending from the financial sector to the non-financial sector

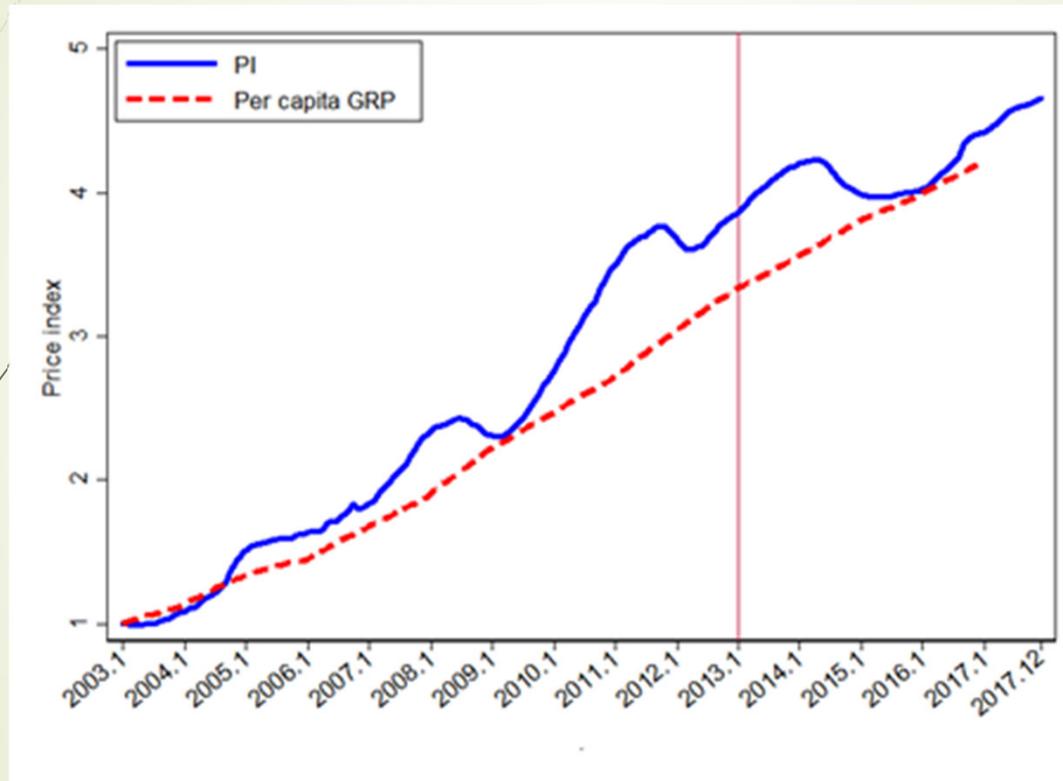
Figure 4: The Size of Wealth Management Products



Note: The figure plots total WMP balances as percent of GDP. Data source: China's Banking Wealth Management Market Annual Report (various issues)

Source: Song and Xiong (2018) “Risks in China's Financial System

The Housing Boom



Source: Liu and Xiong (2020) "China's Real Estate Market"

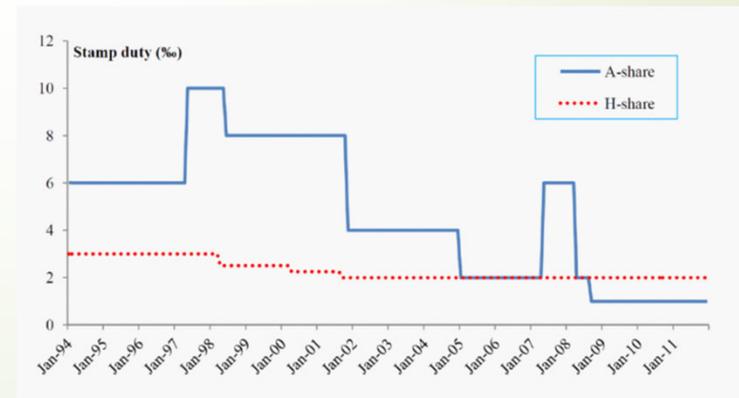


Financial Crises in China?

- ▶ In a western system, financial crises are like pandemics
 - ▶ During booms, institutions compete to take on leverage, ignoring the externality on the system
 - ▶ During busts, each runs for the exit, exacerbating the falls
 - ▶ Difficult for a laissez-faire system to handle externality
- ▶ A different institutional foundation in China
 - ▶ The rising leverage is directly related to the state policies (intentionally or unintentionally)
 - ▶ Most of the debt was from state banks to state firms and local governments, through both formal and shadow banking
 - ▶ The housing boom is directly related to local governments
 - ▶ Government interventions and guarantees prevent panic runs

Intensive Government Interventions

- History of policies and regulations
 - bank required reserve ratio (36 changes 2003-2011)
 - suspension of IPO issuance (9 times since 1992)
 - stamp tax on stock trading (7 changes since 1992)
 - countercyclical mortgage rate and first payment requirement
 - "national team" directed to bail out stock market in summer 2015
 - installation of circuit breakers in 2016





Consequences of Government Interventions

Brunnermeier, Sockin & Xiong (2018)

“China’s Model of Managing the Financial System”

- Government intervention helps to stabilize financial markets
 - unregulated markets can be highly volatile and might break down when noise trader risk is sufficiently large
- Adverse effects:
 - active government intervention renders noise in government policy a pricing factor
 - intervention can cause investors to speculate on government noise rather than fundamentals, which amplifies effects of policy errors
- Tension between objectives
 - reducing price volatility
 - improving informational efficiency
 - while price volatility is lower with intervention, informational efficiency can be worse



Government Efficiency and Market Efficiency

Efficiency of the government system directly affects China's economic growth and financial stability

Xiong (2019) "The Mandarin Model of Growth"

- ▶ A macro model with the local government taking a central role to drive the economy through its active Infrastructure investment
 - ▶ Agency problems between the central and local governments
 - ▶ Tournament motivates local governments for infrastructure investment
- ▶ Career incentives induce short-termist behaviors
 - ▶ overreporting of local output
 - ▶ excessive leverage by local governments
 - ▶ leverage spillover across regions



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Book Synopsis **The Making of an Economic Superpower: Unlocking China's Secret of Rapid Industrialization**

Yi Wen, Sep 27, 2017

This book argues that China's rapid industrialization since 1978 can be attributed to its rediscovery of the secret recipe of the original Industrial Revolution. The secret recipe is not based on institutional changes per se but rather the sequential creation of mass markets to support mass production. Market creation requires a strong state and appropriate industrial policies because mass markets are a public good that is extremely costly to create and can only be created through stages and under enormous political stability and social trust.

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