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China's Financial Sector Reforms and Their Impact on Its Economy

By Elgin Chan

SYNOPSIS

China has tinkered with its economic and financial systems to maintain central control and growth but its reforms are constantly challenged by the needs of the state-owned enterprises and foreign investors. The private sector in China is also important in Beijing's reform efforts but it received unpredictable treatment by policymakers. A delicate balance is required going forward.

COMMENTARY

China's financial sector has undergone significant reforms since the country's "reform and opening-up" initiative in 1978. These reforms were conducted in three main stages: (i) China's dual-track system from the 1980s to 1990s; (ii) China's gradual privatisation of its state-owned financial companies, the opening of its capital markets to foreign investors, and loosening of financial controls from 2000s to 2020; and more recently, (iii) China's tightening of economic reforms and centralising of its financial regulatory architecture from 2020 to the present day.

The Birth of China's Financial Sector (1980s-1990s)

Beijing's economic policies from the 1980s to the 1990s played a crucial role in transforming its financial sector. Indeed, during that period, China was able to expand its banking sector from having only one bank in 1978 – People's Bank of China – to one that now encompasses four of the world's top five banks by assets.

In accomplishing this, China employed the state capitalism model, where the state assumed an active role in correcting market failures and promoting economic activities through its state-owned enterprises (SOEs). To undertake these responsibilities, Beijing had to establish "comprehensive national power" by cultivating "national

champions" in important industries such as banking, technology, and energy, that it deemed supportive of its national security and economic interests.

Hence, for Beijing to establish a strong financial sector that would eventually compete with its more established Western counterparts, it had to implement the dual-track system. This system, which endowed Beijing with greater authority over the financial sector and imposed more restrictive financial regulations on international banks, produced considerable success in its initial stages during the 1980s to the mid-1990s by allowing state-owned banks to develop unhindered domestically.

Furthermore, in contrast to the majority of privately held financial institutions in the West that operate for profit, China's state-owned banks furnished the state with the leverage to conduct economic policies and provide targeted lending to its preferred industries. Indeed, China's SOEs undertook outsized roles in the economy when compared with the US' mixed market economy model – China's SOEs contributed about 30 per cent to the country's GDP, and accounted for about 40 per cent of the total number of enterprises.

However, such lending practices negatively impacted China's financial strength as it led to an overextension of bank loans to high-risk, inefficient SOEs. China's state capitalism model essentially resulted in wasteful and inefficient use of capital in return for greater state control over its economy.

Indeed, the negative impact on China's economy during that period was enormous, as it led to a sharp rise in non-performing loans (NPLs) amounting to RMB 1.5 trillion. As a result, these NPLs posed significant risks to the financial viability of the country's state-owned banks.

Treatment of NPLs, and Privatisation of State-owned Banks (2000-2020)

Beijing was initially opposed to any sort of financial reforms despite the serious threats that the NPLs posed to the economy because the loans extended to the loss-making SOEs created jobs and provided for social stability.

However, by the end of 2001, China's financial quandary worsened. The International Monetary Fund estimated that around 23 to 42 per cent of loans at the big four banks – Agricultural Bank of China, Bank of China, China Construction Bank, and Industrial Commercial Bank of China – were NPLs.

The banking sector's spiraling NPLs posed a significant danger to China's economy and, more crucially, to the legitimacy of the Chinese Communist Party (CCP). To deal with this, Premier Zhu Rongji enacted a series of economic reforms: (i) the "grasping the large and letting the small go" policy of privatising and relinquishing control over smaller and unprofitable SOEs; (ii) the creation of asset management companies to strip out the NPLs from state-owned banks; (iii) the establishment of Central Huijin Investment Company to recapitalize – amounting to US$60 billion – the big four banks; and, more importantly, (iv) the privatisation of between 15 to 25 per cent of the state's shareholdings in the big four banks.

In a further move to attract foreign capital to China's stock exchanges, Beijing

established the Qualified Foreign Institutional Investor (QFII) and Renminbi (RMB) QFII programmes in 2002 and 2011, respectively. These programmes allowed foreign institutional investors to invest in China's RMB A-share and B-share markets.

Furthermore, a previous regulation that required foreign investors to repatriate more than 20 per cent of their monthly investment income was lifted in June 2018. These were positive steps in liberalising the capital markets (stock and bond markets). To further liberalise China's financial markets, the Shanghai-Hong Kong Stock Connect and Shanghai-Hong Kong Bond Connect were introduced in 2014 and 2017 respectively, which allowed investors in each market to trade shares in the other market using their brokerages.

Additionally, Beijing also introduced several reforms that allowed foreign investors to take majority stakes in life insurers in 2019 and securities and fund management companies in 2020, which were positive for China's financial marketisation. These financial reforms have been successful in instilling greater trust in China's financial sector among international investors.

Indeed, foreign banks – Goldman Sachs, JP Morgan and UBS – have subsequently taken majority stakes in their respective joint ventures in 2020. Beijing's investor-friendly and market-oriented policies between 2000 to 2020 therefore allowed foreign capital to be deployed in China, increasing the diversification of risk away from the onshore financial system, and promoting international standards of governance.

Tightening of Private Enterprises and Financial Sector Control (2020-Present)

However, in an effort to regain greater authority over its economy, Beijing enacted a series of economic reforms that cracked down on large private enterprises such as technology companies, property developers, and tuition centres. These initiatives raised serious concerns among investors, which erased more than US$1.5 trillion of the market value of Chinese technology companies in 2021.

Moreover, private companies and foreign investors have decreased or stopped making investments in China, which has led to job losses in the private sector. This has resulted in the largest salary drop for China workers since 2016. The situation has been worsened by the fact that the youth unemployment rate has risen above 20 per cent, which will undoubtedly lead to more social challenges.

As part of a larger effort to centralise financial control and decision-making under its purview, Beijing overhauled its financial regulatory framework in March 2023, giving the CCP more authority over the policies and governance of the financial industry, including hiring and resource allocation.

Simply put, China has made it clear that the financial system operates as a branch of the state and functions more as a "utility" than as a market-based, commercial system. Under such a framework, financial institutions in China would face a more extensive and stringent regulatory landscape.

Implications and Recommendations

China's unpredictable policy changes are disquieting to both Chinese and foreign investors, who have described the regulatory clampdown as "anti-capitalist" or due to the CCP's "lust for control".

The current sell-off in Chinese banks, technology companies, and real estate shares is evidence of the extraordinary capital flight that has ensued from these reforms, which has further deflated the economy. Undoubtedly, these policy steps will increase the strain on the state-owned financial sector, which already has an increased role in supporting the economy. In fact, we are seeing cracks in the financial sector as state-owned banks are facing an increase in NPLs from the current economic slowdown.

To recapitulate, China's financial system has gone through more than four decades of reforms, which saw spikes in NPLs during the 1990s (that resulted in the privatisation of state-owned financial companies), liberalisation of its financial markets, and the loosening of capital and foreign exchange controls. These reforms were beneficial in that they increased China's financial sector competitiveness while also drawing much-needed foreign capital to stimulate the economy.

China's financial system reforms have not always been smooth. In fact, they have encountered difficulties until today because of the inefficiencies attributed to loans prescribed to China's SOEs, top-down governance, and strict government controls. Beijing should keep pushing for increased openness and competition in its financial sector.

China's capital markets, albeit taking enormous strides and chalking up big achievements, are still relatively weak in terms of investor base, and corporate governance compared with their Western counterparts.

The state's holdings of inefficient SOEs remain high. The state could engage professional capital managers to run these large SOEs as profit-maximising corporations while it maintains majority stakes in them, a model similar to that of Singapore's Temasek.

China's liberalisation of capital, foreign exchange, and interest rate controls remain elusive in the short term as the state desires control over the amount of capital flowing out of the country while safeguarding the profitability of its domestic banks albeit through non-market mechanisms. In contrast with the country's financial system of the 1990s, China's financial system is now robust enough to compete with foreign institutions both domestically and internationally. Beijing would do well to continue to promote gradual liberalisation in those areas.

Nonetheless, Beijing's desire for greater authority over its economy and financial system has made it more difficult to attract foreign investments. It is caught between "a rock and a hard place".

Elgin Chan is a PhD student at the S. Rajaratnam School of International Studies (RSIS), Nanyang Technological University (NTU), Singapore. Chan's research

interests include international political economy, international finance institutions, and global financial architecture.

S. Rajaratnam School of International Studies, NTU Singapore
Block S4, Level B3, 50 Nanyang Avenue, Singapore 639798
T: +65 6790 6982 | E: rsispublications@ntu.edu.sg | W: www.rsis.edu.sg