Where is the Chinese Banking System Heading?

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China has become a very important financial force at a time when the world faces severe problems in the financial sector. In fact, there are no major problems with the global financial crisis in China which has the third biggest banking system in the world, measured in total assets. China's outstanding growth performance justifies the general optimism about its future. Previous reforms have contributed to China's rapid advancements in economic performance, but pending reforms in the financial sector led to misallocation of resources as too high saving ratios, financial underdevelopment and repression. Successful finalization of the reforms is key for China's future economic development. The problems remain in terms of an inappropriate incentive structure caused by political interference and influence on lending and financial repression. Incentive-wise not much has changed except the performance of the Chinese banks since the first reforms of the banking system.

The Chinese banking system is dominated by four big state banks, holding over 50 percent of assets, and over 60 percent of assets are directly linked to state institutions through community banks and loan facilities. The past reforms included restructuring and recapitalization which resulted in an injection of around 7 percent of China's annual GDP into major commercial banks. Furthermore, Chinese authorities introduced limited liberalization in terms of ownership, price and quantity, and built-up financial regulation and supervision of the financial sector. These reforms were a beginning but do not solve the incentive problems incorporating the underdevelopment of capital markets and its distortion of saving decisions. The public ownership impedes the establishment of a commercially driven financial system, and the low cost of capital, caused by incomplete interest rate liberalization, alters banks' behavior which leads to a situation of over-investment and results in inefficiencies in credit allocation and a build-up of financial vulnerabilities.

Those financial vulnerabilities lay in the fast growth of credits and loans compared to a relative low capitalization. Experience has shown that banking crises are associated with lending growth and non-financial sector indebtedness. This causes three main future risks for the Chinese financial system:

- Fiscal risks caused by financing macroeconomic stimuli in the period 2008-2010. Those stimuli are mainly financed by regional governments which might lead to the central institutions not recognizing that all the contingent liabilities might increase the debt to GDP ratio up to 80 percent instead of documented 18 percent. Publicly owned banks might be exposed to this debt.
- Monetary risks evolve through the low cost of capital, potentially causing asset price and housing market bubbles due to over-investment.
- A shadow banking system, mainly consisting of informal lending and off-balance sheet lending, might put financial stability at risk through underdeveloped financial regulation and supervision and a skewed lending concentration towards real estate developers.

In order to overcome these caveats the incentive structure needs to be reshaped through further reforms. An ownership reform or private ownership, not necessarily foreign ownership, and market-oriented monetary policy tools potentially lead to a higher stability and efficiency of the financial system. A complementary, fully liberalized interest rate would decrease the shielded net interest margin of the Chinese, mostly publicly owned, banks as comparisons to other countries show.

The discussion started with a question on whether the current situation, with low efficiency in the Chinese financial system, is politically sustainable with lower growth rates. It is likely that the current situation is politically not sustainable due to the fact that the low interest rate boosts inflation and creates a bubble, while Chinese labor force experienced a wage repression in the last decade. There exists a political tension between a sharp increase in wages and a market-equilibrium price for savings in order to increase political acceptance and social rebalancing in China.

Another point of discussion was the falling ratio of non-profitable-loans (NPL) to the amount of loans which might be interpreted as an increasing quality of new loans. The main reason for a vanishing NPL ratio is that the amount of loans is increasing due to high GDP growth rates while the amount of NPL remains constant such that an increasing quality of credits in China cannot be intrinsically confirmed.

Concerns were raised on the role of the People's Bank of China (PBC) and whether the recent reforms have changed its profile and influence. There was consensus that the PBC's role is still significant and the central bank is a motor in order to push new reforms of the Chinese financial sector, even the central bank does not seem to have highest interests in trade and interest rate liberalization.

Furthermore, worries have intensified that a too quick adoption of western liberal financial systems, which show severe imperfections these days, would conflict with the old Chinese system which was mainly a tool to grant money for local Chinese businesses in the past. The Chinese financial sector should be commercially driven but an adoption of the liberal Anglo-Saxon system would cause other imbalances and misallocations. Especially China's separated system, consisting of a Shanghai based financial sector and Hong Kong based financial center, posed a question on Hong Kong's role as a financial market place. Hong Kong is certainly the entry point to China for foreign businesses and a connection to international markets for Chinese firms. On the other hand, Hong Kong is also a vehicle for Chinese banks and firms to use shadow banking in order to have easier access to international capital markets and foreign currencies. Hong Kong plays a key role in China's financial development. However, due to its growing shadow banking, sub-optimal financial regulation, supervision and severe repression it is also a potential source of instabilities and could increase risks for China's financial sector.