Chinese Financial Reform: No Longer Time to Cross the River by Feeling the Stones

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China's rapid growth is one of the great economic and political stories of our age. The country's breakneck growth is single-handedly lifting a quarter of the world's population out of poverty. It is also having a profound effect on other countries. We see this in everything from the rapid expansion of its merchandise trade and its emergence as the single most important source of finance for the U.S. current account deficit to its impact on global prices of raw materials and commodities, worries about the contribution of its coal-fired power plants to global warming, and the willingness of the international policy community to cede it additional power in the IMF.

Were anything to derail this runaway train, the implications for social stability in China but also for the rest of the world would be profound. The most important vulnerability that could conceivably disrupt growth in the short run is the weakness of the country's financial system. There is ample recognition of this problem. China's banking system is criticized for its high level of nonperforming assets. Its equity markets are criticized as opaque, its corporate bond market as nonexistent. Its exchange rate is criticized as overly rigid and for contributing to the problem of global imbalances.

These criticisms are well founded, but there is also a sense in which they miss the point. The point is that China's banking and financial system has served it very well during the last quarter-century of very rapid growth. The banking system has helped to mobilize large amounts of household savings for investment in industry. The country's complex system of equity-market and capital-account regulation has succeeded in attracting foreign money without opening the floodgates to either inflows or outflows. A stable, competitively-valued exchange rate has been integral to China's strategy of export-led growth.

Indeed, the same lesson flows from the experience of other economies. Consider, for example, the seemingly very different case of Europe after World War II. The quarter-century from the late 1940s to the early 1970s was Europe's high-growth period, when it was recovering from several disastrous decades and closing the gap vis-a-vis the technological leader, the United States. Europe too relied on a bank-based financial system, including many state-owned banks, to mobilize savings and plow them into investment. European governments used the banking system to channel investment toward sectors like coal, steel, electricity and transportation. They too pegged exchange rates at levels that became increasingly undervalued as the period progressed as part of a strategy of export-led growth. The high investment rates and rapid export growth supported by this set of financial arrangements were the foundation stones for its golden age of rapid growth.

The problem was that these arrangements were no longer suitable once Europe had exhausted the opportunities for easy growth made possible by high investment and rapid export growth. Its bank-based financial system was less well suited than securities markets for taking bets on competing technologies as growth came to depend on more on innovation than emulation. Its pegged exchange rates created serious problems for monetary management as economies became more exposed to capital flows.

Clearly, the continent needed a new set of arrangements. But the status quo bias of policy makers and lobbying by special interests that benefited from prevailing arrangements slowed the pace of change. The result of this mismatch between new circumstances and old arrangements was a very sharp growth slowdown.

The implications for China are direct.

First, the country now needs to move away from a financial system centered on state-owned banks that plow investment into export-oriented industries using familiar technologies and toward toward a more market-based, innovation-friendly financial system. Big state banks continue to loan disproportionately to large enterprises, with one set of estimates that I have seen suggesting that only 15 per cent of banks loans go to SMEs, which are the engines of innovation in advanced economies.

The hybrid nature of the banking system also frustrates efforts at monetary control. With two of the big four banks, the Bank of China and China Construction Bank, having gone public and been listed overseas, they are no longer 100 per cent governed owned, limiting the authorities' ability to control credit growth by diktat. But neither do the big four banks face hard budget constraints, limiting the ability of the authorities to control credit growth by raising interest rates. The only solution is to step up the pace of commercialization.

Second, while there has been progress in unifying equity markets and rendering them more attractive, the equity market has performed poorly, despite the sterling performance of the economy. Foreign investors still complain about lack of transparency and liquidity, and start-ups and other technologically innovative firms still complain about the difficulty of accessing external finance.

Third, the very limited flexibility of the exchange rate also poses a problem for monetary control, given the difficulty of sterilizing capital inflows, something that is only going to become more difficult with time. It slows the development of better balance between consumption and investment and between traded and nontraded goods. It heightens China's vulnerability to a slowdown in the United States. Allowing greater exchange rate variability and tolerating faster appreciation would help with all these problems.

The Chinese authorities are aware of the need for change. But they face resistance from the beneficiaries of the current system, from managers of state-owned enterprises to workers in export-oriented industries. These problems will only become more difficult as the political system opens and policy becomes more contested. Status quo bias also stands in the way, as Chinese officials eschew rapid reform that risks "killing the golden goose of growth" in favor incremental change that involves "crossing the river by feeling the stones." If they are to avoid serious difficulties, they have to start moving faster.

One of the strengths of Chinese policy is that the officials responsible for formulating it appreciate the need to look carefully at the experience of other countries. In the present case, this means looking not just at the experience of Europe in the 1960s, but also Japan in the 1970s and Thailand, Korea and a variety of other Asian countries in the 1990s. The lesson from all these countries is the need to step up the pace of change and to actively counter the tendency for existing institutions to remain locked in long after they have outlived their usefulness, in order to avoid the kind of economic difficulties these other economies encountered as a result. Chinese officials understand the problem. As to whether they can solve it, only time will tell.

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