

How Should the Chinese Financial System be Reformed

Conference on China's Financial Market
Liberalization

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Introduction

- China's economic performance has been impressive
- The financial system has not been a brake on this so far because retained earnings could finance so much of the growth
- With slower growth there are less retained earnings and the financial system needs to play a bigger role in financing growth
- What reforms to the financial system are needed to ensure that China can continue to grow?

The Largest 15 Economies in the World: GDP and Growth

GDP in 2013		GDP in 2013 (PPP)		GDP growth: 1990-2013 (Constant Prices)		Per capita GDP growth: 1990-2013 (Constant Prices)		
Rank	Country /Region	US\$ Billion	Country /Region	Int'l \$ Billion	Country /Region	Annual growth	Country /Region	Annual growth
1	United States	16,800	United States	16,800	China	9.9%	China	9.3%
2	China	9,181	China	16,157	Vietnam	6.9%	Vietnam	5.6%
3	Japan	4,902	India	6,499	India	6.3%	India	4.6%
4	Germany	3,636	Japan	4,660	Angola	6.1%	Sri Lanka	4.4%
5	France	2,737	Germany	3,512	Malaysia	5.9%	Korea	4.3%
6	U.K.	2,536	Russia	3,480	Nigeria	5.9%	Taiwan	4.1%
7	Brazil	2,243	Brazil	3,006	Sri Lanka	5.5%	Chile	3.9%
8	Russia	2,118	France	2,454	Bangladesh	5.5%	Bangladesh	3.8%
9	Italy	2,072	Indonesia	2,389	Korea	5.2%	Poland	3.7%
10	India	1,871	U.K.	2,319	Chile	5.2%	Malaysia	3.6%
11	Canada	1,825	Mexico	2,055	Indonesia	5.0%	Thailand	3.4%
12	Australia	1,505	Italy	2,035	Uzbekistan	4.9%	Peru	3.4%
13	Spain	1,359	Korea	1,566	Taiwan	4.8%	Angola	3.4%
14	Mexico	1,259	Canada	1,518	Peru	4.6%	Indonesia	3.4%
15	Korea	1,222	Spain	1,488	Thailand	4.6%	Argentina	3.4%

Source: IMF World Economic Outlook Database April 2014; World Bank International Comparison Program April 2014.

Notes: Countries with population less than 11 million in 2013, GDP less than US\$ 50 billion in 2013, or less than 15 years of GDP observations are excluded from the rankings.

When will China overtake the US?

- In PPP terms the prediction is this year - with a 7.4% growth rate China grows to \$17,353 and with a 2.5% growth rate the US grows to \$17,220
- In the longer run, even if China were only to grow at a (pessimistic) 7% and the US grew at an (optimistic) 3% then China would have an economy 1.5x the US in 2025 and 2x in 2033
- What about per capita GDP in PPP terms?

The Top 15 Large Economies in terms of GDP per capita in 2013

GDP per capita in 2013 * (PPP)		
Rank	Country /Region	Int'l \$
1	United States	53,084
2	Saudi Arabia	51,689
3	Australia	44,667
4	Netherlands	43,389
5	Canada	43,004
6	Germany	42,694
7	Taiwan, POC	41,535
8	Belgium	40,858
9	France	37,344
10	Japan	36,611
11	U.K.	36,510
12	Italy	33,341
13	Spain	32,356
14	Korea	31,174
15	Greece	24,727

Source: IMF World Economic Outlook Database April 2014; World Bank International Comparison Program April 2014.

Notes: Countries with population less than 11 million in 2013, GDP less than US\$ 50 billion in 2013, or less than 15 years of GDP observations are excluded from the rankings.

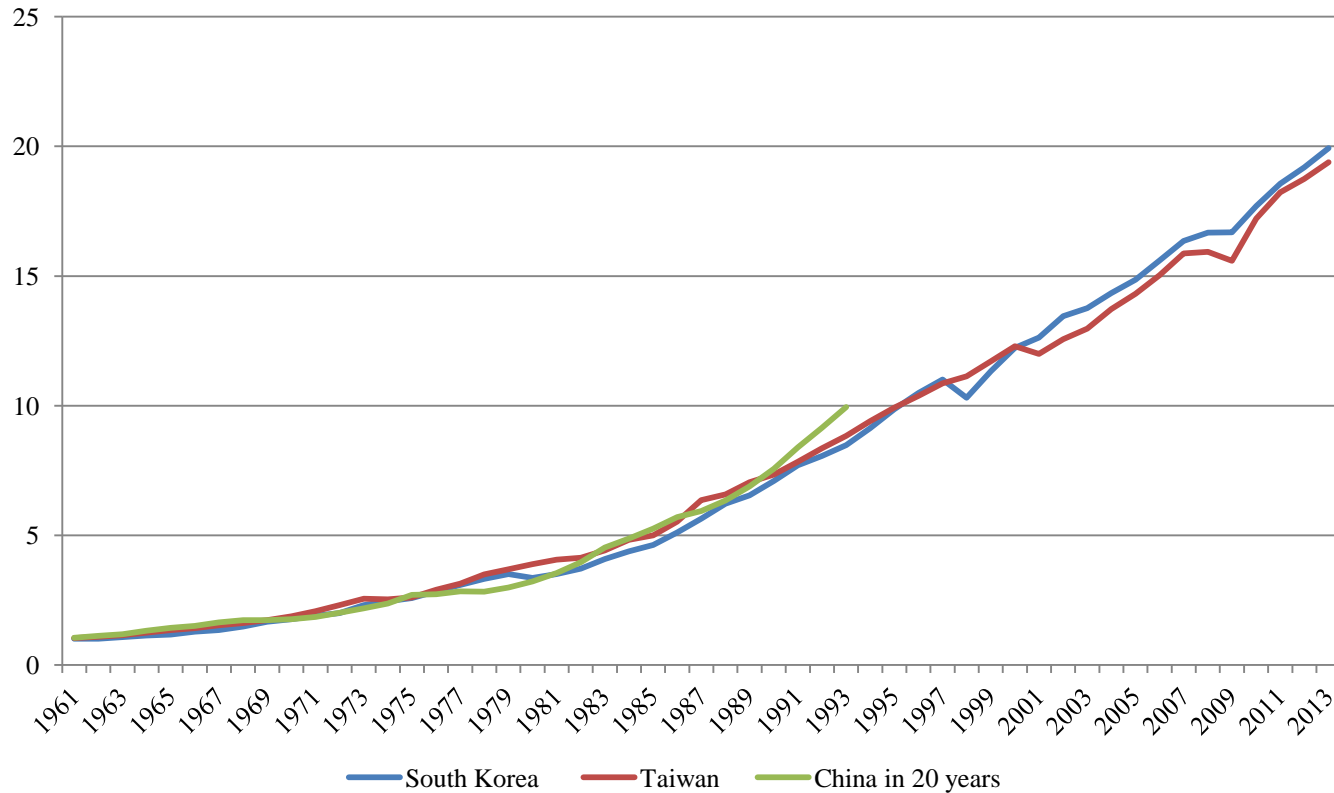
Other successful places

Three large countries/regions have been as successful:

- Japan
- South Korea
- Taiwan, China

China can probably do better but no large country has done so by a significant amount

A Comparison of Growth in GDP per capita in Taiwan, Korea, and China



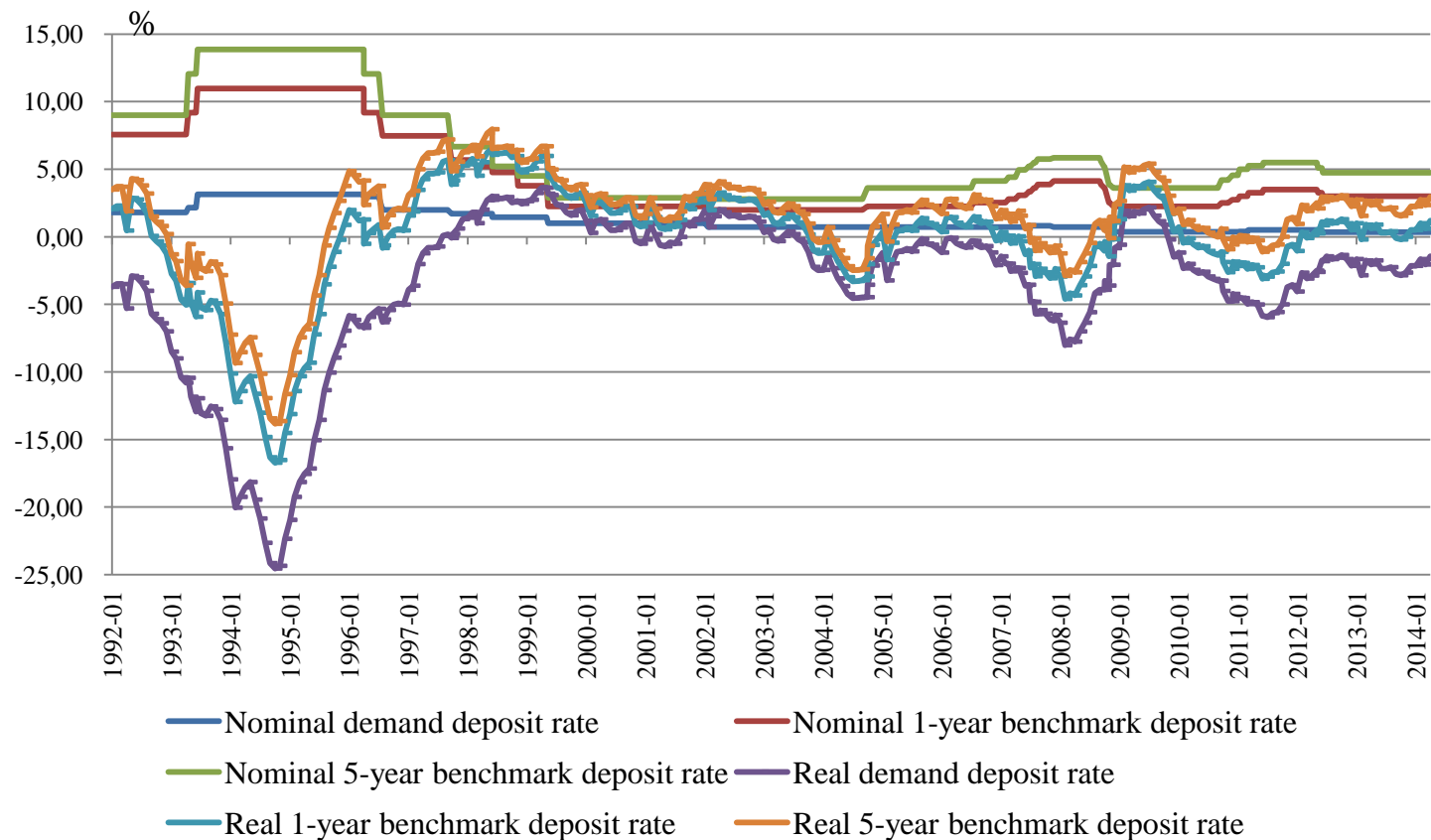
Base year is 1960 for Taiwan and Korea, and 1980 for China

Source: Maddison GDP stat

Savings Vehicles in China

- There are four main savings vehicles in China
 1. Banks
 2. Financial markets
 3. Real estate
 4. Shadow banking system
- We will consider each in turn

Nominal and real returns on bank deposit accounts



Top 10 Global Banks Measured by Market Capitalization (\$billion)

Rank	Bank Name	HQ Country	Market Cap. \$B (May 20, 2014)	Total Return (%) YTD
1	WELLS FARGO & CO	U.S.	260.67	10.53
2	JPMORGAN CHASE	U.S.	203.73	-6.77
3	IND & COMM BK	China	201.48	-5.91
4	HSBC HLDGS PLC	U.K.	201.07	-1.17
5	CHINA CONST BANK	China	175.46	-6.65
7	BANK OF AMERICA	U.S.	154.27	-5.73
7	CITIGROUP INC	U.S.	142.08	-10.21
8	AGRICULTURAL BANK	China	128.73	-4.10
9	BANK OF CHINA	China	121.11	-1.39
10	COMMONW BK	Australia	119.81	9.02

Top 20 Global Banks Measured by Assets

(May 20, 2014)

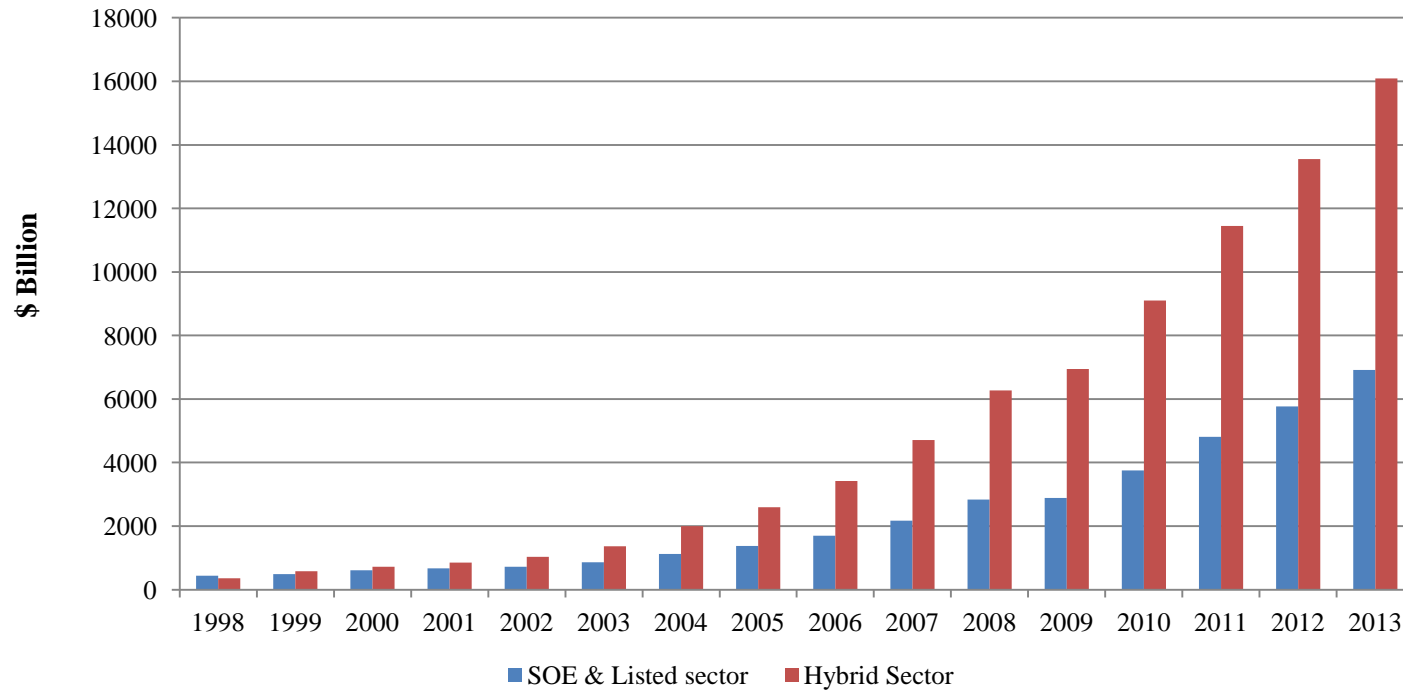
Rank	Bank Name	HQ Country	Total Assets (\$trillion)
1	IND & COMM BK	China	3.17
2	HSBC HLDGS PLC	U.K.	2.76
3	CHINA CONST BK	China	2.60
4	MITSUBISHI UFJ F	Japan	2.50
5	BNP PARIBAS	France	2.48
6	JPMORGAN CHASE	U.S.	2.48
7	AGRICULTURAL	China	2.46
8	BANK OF CHINA	China	2.29
9	BARCLAYS PLC	U.K.	2.27
10	DEUTSCHE BANK-RG	Germany	2.25
11	BANK OF AMERICA	U.S.	2.15
12	CREDIT AGRICOLE	France	2.14
13	CITIGROUP INC	U.S.	1.89
14	SOC GENERALE SA	France	1.74
15	ROYAL BK SCOTLAN	U.K.	1.71
16	MIZUHO FINANCIAL	Japan	1.71
17	BANCO SANTANDER	Spain	1.61
18	SMFG	Japan	1.57
19	WELLS FARGO & CO	U.S.	1.55
20	LLOYDS BANKING	U.K.	1.41

Reforms to China's banks

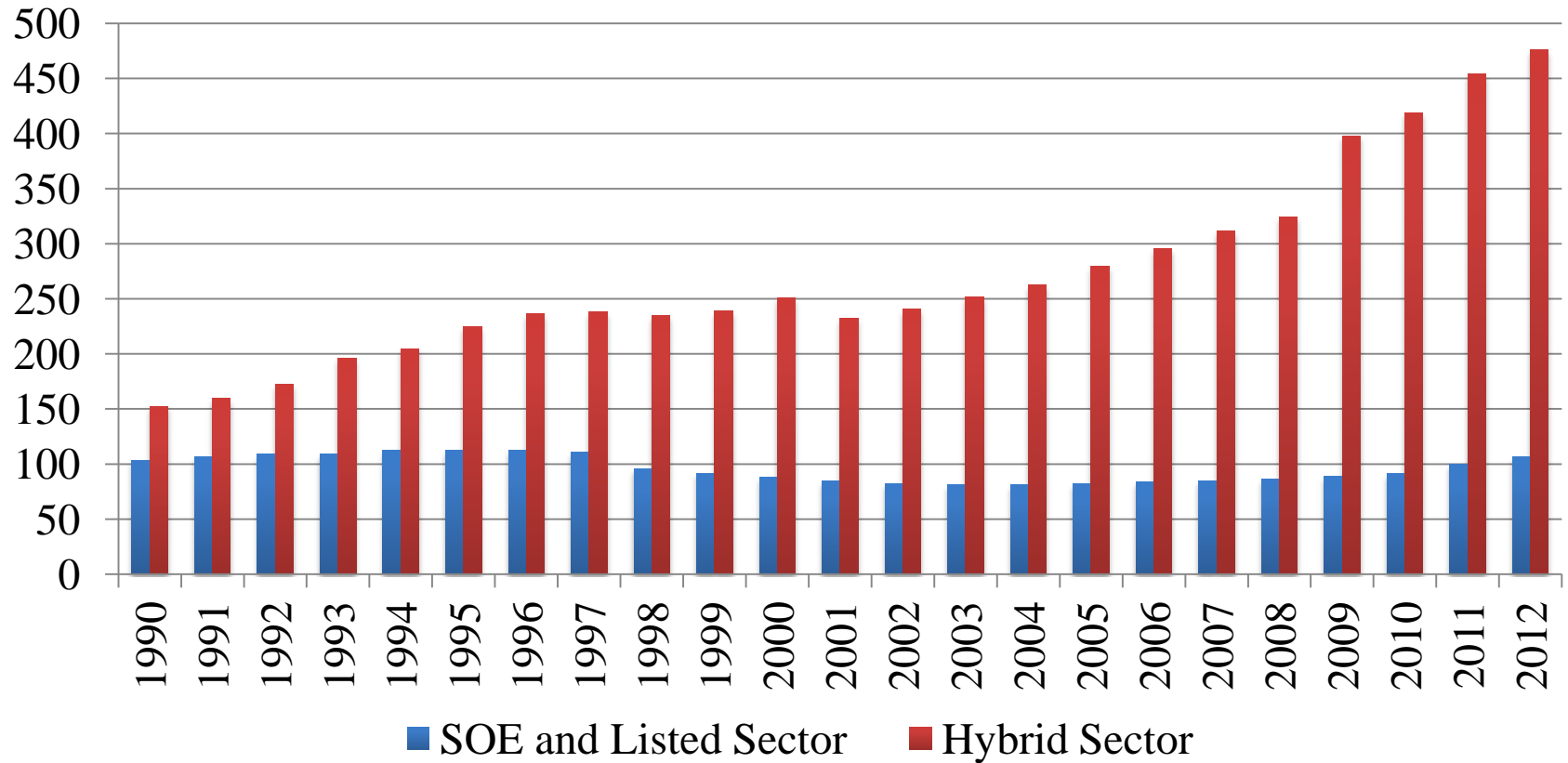
- China's large banks have performed reasonably well compared to international peers
- However, they have not provided good returns to depositors
- They lend mostly to SOEs and listed companies that are not the dynamic part of the economy

Successful part of China's economy

**Industrial Output by Sectors
(above Designated Size)**



Employment by Sectors



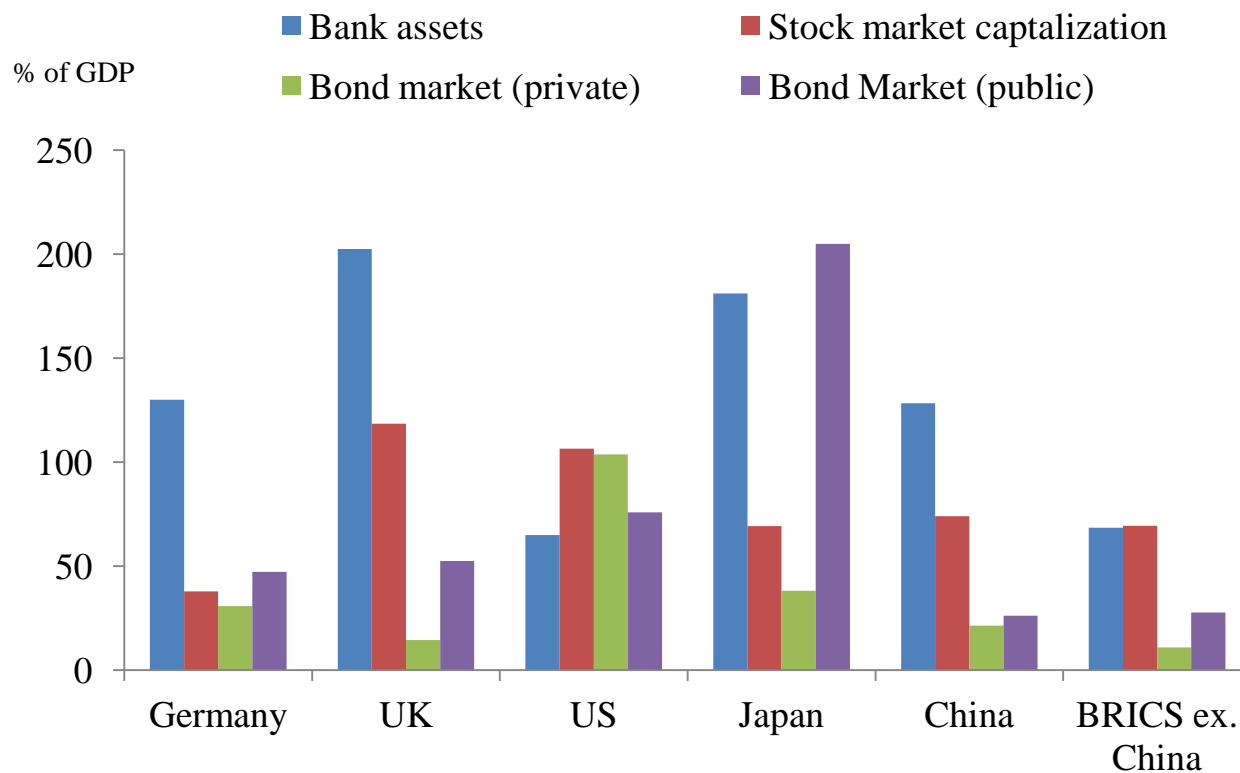
Reforms for banks

- Interest rates need to be fully deregulated
- Banks need to start lending more to productive parts of the economy, namely to hybrid firms (i.e. private and local government owned firms) and in particular small and medium size enterprises and less to SOEs and listed firms
- Increase competition and allow foreign banks to enter more easily

Financial markets

- Financial markets have not played an important part in funding industry so far
- The stock market has performed very poorly in terms of growth in value
- Other markets are still at an early stage

Financial Markets: Global Market Comparison

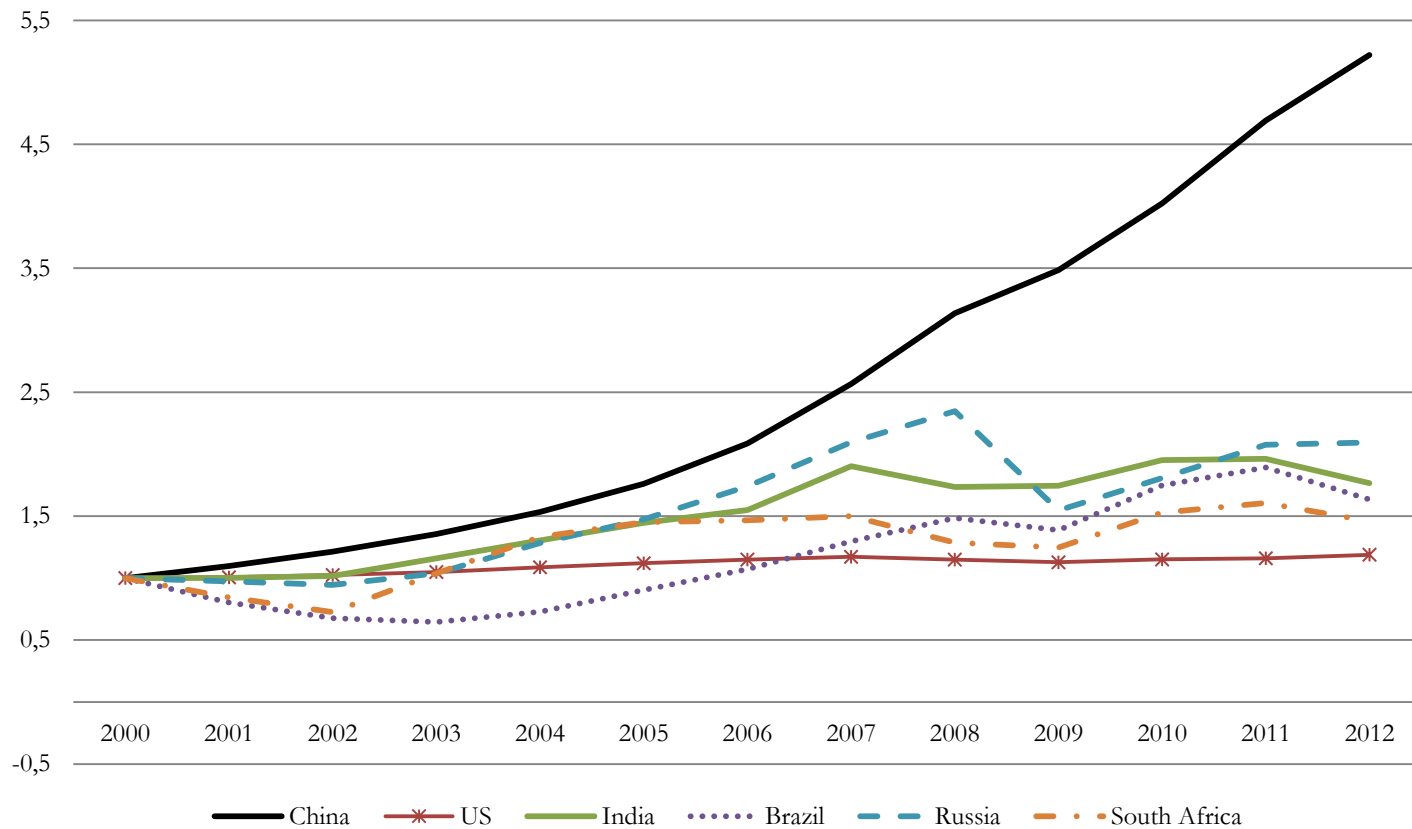


Source: World Bank Financial Development and Structure Dataset (Nov. 2013)

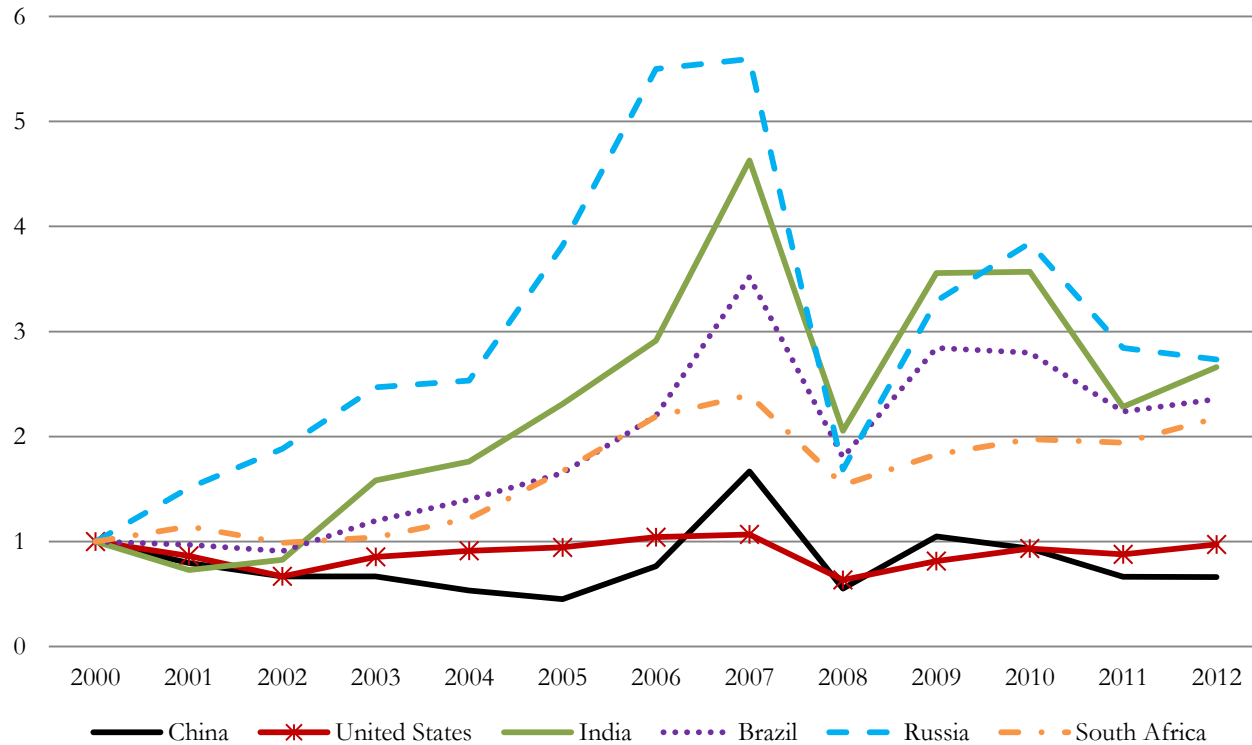
Top 12 Global Stock Exchange Measured by Market Capitalization

Ranking	Stock Exchange	2013 Dec Market cap US bn	2012 Dec Market cap US bn	2013 Dec share turnover
1	NYSE Euronext (US)	17,950	14,086	70.9%
2	NASDAQ OMX (US)	6,085	4,583	144.6%
3	Tokyo SE Group	4,543	3,479	129.6%
4	London SE Group	4,428	3,397	46.5%
5	NYSE Euronext (Europe)	3,584	2,832	355.2%
6	Hong Kong Exchanges	3,101	2,832	40.9%
7	Shanghai SE	2,497	2,547	151.6%
8	TMX Group	2,114	2,058	62.6%
9	Deutsche Börse	1,936	1,486	67.8%
10	SIX Swiss Exchange	1,541	1,233	45.4%
11	Shenzhen SE	1,452	1,150	269.3%
12	Australian SE	1,387	1,198	57.7%
	China (SHSE, SZSE, HKSE)	7,050	6,529	127.14%

Comparison of real GDP growth



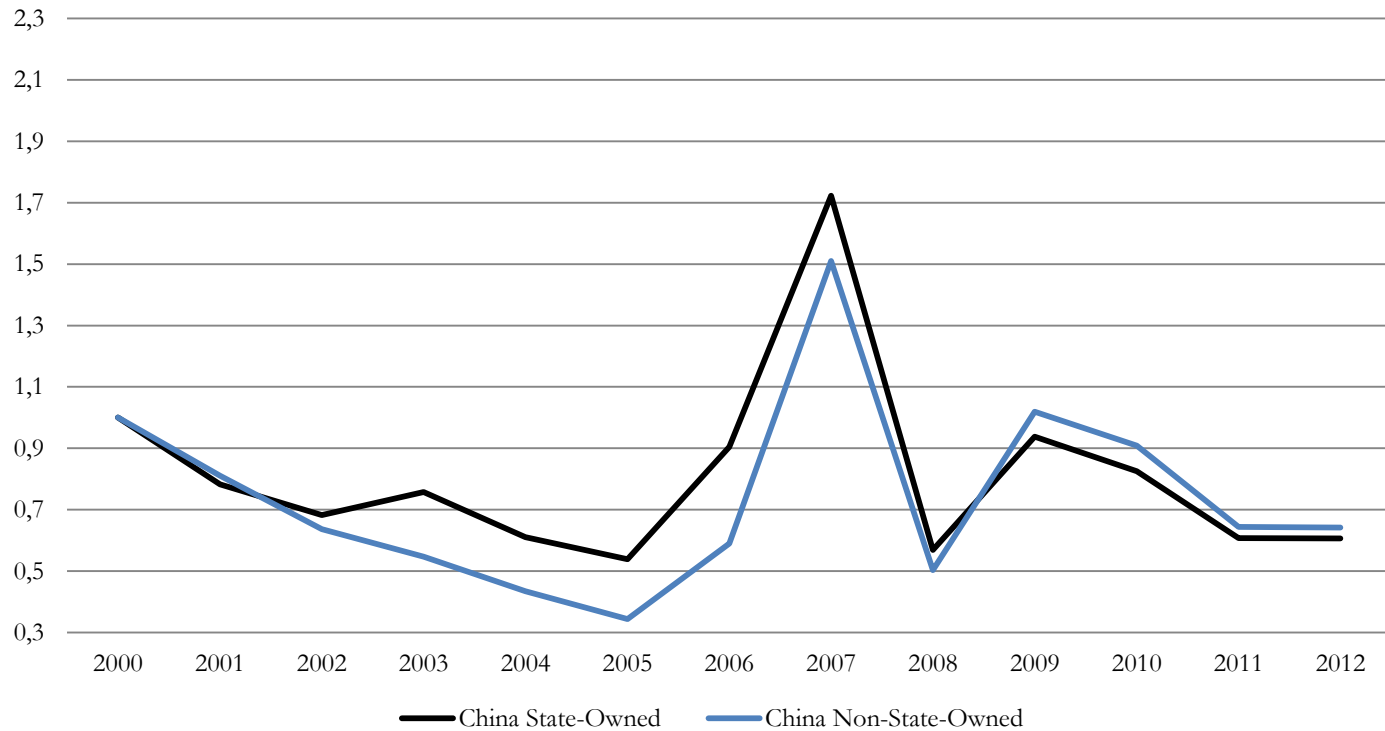
Comparison of real buy and hold returns



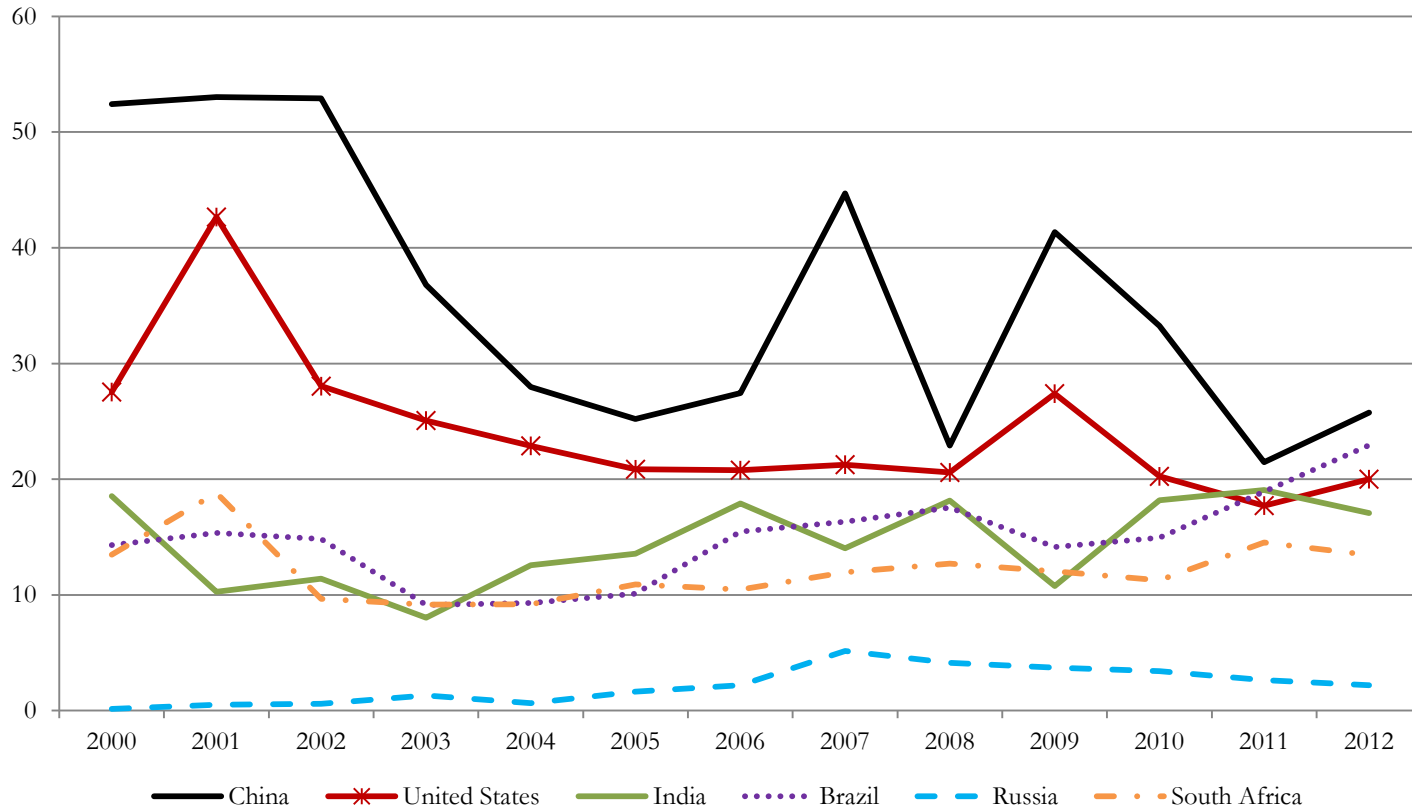
Buy and hold return value weighted



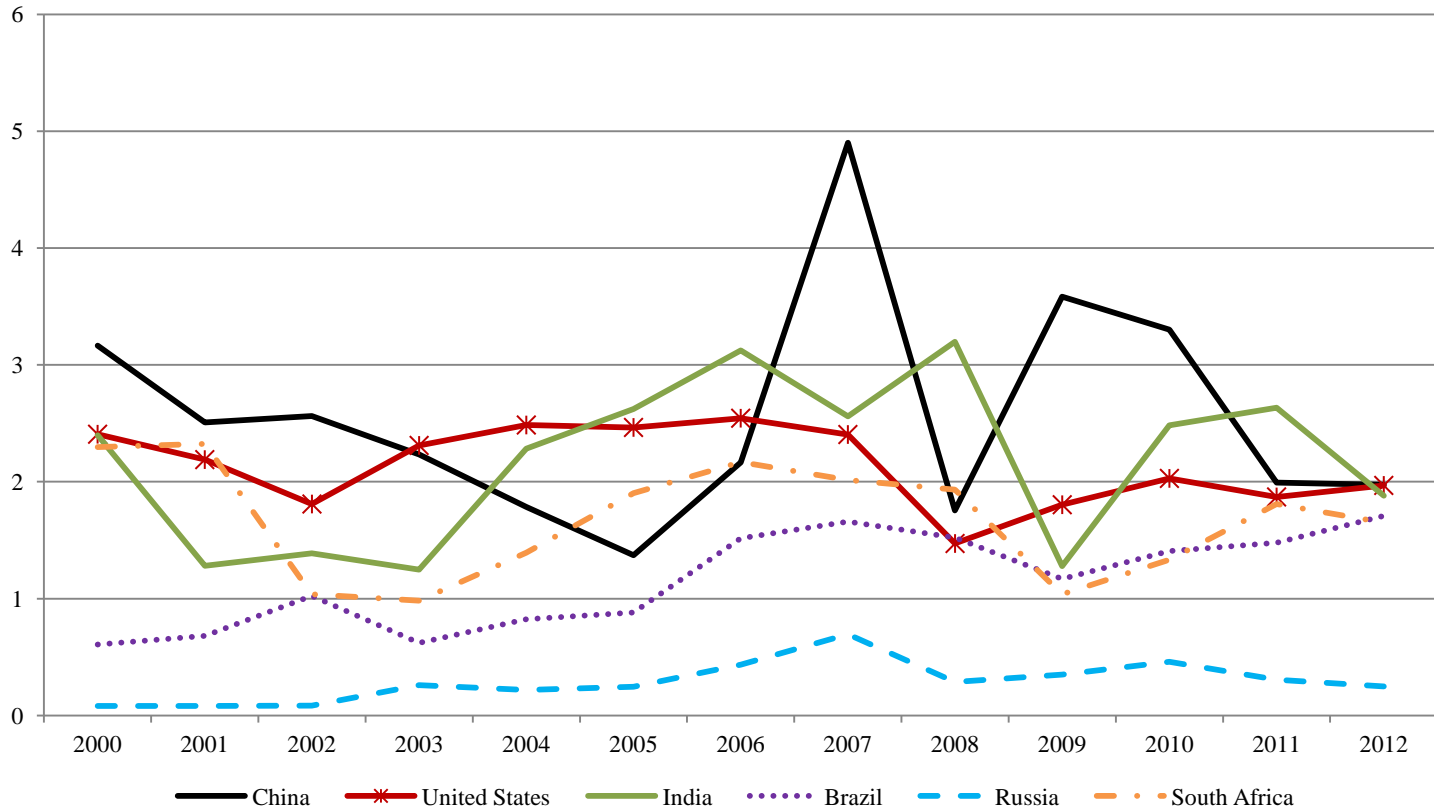
Buy and hold return of China SOE vs. Non-SOE



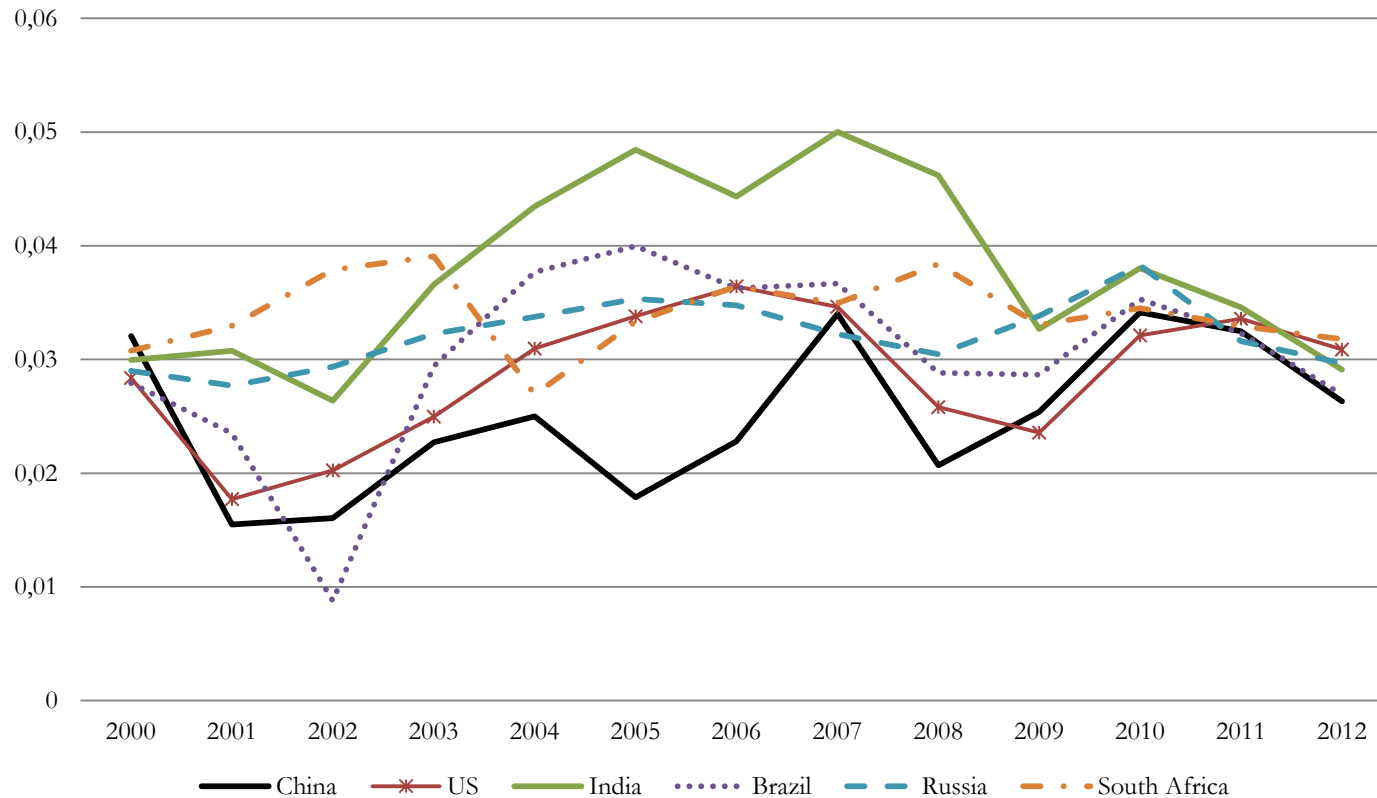
Comparison of Price-to-Earnings Ratios



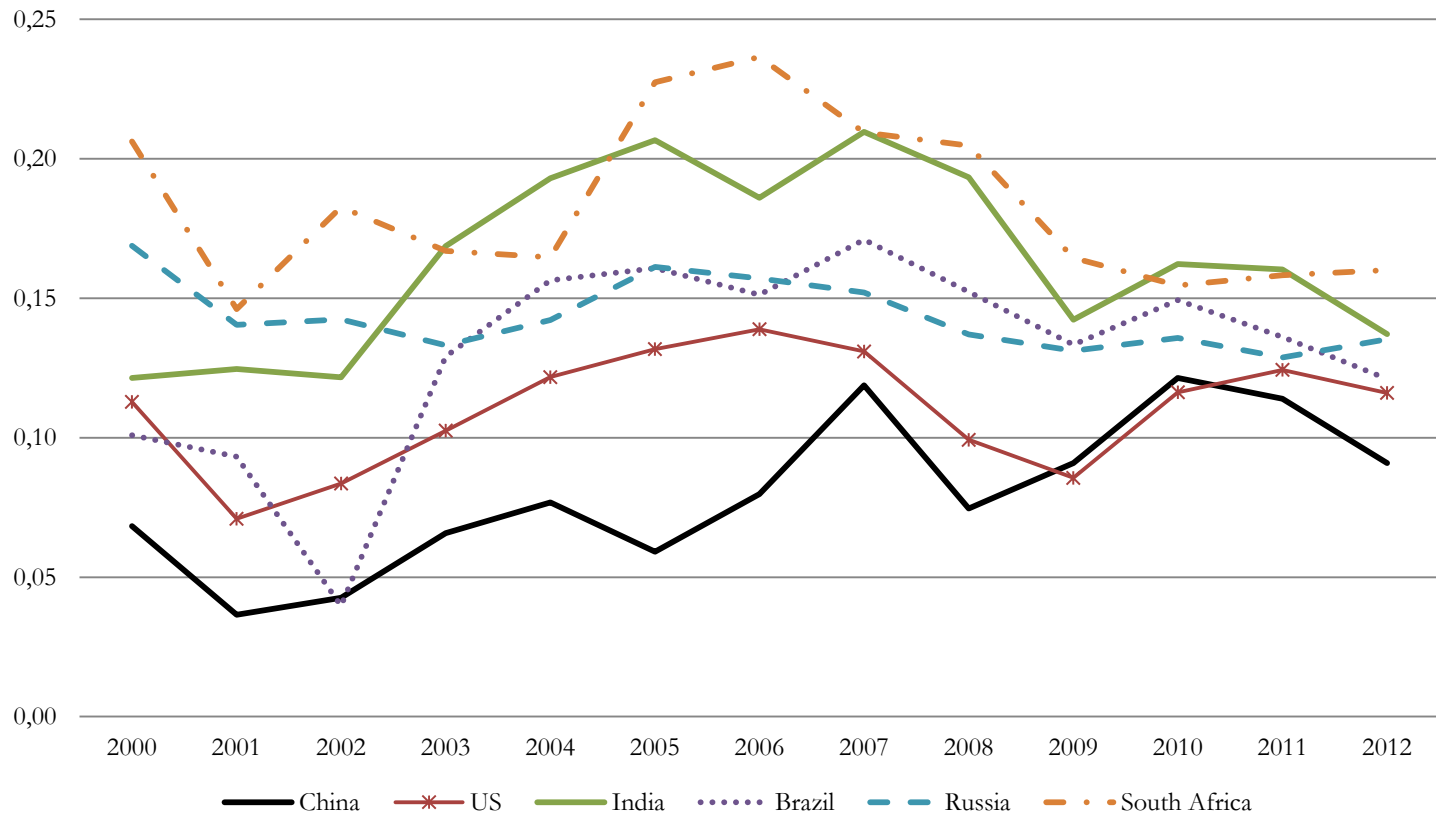
Comparison of Market-to-Book Ratios



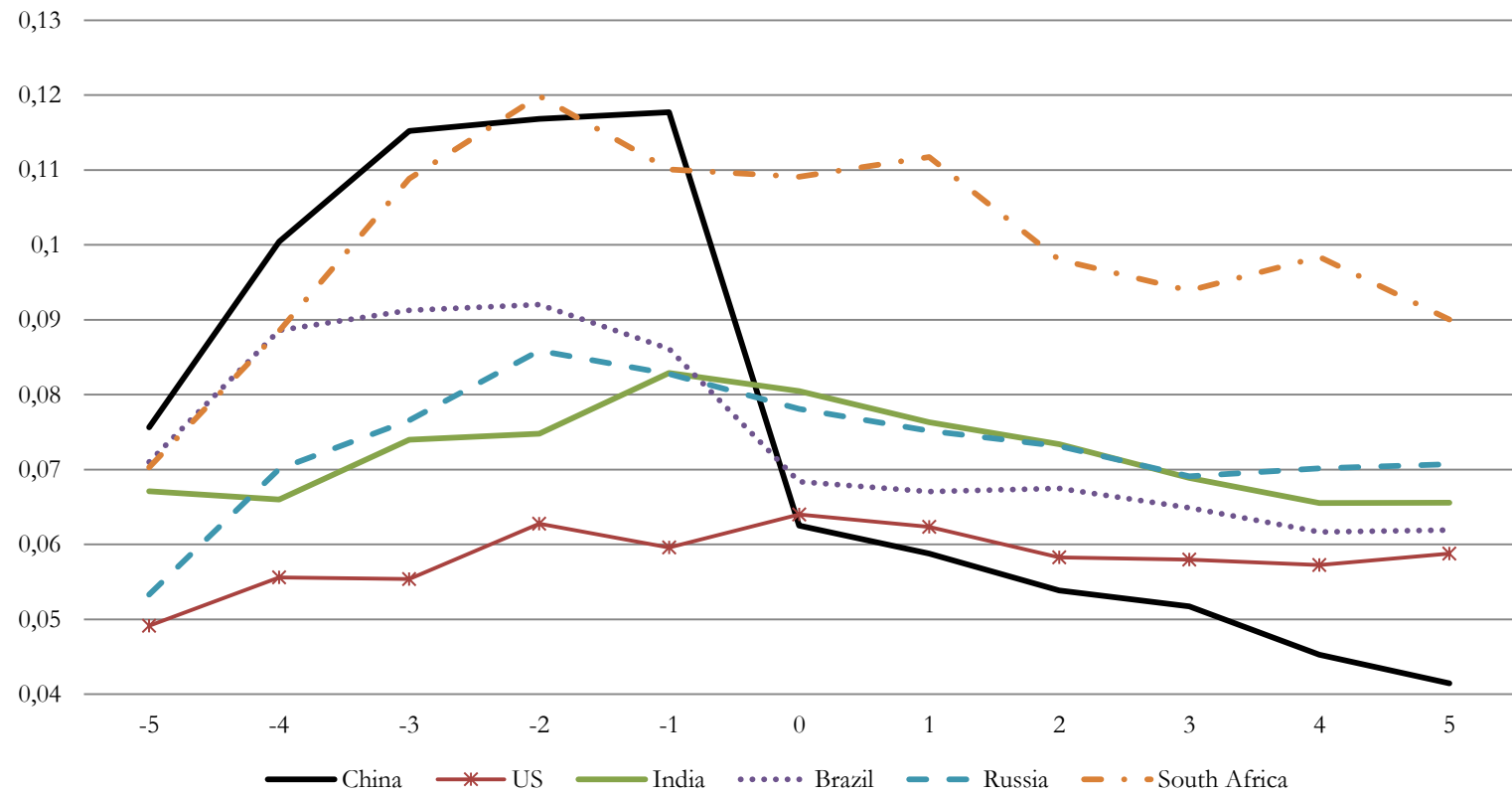
Comparison of ROAs across countries



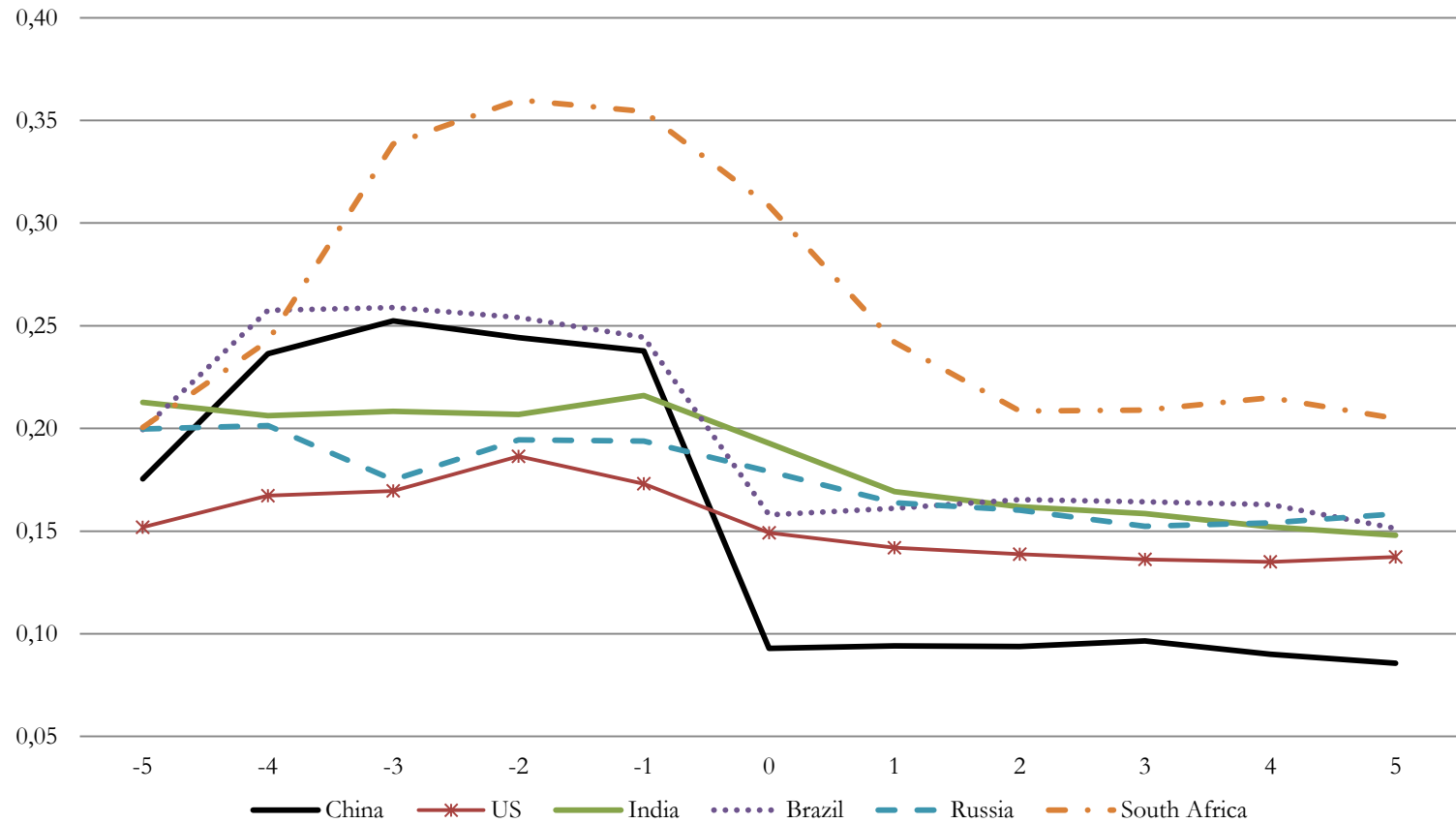
Comparison of ROEs across countries



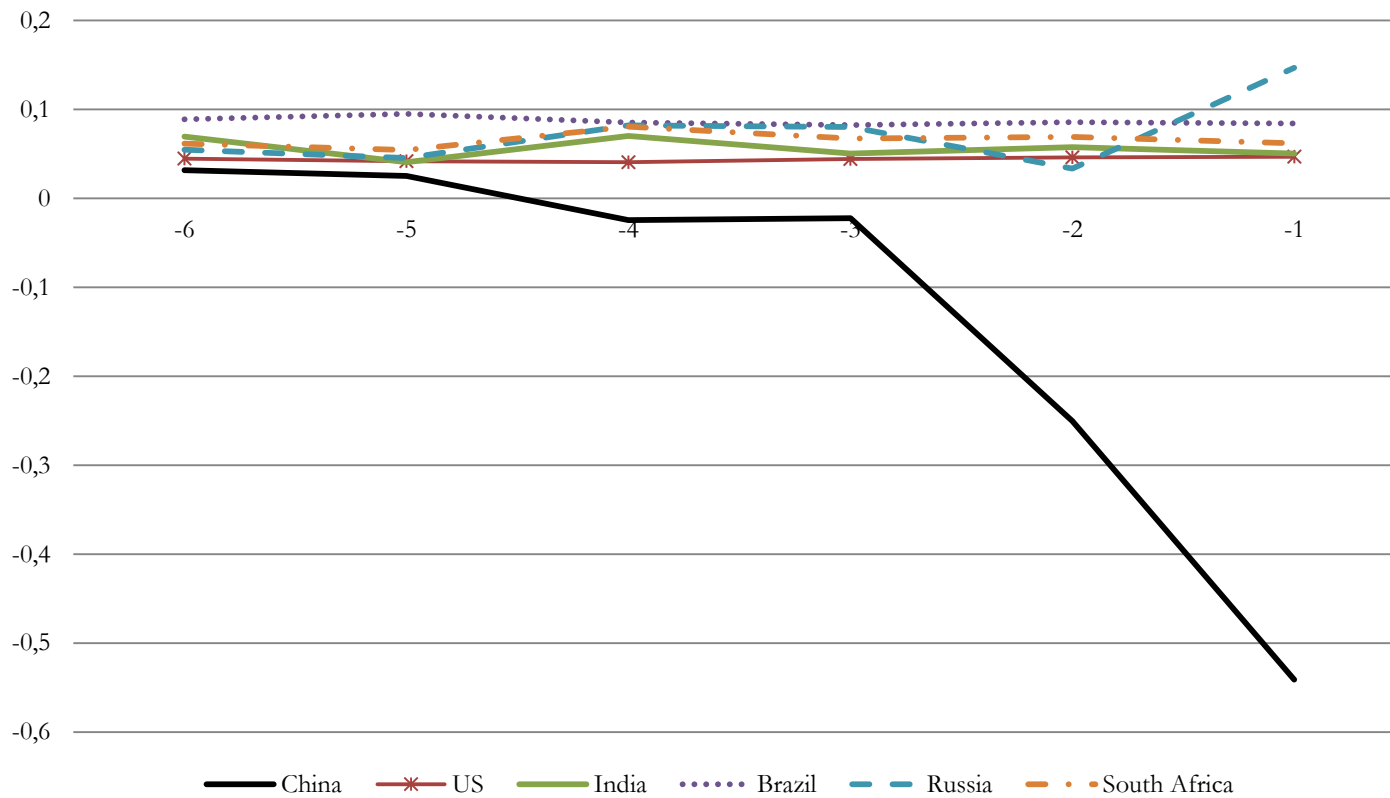
Comparison of ROAs around IPOs across countries



Comparison of ROEs around IPOs across countries



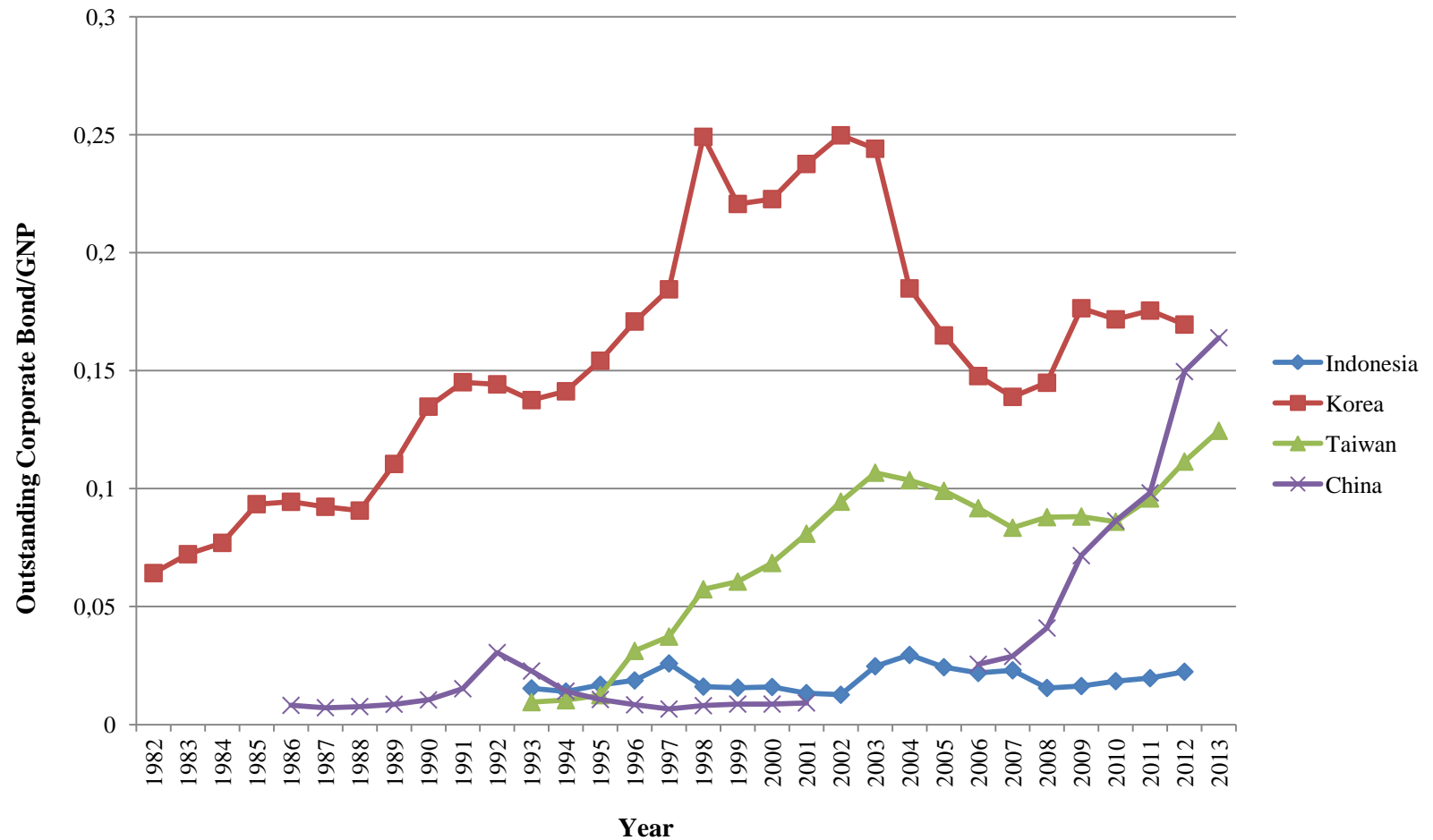
Comparison of ROAs before delisting across countries



Other Financial Markets and Institutions

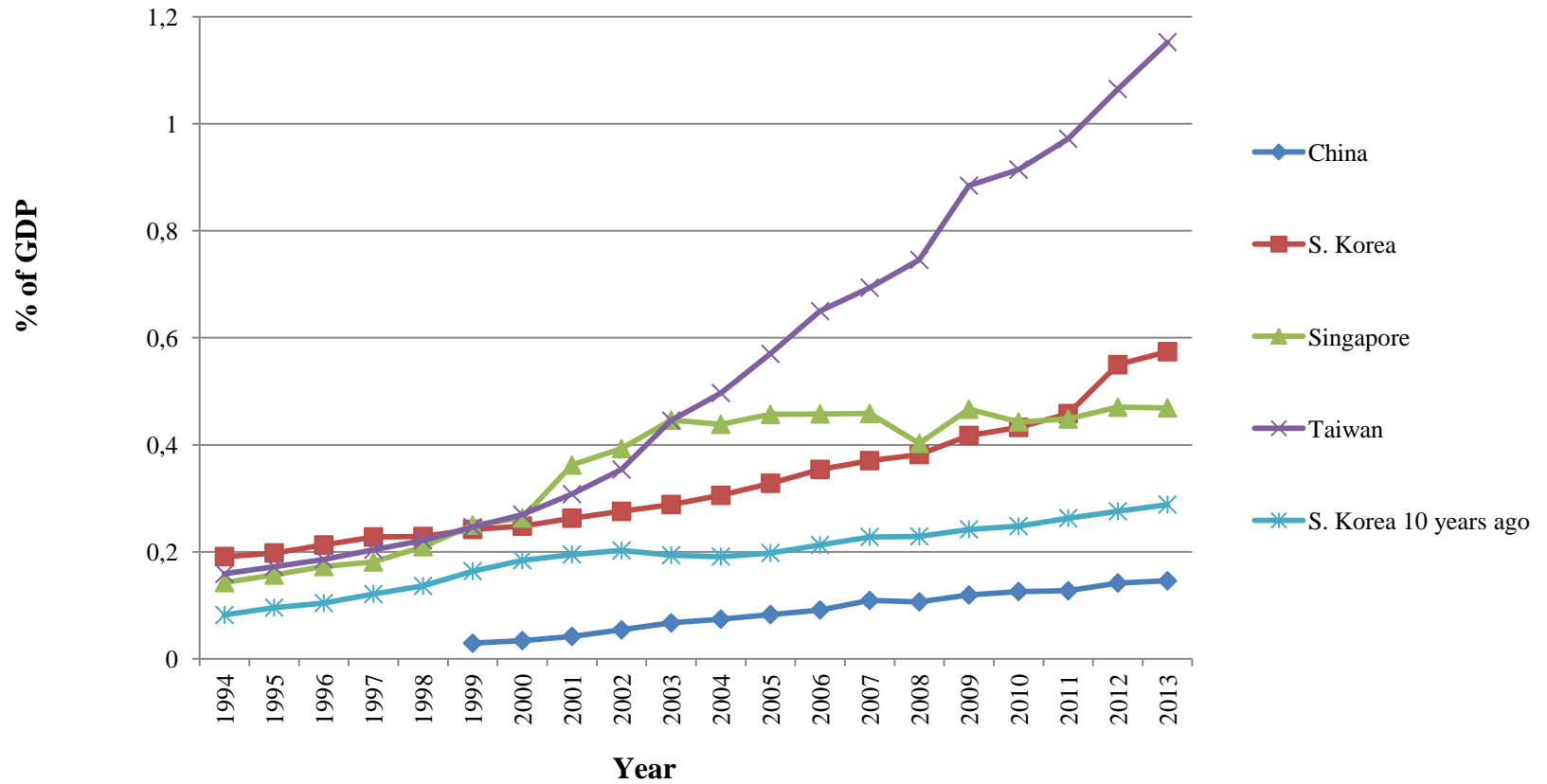
- Public debt market
 - Reasonable size
- Corporate debt market
 - Growing fast
- Insurance sector
 - Early stage of development
- Pension and mutual funds
 - Also at early stage

Corporate Bond Market

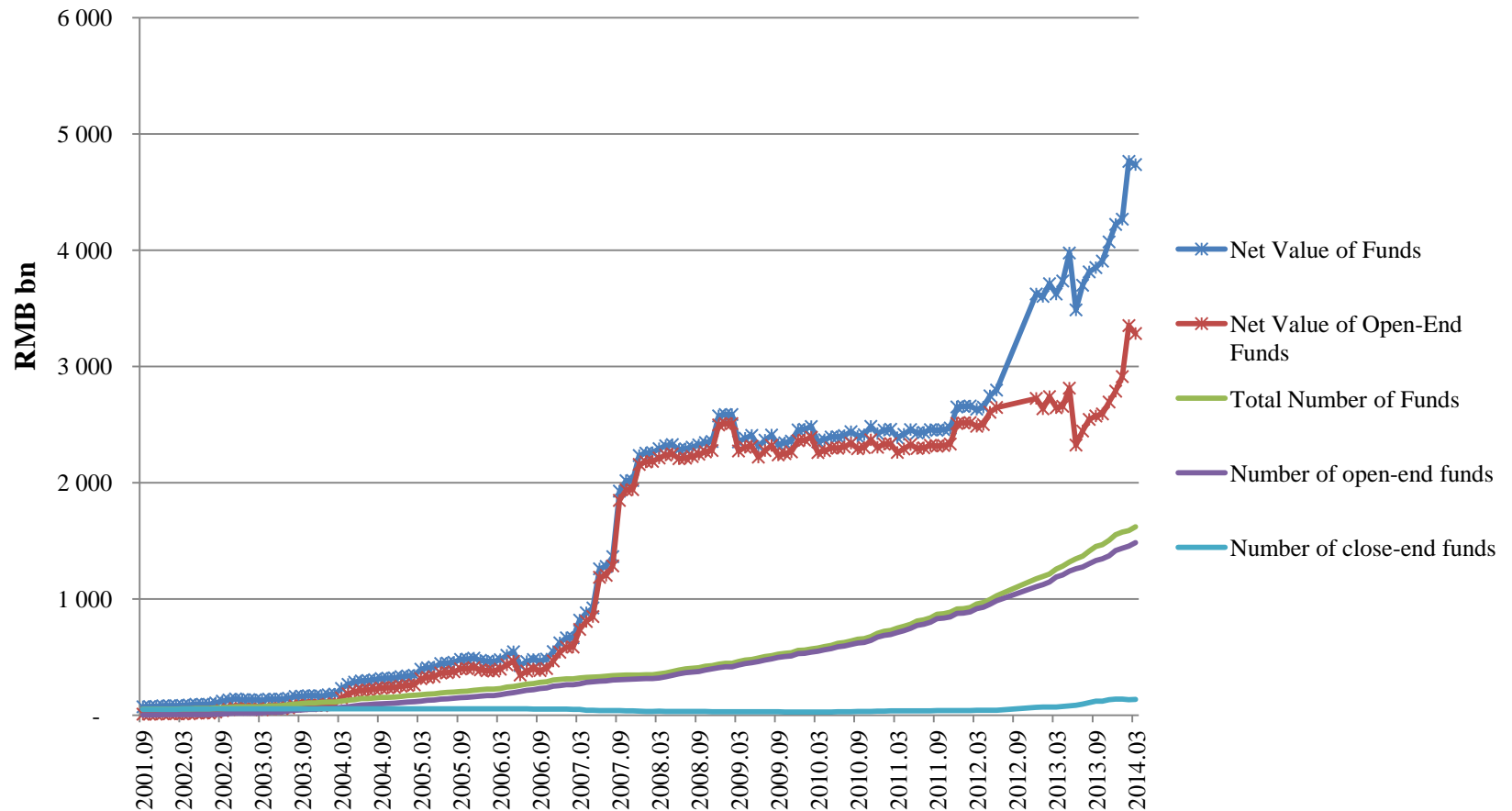


Insurance

Assets Managed by Insurance Companies



China's Mutual Fund Industry (2001-2014)



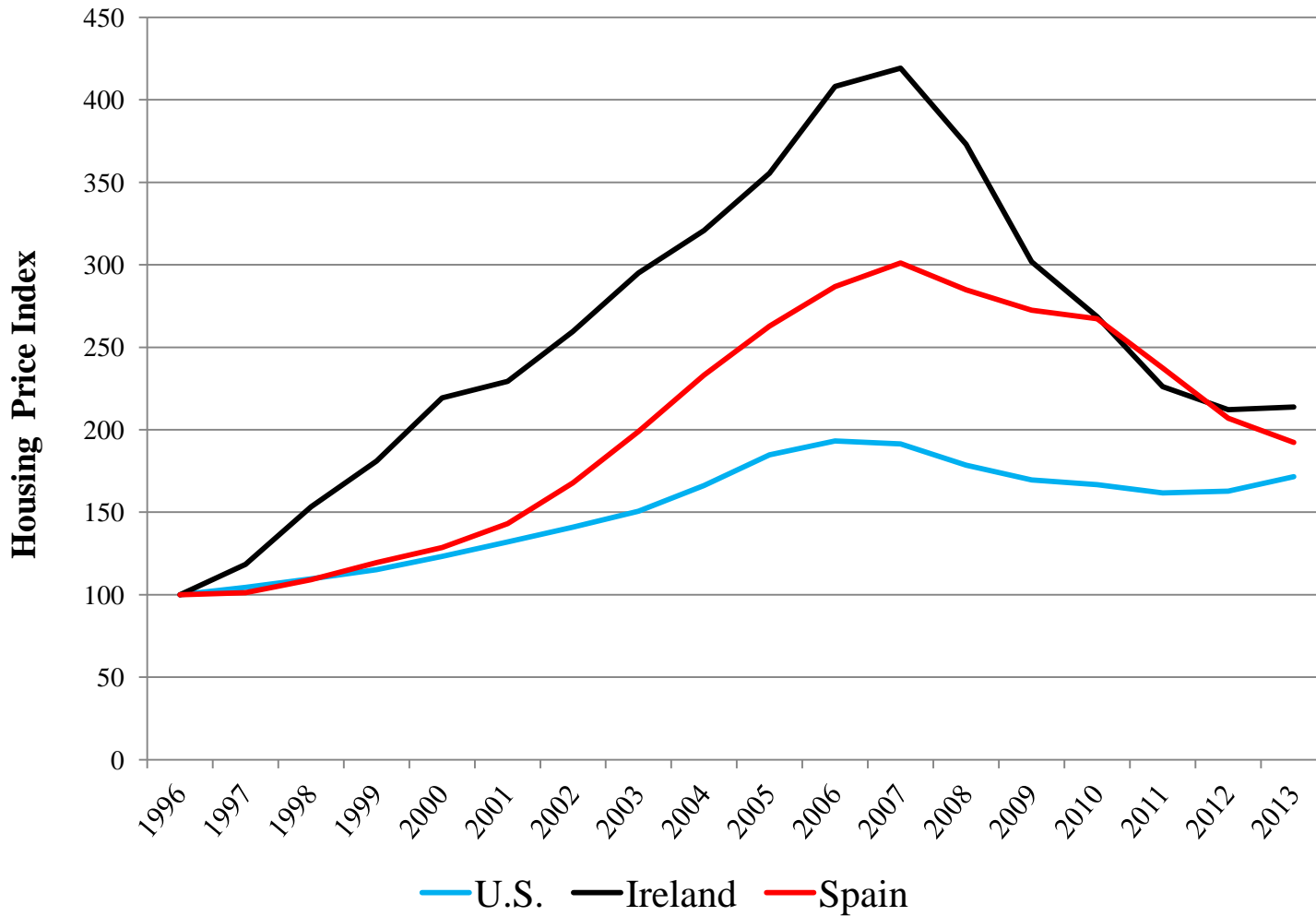
Reforms for financial markets

- Stock markets need to have firms that are growing listed, the IPO process needs reforming to make sure pre-IPO numbers are realistic, and delisting needs to be made easier
- Public bond market needs to develop full yield curve
- Corporate bond market should be encouraged and growth continued
- Development of a large institutional investor sector should be encouraged

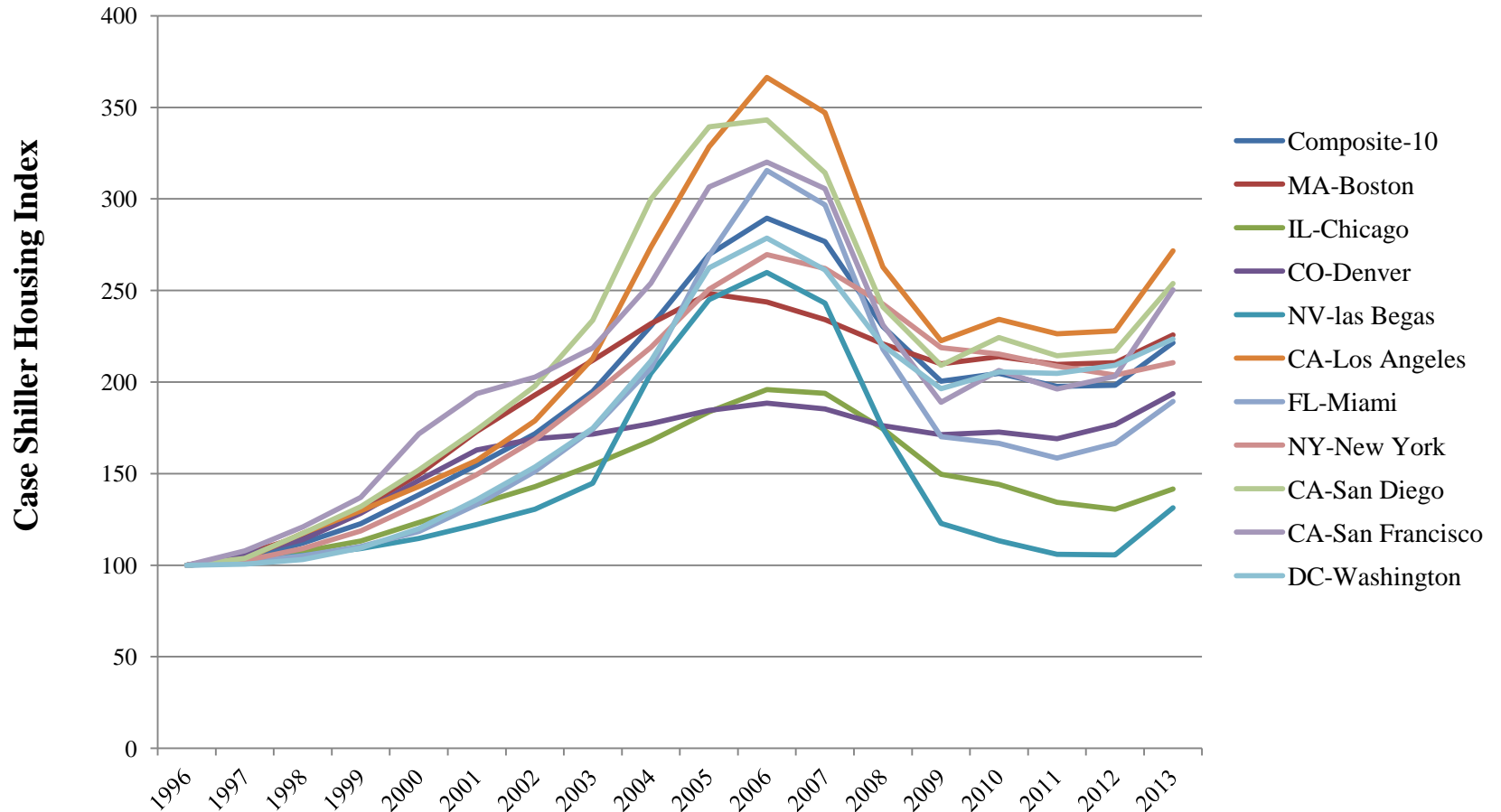
Real estate

- One of the most important investment vehicles in China is real estate
- How has China's real estate performed relative to international markets?
- We start with the U.S. and Europe

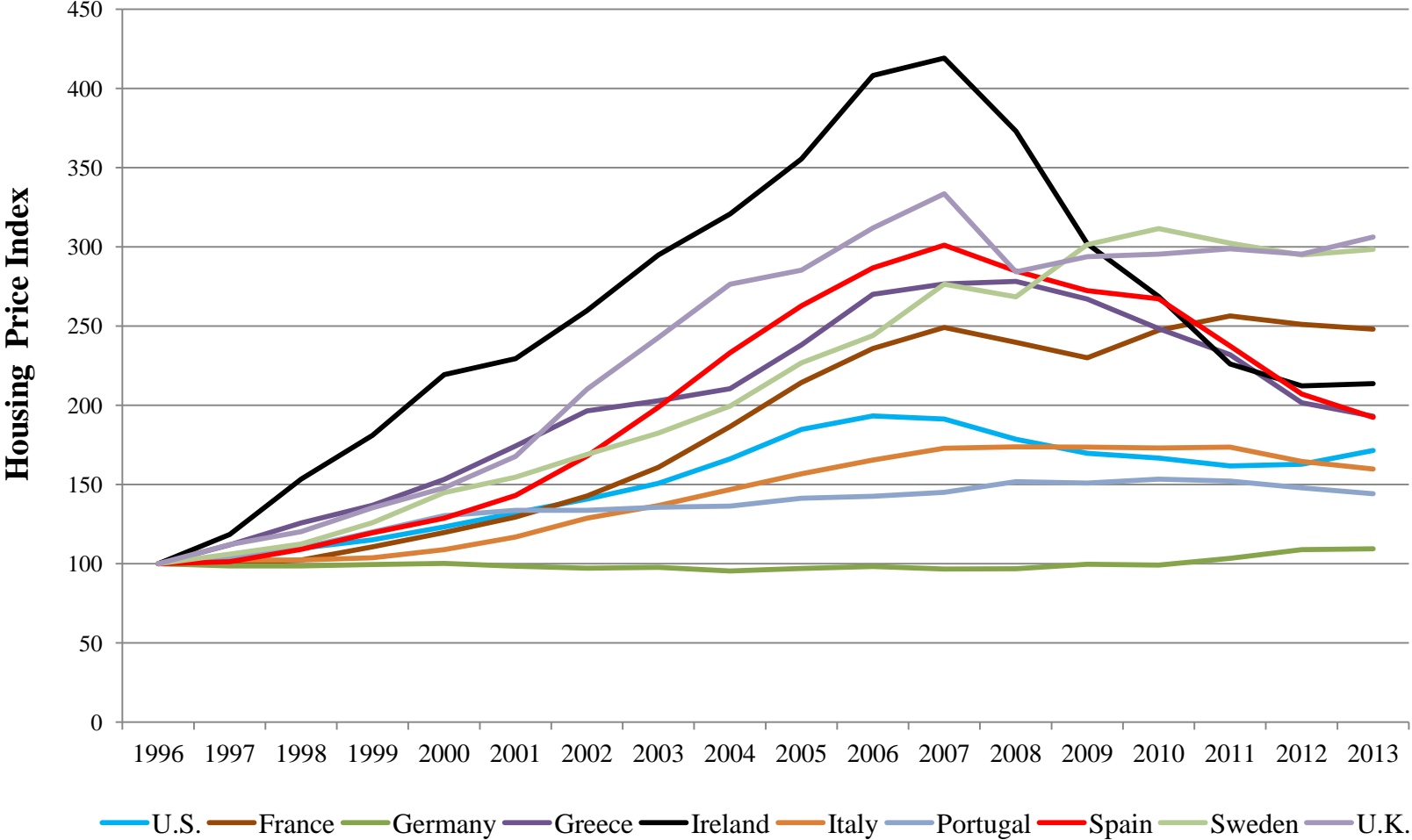
Nominal housing Prices in Ireland, Spain and the U.S.



Nominal Housing Prices in Different U.S. Cities



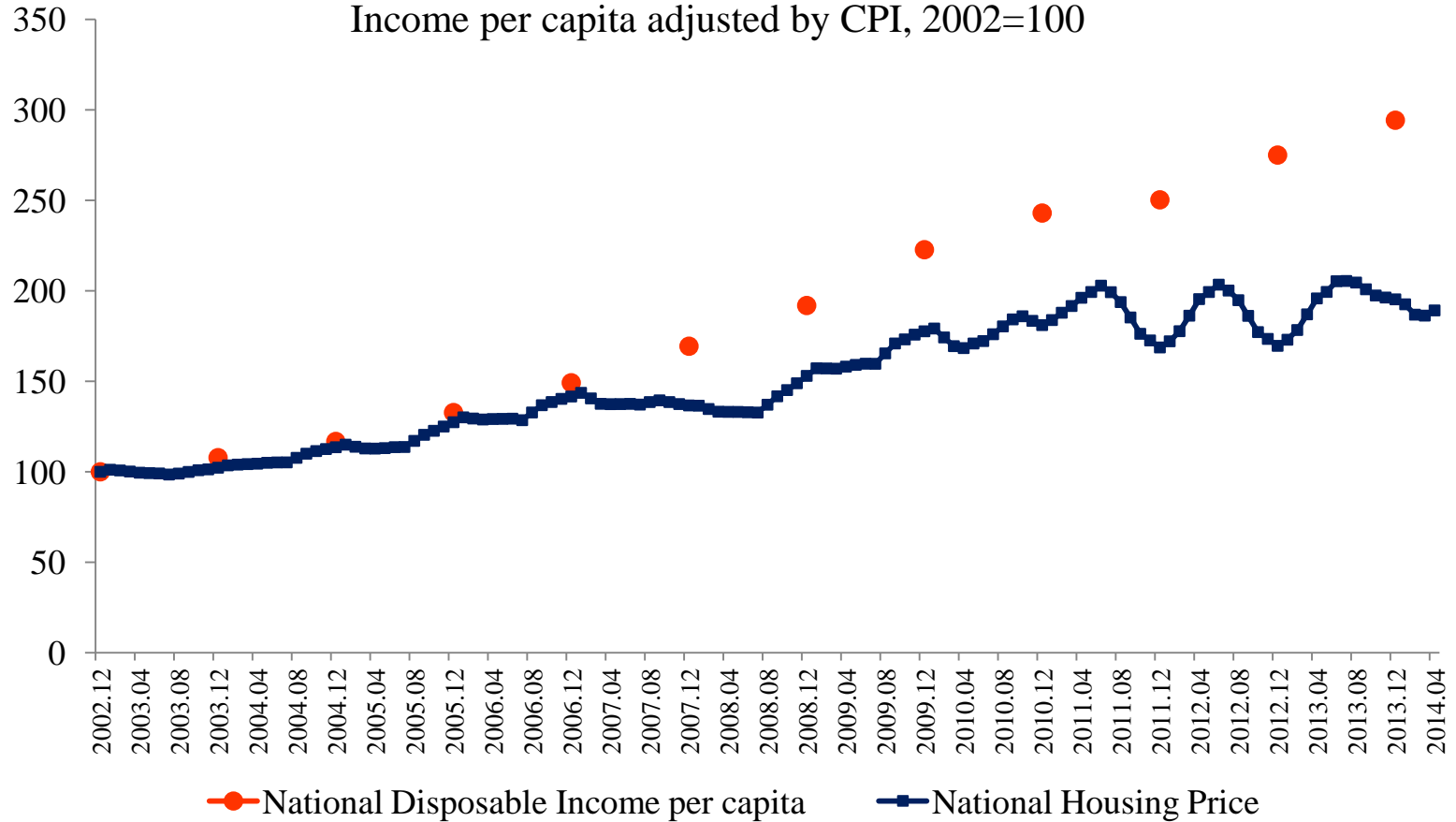
Nominal Housing Prices in U.S. and Various European Countries



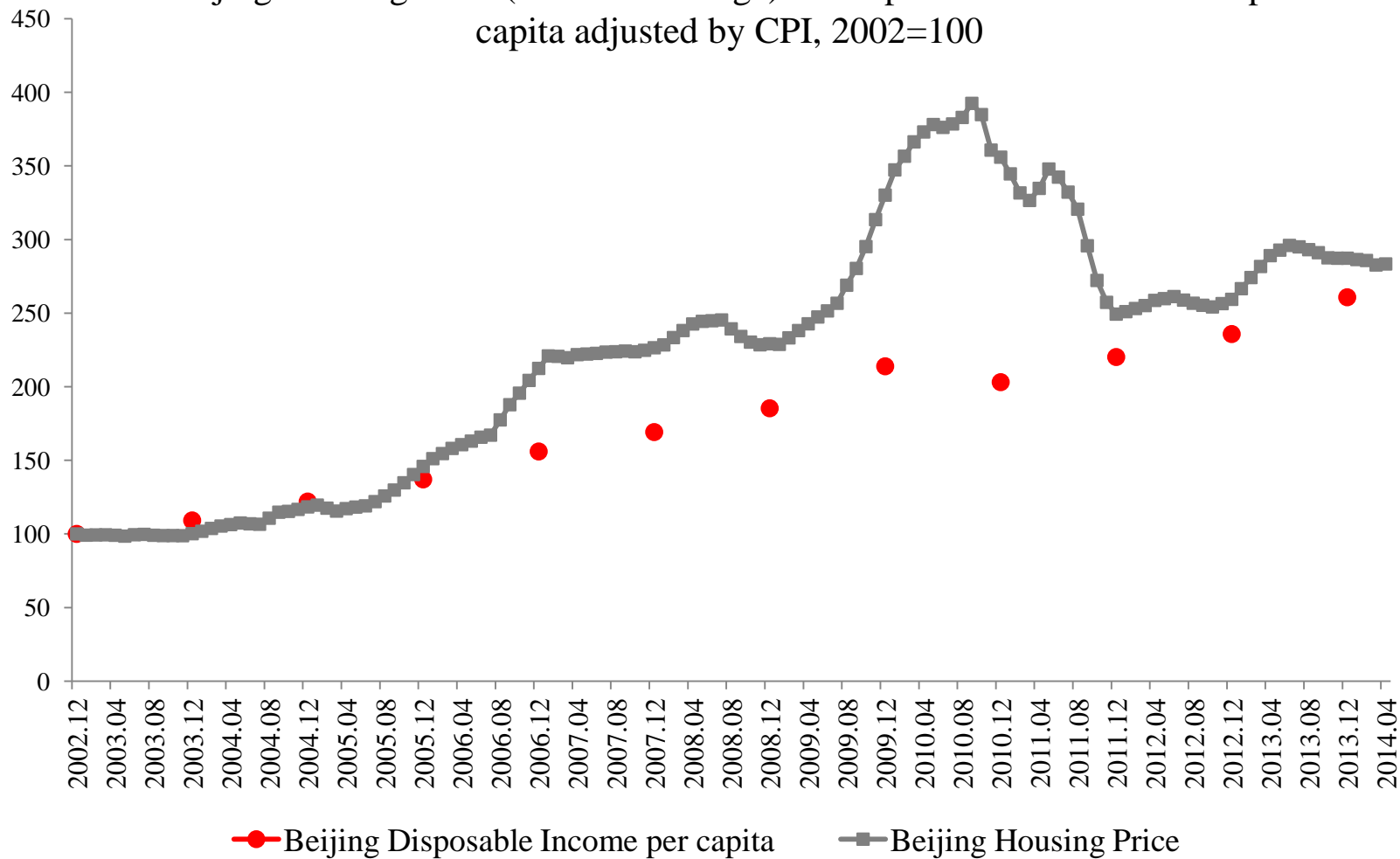
Is there a real estate bubble in China?

- Stimulus and loose lending policy have led to large price increases in China that may pose a problem going forward
- Chinese government has put in place many measures to prevent overheating
- These seem to have had some success

National Housing Price (6-mongth average) vs Disposable Annual
Income per capita adjusted by CPI, 2002=100

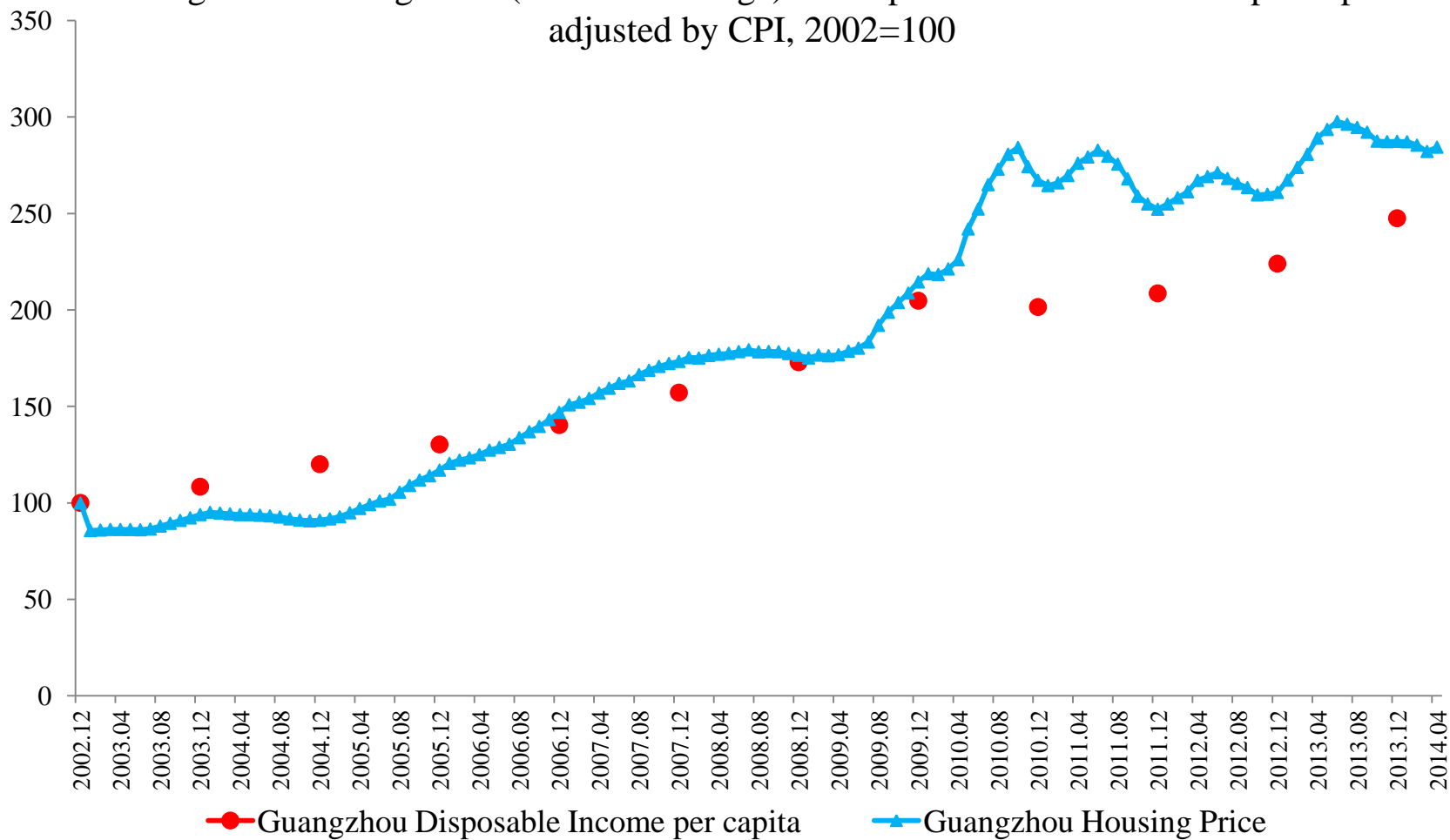


Beijing Housing Price (6-month average) vs Disposable Annual Income per capita adjusted by CPI, 2002=100



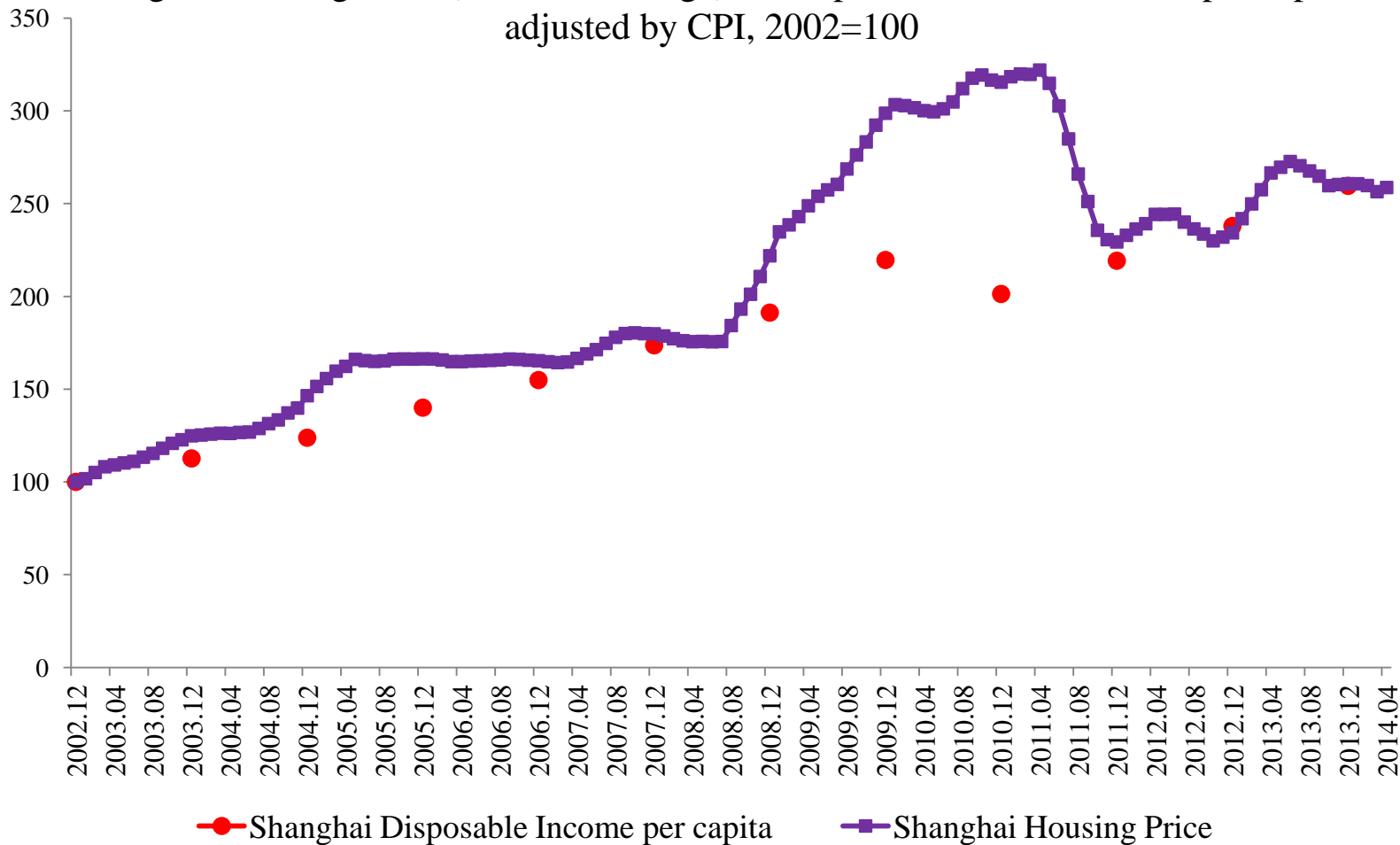
Sources: CEIC, National Bureau of Statistics, CIC.

Guangzhou Housing Price (6-month average) vs Disposable Annual Income per capita adjusted by CPI, 2002=100



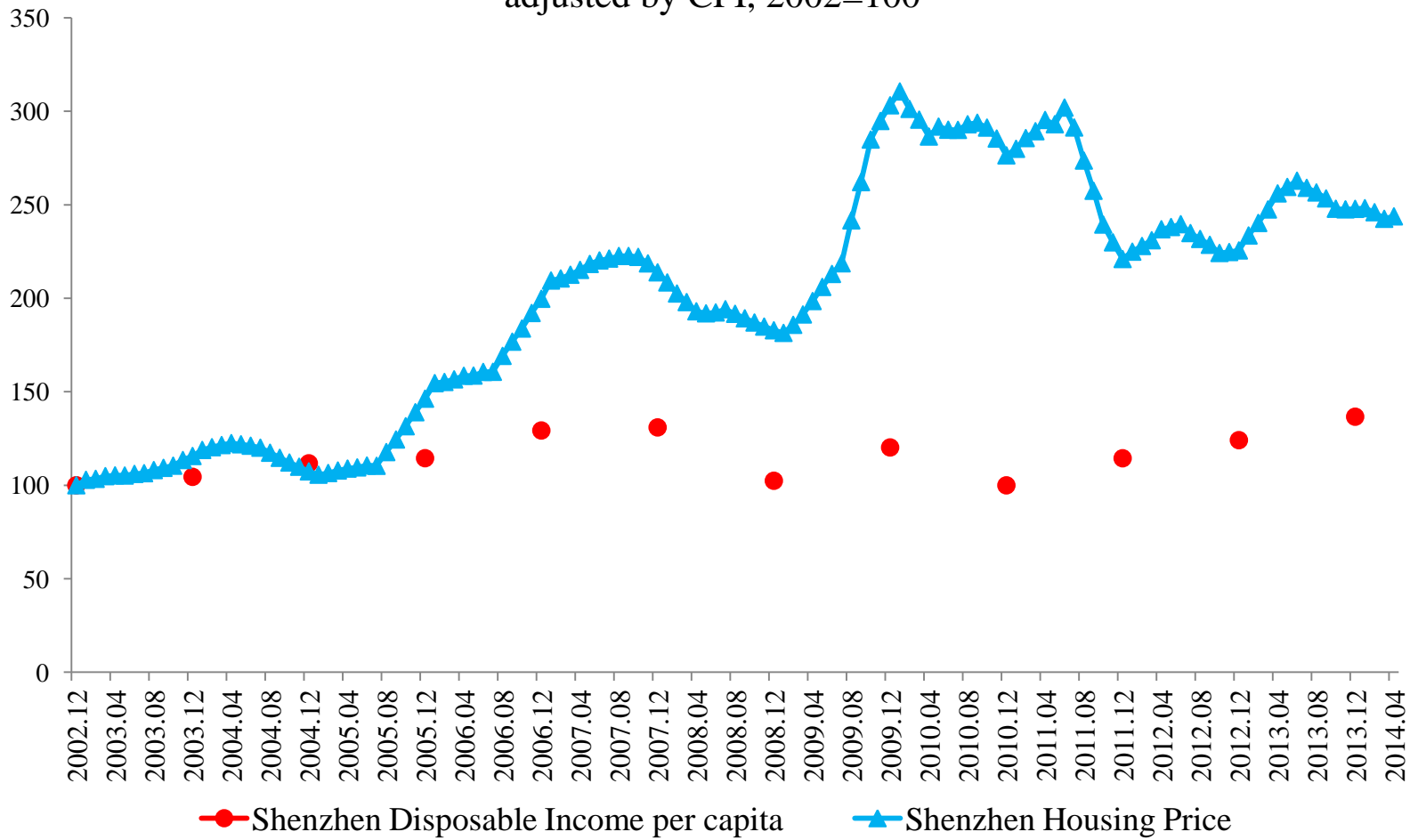
Sources: CEIC, National Bureau of Statistics, CIC.

Shanghai Housing Price (6-month average) vs Disposable Annual Income per capita adjusted by CPI, 2002=100



Sources: CEIC, National Bureau of Statistics, CIC.

Shenzhen Housing Price (6-month average) vs Disposable Annual Income per capita adjusted by CPI, 2002=100



Sources: CEIC, National Bureau of Statistics, CIC.

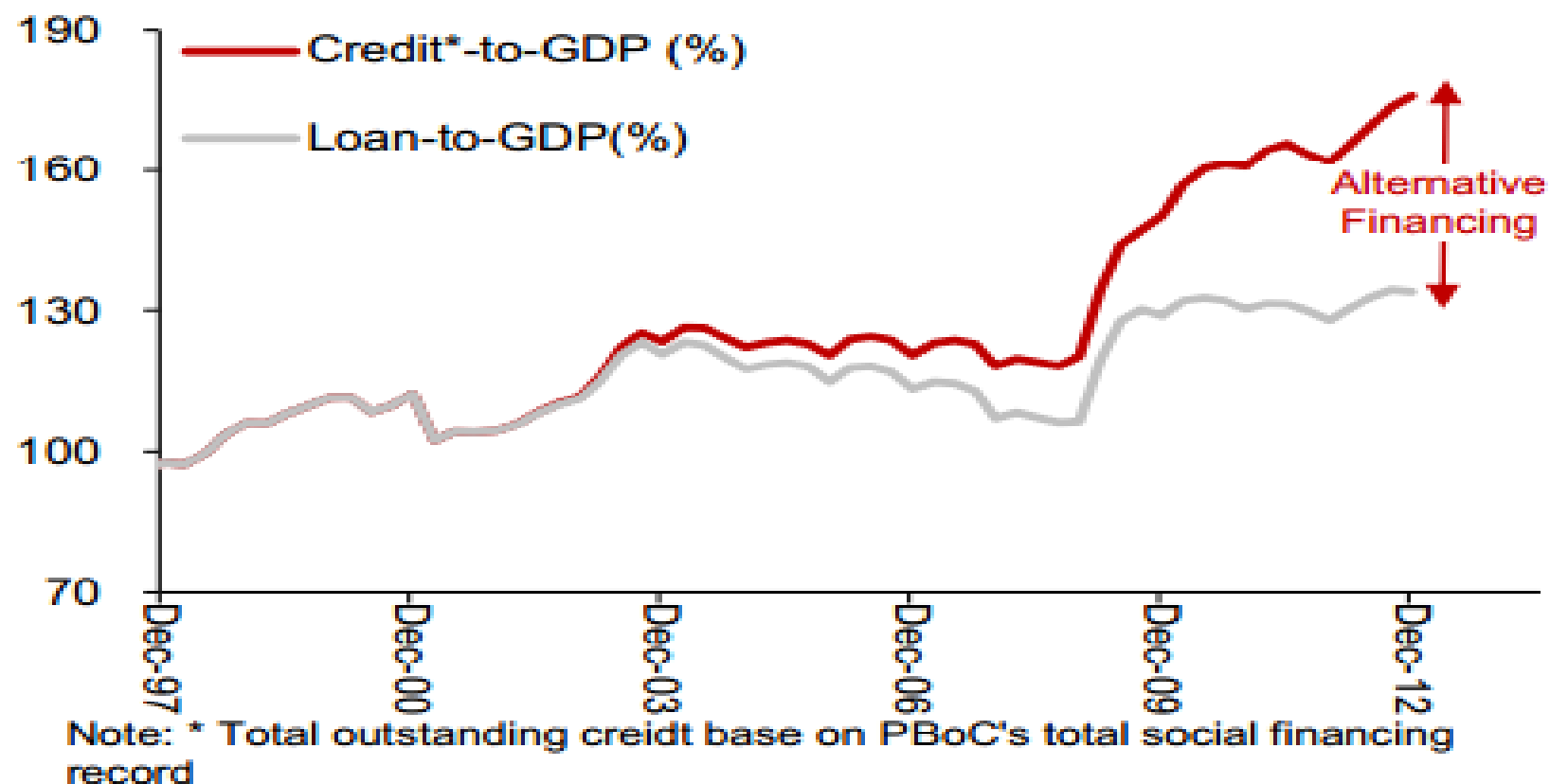
Reforms for real estate markets

- There is some evidence of bubbles in some cities, particularly around the stimulus package of 2009 and so the kind of stimulus used then should not be repeated
- Macroprudential policies adopted by the government seem to have had some success
- Change local public finance so that money is raised by local taxes or block grants from the central government rather than land sales

Chinese shadow banking system

- Not much is known about the operation of this sector
- It seems to play an important role and needs to be studied much more

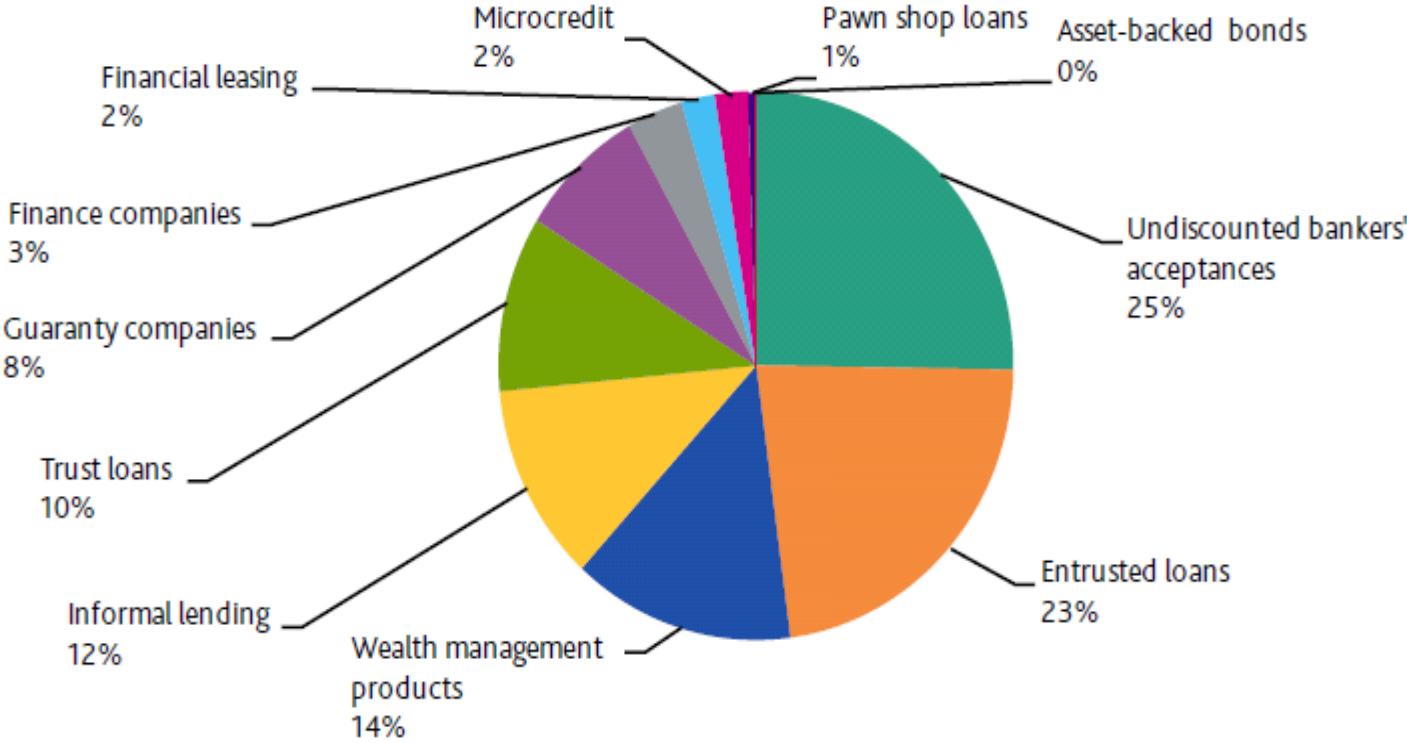
Exhibit 6: ... the Chinese credit boom became apparent



Source: NBS, CEIC, Credit Suisse

EXHIBIT 2

Composition of Chinese Shadow Banking Sector (Broad Definition)



Source: Moody's

Reforms to shadow banking system

- Be careful in regulating this sector that it is not eliminated
- Encourage the development of this sector as much as possible as it seems to perform a very valuable role

Other reforms - Rmb as a reserve currency

- Currently managed float – RMB slowly strengthening
- Reserves as of June 30, 2014 are \$3.99 trillion
- PPP exchange rate theory suggests the RMB will strengthen in the long run but more important issue is the capital account

Shanghai Free Trade Zone

- To act as a pilot scheme for many reforms, particularly reforms to the financial system
- Key reforms include
 - Capital account convertibility
 - Interest rate liberalization
 - The cross-border usage of Rmb
 - Foreign exchange management
 - Opening up the financial sector to foreign institutions
 - Allowing eligible Chinese financial institutions to develop offshore businesses

Concluding remarks

- Government has been doing a good job in terms of reforming the financial system
- Speeding up the reforms may help the economy to grow faster or for a slowdown in growth to be prevented
- The shadow banking system in China is very different than in the US and should be encouraged