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Asset or Liability? The Role of the Financial System in the Political Economy of China's Rebalancing

Julian GRUIN

Abstract: China's financial system, dominated by the banking sector, has played a central role in the development of an imbalanced trajectory of economic development and growth. As one of the primary mechanisms for implementing decisive macro-economic policy, the banking sector has hitherto served the Chinese growth strategy well in actively allocating capital towards the investment and export sectors, whilst proving capable of managing the macro-economic ramifications of this highly interventionist strategy. However, the role of the financial system in this growth strategy is also rooted in the requirement that authority over financial capital remains closely tied to state institutions and policies, due to elite concern over politico-economic instability. Based on policy analysis and qualitative interviews conducted in mid-2012, the article suggests that whilst the structure of the financial system was conducive to fostering the growth of the real economy, it will hold back not the need for rebalancing, but rather the process of rebalancing itself.

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Introduction

The initial publication, in February 2012, of “China 2030: Building a Modern, Harmonious and Creative High-Income Society” (World Bank and Development Research Center of the State Council 2012) was notable not so much for its contents, which comprised a familiar array of prescriptions for liberalizing China’s economy, but for its joint authorship by both the World Bank and the Development Research Center of the State Council (DRC). As the foremost research unit reporting to China’s cabinet, the imprimatur of the DRC upon the report, and the support of the then premier-in-waiting Li Keqiang, lent increasing credence to the view that China’s top leadership is committed to the broad-scale economic reforms and liberalization that would place the country on a balanced and sustainable path of ongoing economic development (Anderlini 2012). One of the most fundamental aspects of such a re-balancing is the shift away from a growth model dominated by investment and exports towards one more reliant upon domestic consumption. However, the picture that emerges from an examination of the contemporary debate that is taking place within China as to the future of economic reform is far more mixed, particularly with relation to the financial sector. Closer scrutiny of “China 2030” reveals that in contrast to its proposals for the enterprise sector, in which “state capital should be used solely for the provision of public goods and services” (World Bank and Development Research Center of the State Council 2012), the report makes no mention of the privatization of the financial sector. Rather, it speaks of the “commercialization and rationalization of the financial system” and “recasting the rights and responsibilities of government” (World Bank and Development Research Center of the State Council 2012). If indeed “China 2030” is in some way indicative of prevailing attitudes towards economic reform, then undoubtedly the financial sector retains a unique position within the overall reform strategy of China’s policy-makers.

The financial system has remained under the close control of the Chinese state despite the development of a distinctively capitalist pursuit of economic growth and wealth accumulation that has witnessed the development of increasing tendencies towards competitive market dynamics in other sectors of the economy. Notwithstanding the distinctions between the financial system and the real economy, either functionally or in the eyes of central policy-makers, the financial system has played a crucial role in the trajectory of China’s economic development

in setting the course and regulating the velocity of China's growth path. The primary question posed in this article is whether the financial system is likely to serve as an independent constraint upon rebalancing towards consumption, away from investment and exports or, if other politico-economic constraints upon rebalancing are overcome, the financial system will come to more or less reflect this policy reorientation and thus play a conducive and supportive role in the rebalancing process. I examine the role of the financial sector in the development of imbalances within China's political economy, assess recent developments in this relationship between the financial system and the real economy in the context of rebalancing, chart the current attitudes and debates about the future of financial reform within China's policy-making elite, and finally provide a speculative insight into the path that this reform is likely to take.

The goal of transforming China's political economy into one that is more balanced and sustainable relies in large measure on using the financial system as the primary set of tools not only for controlling the micro-dimensions of sectoral- and firm-specific development and growth, but also for implementing decisive macro-economic monetary policy. The former function has had a profound direct impact upon the flow of cheap capital in order to foster state-led investment and to subsidize the manufacturing export sector, whilst the latter has provided the functional capacity to mitigate the unintended consequences of a closely managed strategy of economic growth. This symbiotic relationship between the financial sector and a national growth strategy that has given rise to significant imbalances within the political economy raises a secondary question of whether or not the financial system, as a state-controlled and politically driven set of interlocking institutions, has taken this form for reasons that are separate from the growth strategy, and is therefore in some way responsible for the evolution of China's development trajectory, or whether the structure and nature of the financial system is merely a product of this growth strategy. An exploration of this question will thus provide an insight into whether the financial system is likely to hinder or foster broader economic rebalancing.

I argue that the financial system occupies a specific and unique role within the political economy, one which was conducive to the government's pursuit of a specific investment- and export-led growth strategy, but which now serves to inhibit and obstruct the goal of rebalancing. The rebalancing objective may well be a significant one within China's

elite policy-making circles, however when it comes to the role of the financial sector in this process, both the form and method of reform are likely to diverge considerably from any expectations of a significant relinquishing of state authority and control over the levers of capital. In the reform era the financial sector has repeatedly responded to episodes of real economic stress with a combination of the prioritization of economic policies that are conducive to achieving ongoing economic growth with the retrenchment of the state, and thus the Chinese Communist Party (CCP), as the ultimate authority over the nature and implementation of this economic growth. In this way, the financial system itself possesses an endogenous inertia that sets it apart from the reform process that is underway in sectors of the real economy, which are more subject to the interplay of vested interests than ideational factors. In their management and reform of the financial system, policy-makers can be expected to respond to shifts in priority towards economic rebalancing. However in doing so, the prioritization of authority and control specific to the financial system will be maintained, leading to a significant and potentially retarding impact upon the direction and nature of overall economic rebalancing.

The Political Premise of China's Financial System

Since the reform and opening up period commenced three decades ago, the greatest changes in the reconfiguration of the Chinese political economy have been visible in the shifting patterns of state ownership of the various sectors that have driven China's impressive GDP growth rate. Capital-intensive industrial upgrading has been led by a core group of state-owned enterprises in conjunction with local government investment in infrastructure, whilst a globally competitive manufacturing sector has been led by the emerging private sector. The financial sector has resided at the core of this reconfiguration of the Chinese political economy, as a system of financial intermediation that, under the continued control of the state, has been responsible for fostering the capacity of these sectors to underpin strong economic growth.

The Chinese financial system remains dominated by the banking sector. Whilst it is an exaggeration to claim, as Walter and Howie do, that "capital begins and ends with the Big Four banks" (Walter and Howie 2011), the role of the banking sector, even for a still-developing country, is particularly pronounced (Allen et al. 2012). The banking sec-

tor thus dwarfs other financial intermediaries, with securities and insurance companies comprising together only 5.47 per cent of total financial assets, including those of the central bank (People's Bank of China 2010). Whilst both the markets for equity securities (corporate stocks) and fixed-income debt instruments (bonds) have developed rapidly, and the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE) are respectively the sixth and 14th largest in the world by market capitalization, these markets remain dominated by the banking sector, which extends funds for institutional investors operating within the stock markets and absorbs the majority of bond issuance. The banking sector itself remains largely dominated by the five largest banks, which cumulatively account for 49.2 per cent of the sector's assets (China Banking Regulatory Commission 2010). Joint-stock commercial banks (JSCB), city commercial banks (CCOMB) and policy banks (15.6 per cent, 8.3 per cent, and 8.0 per cent, respectively), cumulatively comprise 31.9 per cent of the sector's assets. National regulatory authorities were established between 1997 and 2003, in order to improve corporate governance and commercial practices within the three areas of financial intermediation.

Although the continuous process of financial reform since 1978 has resulted in the establishment of all the institutions of a modern financial system, it is clear that the financial system is far from operating upon the principles of a competitive, commercially-oriented market. The role of the People's Bank of China (PBC) as a non-independent central bank implementing policy authorized through the State Council is well known, whilst the other principal arms of the financial sector depart significantly from "international best practice" in their close connection and subordination to the institutions of state policy-making (Brehm 2008). The China Banking Regulatory Commission (CBRC), for example, operates under the mandate of Article 15 of the 2003 "Law on Banking Regulation and Supervision" which places its regulatory authority under the supervision of the State Council. As Liu Mingkang, the then-chairman of the CBRC pointed out in 2008, whether the incentives for increased performance are sourced in market profits or social [ie. political] advancement, regulatory and administrative governance structures should be capable of achieving this balance (Liu 2008). The banks themselves are equally subject to political subordination; although the Central Financial Work Commission, which under the leadership of Wen Jiabao (then vice-premier) had directly appointed all senior figures in the financial sector

(Heilmann 2005), was disbanded in 2003, the nomenclature system remains highly effective and is evidenced in the symbiotic professional and personal relationships between senior bank managers and the Party system (Wen 2012). As one central government official captures it, “the chairmen of the big banks cannot be said to be real bankers. They are politicians” (Anonymous 5).

Why does the financial system retain this form? As analysts such as Allen et al. have argued, the formal financial system, when assessed on a return-on-capital basis, has been notably inefficient (Allen, Qian, and Qian 2005). On this measure, they argue that the channels and mechanisms of informal finance, which operate largely beyond government regulation but with its implicit consent and tolerance, have been the most successful in fostering the rapid growth and high efficiency of the “hybrid sector” (Allen et al. 2012). However, from the perspective of enabling and accelerating a particular growth strategy that accorded with the politico-economic realities of China’s socio-economic circumstances, this system of capital allocation has been a resounding success. Financial industry analysts have made this point by referring to how:

at the heart of growth is a focus on capital investment in infrastructure, designed to create more productive lives, funded by a government which may bear losses but is capable of capturing the still positive externalities of rising tax revenues [...] These foundations seem brittle to Western investors used to judging the health of an economy through the returns to capital. But the Chinese are comfortable with low capital returns if the pay-off is a stronger economy (White and Cain 2012).

The banking sector has played a central policy role as a repository for household savings in order to support the government’s growth strategy, a priority that is clear from the management of different issues that remain largely inexplicable to western financial analysts.

Such an attitude towards financial efficiency is illustrated in the example of the policy response to the issue of non-performing loans (NPL) within the banking sector. When the rates of NPL within the four largest state-owned commercial banks (SOCB) increased to intolerable levels in the late 1990s, asset management companies (AMC) were established in order to provide immediate balance sheet relief to these banks. From the perspective of achieving the greatest return upon this capital, these AMC ought to have been subject to market oversight or the supervision of commercial stakeholders, or to have possessed advanced corporate gov-

ernance mechanisms that would have ensured maximally efficient practices. Rather, they transpired to serve a role that was equally or more important, in that they allowed the banking system to maintain its role as the stable repository for household savings, and thus a critical support for broader national development (Anonymous 1). As one senior executive in a large state-owned bank put it, “the taxpayer suffers the ultimate loss. But it’s an acceptable social cost of the national growth strategy” (Anonymous 6). This willingness to engineer compromises and accept trade-offs between sectors and firms is evident in the actions of the leadership; in 2004, Wen Jiabao stated in a meeting of the State Council that it does not matter so much if some firms are losing money and some are making money, as long as it is all within the same country and within the same system (Anonymous 5). Such statements are indicative of the attitude within the policy-making leadership which does not place ultimate emphasis upon the goal of realizing market equality or freedom, but rather is intent on actively managing the political economy in order to construct and perpetuate a particular institutional system underpinning a particular pattern of development.

This depiction of the financial system raises the proposition that, whilst not determinative of the growth trajectory that has been pursued over the past 30 years, the financial system certainly possessed both the structural characteristics and the internal dynamics that enabled this growth strategy to unfold. The Chinese financial system has never been intended to function purely as a source of corporate profits; any assessment of its role within the broader politico-economic evolution of China’s growth strategy should therefore recognize that financial inefficiencies might not have been the unavoidable and unintended consequences of a stalled reform process, but rather the deliberately engineered trade-offs inherent in pursuing a particular strategy of economic development and growth. With this in mind, the next section turns to the specific ways in which a tightly controlled banking sector played an instrumental role in this strategy.

Deepening Cleavages and the Role of the Financial System

Understanding the structure, and more importantly, the function of the financial system in these terms provides an additional perspective on China’s financial development within the literature on the relationship

between financial liberalization and economic growth (Shaw 1973; McKinnon 1973). There is significant empirical evidence at a general level that the two are positively correlated (Levine 2005; Roubini and Sala-I-Martin 1992). There is also a growing literature on how repressive financial policies foster a number of specific politico-economic imbalances, including inequality (Johansson and Wang 2012b), sectoral transformation (Johansson and Wang 2011), and an economy's external position (Johansson and Wang 2012a). Arguments have also been made in favour of the need for developing countries to manage money supply and financial stability through repressive domestic financial policies (Hellmann, Murdock, and Stiglitz 1997; Stiglitz 1994) and limits upon the extent and pace of external liberalization (Prasad et al. 2003; Stiglitz 2000).

The relationship between financial repression and growth however is not necessarily linear (Johansson 2012), and these two views are not necessarily incompatible. Under certain conditions, financially repressive policies of interest rate regulation and directed-credit allocation may be beneficial for economic growth (Huang and Wang 2011). Such repression can generate an “adaptive efficiency” at the expense of “allocative efficiency” (Li 2001; Maswana 2011), by carving out the policy space for fostering rapid development in the real economy through a state-led growth strategy. The constraints of institutional path-dependence in China's political economy, both in the immediate aftermath of the Maoist era and the post-1989 interregnum, left policy-makers facing three potentially conflicting factors:

- the structural resources and opportunities of the Chinese economy, in the form of an abundance of cheap labour, low levels of capital stock, and shortage of capital-intensive advanced industry (Lin 2012);
- the demand for significant increases in national wealth and rises in household living standards; and
- the priority placed by the CCP upon maintaining political stability and its unchallenged authority over the country's development trajectory.

This prompted an emphasis upon investment and exports at the expense of domestic consumption as part of a specifically calculated set of policy priorities intended to reconcile these three factors.

Financial repression may thus be beneficial for economic growth under certain conditions, but it will nonetheless generate economic dy-

namics that threaten the balanced nature of that growth. The effect of repression on China's growth was positive during the years up to 2000, when it turned negative (Huang and Wang 2011). At this point, a disjuncture arose and began to widen between the optimal growth strategy of the Chinese economy and the existing growth model founded on policies of financial repression. Although China was characterized by low consumption levels relative to investment and exports between 1978 and 2001, such a situation was historically not exceptional amongst newly industrializing economies, and it was post-2001 that major imbalances in China's political economy began to emerge as investment as a share of GDP increased, and consumption began its decline from 46 per cent to 34 per cent in 2010 (Lardy 2012). Other methods of evaluating economic imbalance indicate similarly that the early 2000s marked the point at which imbalances began to develop in a dramatic and potentially unsustainable manner (Lardy 2012). The coincidence of this development with the level of financial repression can be seen in the steady decline of repression during the 1990s, before levelling in 2002, dipping in 2004, and then rising again through to 2008 (Huang and Wang 2011).

Policies of Financial Repression

As one of the core elements of China's growth strategy, the financial sector has prioritized specific sectors of the economy through a strategy of financial repression that has emasculated growth in consumption by transferring wealth from the household sector to the state-owned sector (Johansson 2012). This repression has taken two interlinked forms. In order to enable and promote capital-intensive investment, it has involved centrally mandated interest rates which, combined with the imposition of capital controls and the limiting of channels for the investment of household savings, has generated significant capital reserves to finance investment. In order to foster the competitiveness of the manufacturing export sector, the exchange rate has been maintained at artificially low levels, raising the cost of imported goods and reducing incentives to produce for the domestic market. Each of these mechanisms depends on the financial sector as a system for either channelling funds for investment purposes or for managing the macro-economic inflationary pressures generated by inflows of capital that result from running a large current account surplus.

Commencing in 1997, a policy of gradual interest rate liberalization was instituted, when a 10 per cent band of flexibility was initially intro-

duced for loans to small and medium enterprises. In 1998 this relaxation was extended to all borrowers, before being increased to 20 per cent above the benchmark rate set by the PBC. This liberalization coincided with the onset of the NPL crisis in 1997, and represented a concerted effort by the Zhu Rongji administration to instil greater capacity for the pricing of risk within the commercial banks, the previous absence of which had undoubtedly been a significant factor in the build up of an enormous stock of toxic debt within the banking system. However, the cap on deposit rates was maintained and the floor upon lending rates was maintained at 10 per cent below the benchmark rate, thus guaranteeing that a highly profitable interest rate spread remained at the disposal of the banks.

The specific management of deposit rates has been especially pronounced since 2003. Prior to this, the PBC would make rapid adjustments to nominal deposit rates to reflect increases and decreases in consumer price inflation. However, beginning in 2004, the PBC responded to inflation increases with a lag, whilst reducing nominal deposit rates rapidly in line with decreases in inflation (Lardy 2012). The direct effect of these negative real interest rates has been that the growth in household disposable income has decreased over the past 10 years relative to a less repressed financial environment. There have been two further indirect effects. The first is that the savings rate as a portion of household disposable income has increased, since the objective of savings in a society without a strong social safety net is to reach a target level of financial assets (Chamon and Prasad 2010). Thus China's high savings rate reached an unprecedented level of more than 50 per cent of GDP in the period 2006–2010 (Ma and Yi 2010). The second is that this financial security-motivated increase in savings, the unattractiveness of depositing these savings with commercial banks, and the limited range of other attractive consumer investment options has produced a heightened demand for residential property. As wealthy urban households thus attempt to capitalize upon a speculative real-estate bubble (People's Bank of China Business Management Office 2010), a further transfer of household wealth into the construction and infrastructure sectors takes place, accentuating the divergence between consumption and investment.

The strict regulation of interest rates has not only produced a retarding effect upon household consumption, but has also contributed to the growth in investment as a share of GDP since 2003, as real lending rates on one-year loans declined from 6.8 per cent between 1997–2003, to

only 1.7 per cent in the period since 2004 (Lardy 2012), thereby increasing the range of financially attractive projects to include those with much lower anticipated returns, and thus boosting the share of investment in GDP. With the band of flexibility within which commercial banks are free to deviate from the PBC-set benchmark rates maintaining a rate floor of 0.9 per cent of the benchmark, competition amongst the major banks virtually guarantees the uniformity of lending rates at the lowest level sanctioned by the PBC.

The banking sector has also formed a central component in the PBC's policy of exchange rate undervaluation. For over a decade, the PBC has been tasked with two potentially conflicting policy objectives: maintaining export competitiveness through currency devaluation, at the same time as ensuring monetary stability. An export-driven current account surplus will have an inflationary effect upon the domestic money supply in the absence of central bank intervention to prevent the capital it expends on accumulation of foreign exchange reserves from entering the domestic money supply. Since 2003, the PBC has sterilized this surplus capital through two methods. Firstly, it has directly imposed bond quotas upon the SOCB which require them to hold a certain amount of interest-bearing bills issued by the central bank, thus reducing the money supply. By the end of 2010, commercial banks had acquired approximately 4 trillion CNY of central bank bills at 1.692 per cent for three-month maturity, and 2.126 per cent for one-year maturity. The discrepancy between these returns and the average lending rate of 6.11 per cent constitutes an implicit tax upon commercial banks (Milana and Wu 2012). Secondly, it has increased the required reserve ratio, forcing banks to deposit greater shares of their capital with the central bank and thus curtailing their lending operations. The effect of these sterilization methods has been to reduce the portion of the total money supply in circulation. It has been estimated that roughly one quarter of China's total monetary base is illiquid (Gang 2010).

The ongoing viability of both of these sterilization methods depends on the maintenance of low interest rates (Zhang 2012). Since intervention in the foreign exchange markets is continuous, large-scale and unidirectional, in the absence of structural changes that would reduce the need for forex market intervention, investors in central bank bonds will calculate that the sterilization efforts cannot remain sustainable and viable in the long-run. If interest rates were flexible, this calculation would force up interest rates upon the PBC bonds, and thus significantly in-

crease the costs of sterilization borne by the central bank, since a difference between the interest earned on the foreign currency-denominated debt instruments that comprise official reserves and the interest paid on the bonds issued to the SOCB would emerge and continuously increase. Thus by setting interest rates at a low rate, the PBC avoids these increased sterilization costs, but in doing so implicitly taxes the banks that are holding these bonds rather than other, more lucrative investments (Zhang 2012). The PBC then offsets this tax by reducing the costs of capital for the banks; it shifts the burden onto household depositors by depressing the benchmark deposit rate.

The Necessary Role of the Banking Sector

As these brief outlines indicate, the policies underpinning investment- and export-led growth could only have been pursued through a system in which political authority over capital was maintained. There are two ways in which the process of institutional change in the financial system reflects this. Firstly, the ability of policy and regulatory agencies such as the PBC and CBRC to exercise virtually direct control over both the constitution and the practices of the banking sector, through the symbiotic ties between executive management and the CCP, has generated the rationale for ensuring the continued dominance of large centralized banks over other financial intermediaries, as well as financial markets. Secondly, both the capacity and the motivation for the banking sector to develop complex financial products and thus a more sophisticated, but volatile, set of investment options is being suppressed by the central government, thus reinforcing the role of the banks as predictable, if unwieldy, mechanisms for financial intermediation, rather than as independent sources of profit.

Whilst undoubtedly there has been significant development of diverse financial activities by the major banks and the image of state-owned banks that perform few functions except take deposits from households and then channel them to state-owned enterprises (SOE) is obsolete, the primary function of the banking system, and the institutional structures surrounding it, have not changed significantly. The banking system remains the primary mechanism for China's monetary policy, and for as long as banks' institutional integrity is not threatened and profit sources remain secure, other activities remain largely subsidiary (Anonymous 4). Thus China's banks have been content to accept their role within this system of intermediating household savings to government-

sanctioned projects and enterprises (McMahon 2011, 2012), and indeed have enjoyed the highest profits of any sector of the Chinese economy over the past 10 years as a result. The banking sector thus plays a crucial role in the development and implementation of policies that have laid the foundations for rapid economic growth, but have at the same time generated significant imbalances within China's political economy. The central role accorded to the financial system within China's political economy further places it at the heart of any analysis of the potential for China's leadership to institute policies that will correct these imbalances. The next section thus addresses a number of issues specific to the role of the financial system as a component of efforts to pursue the objective of rebalancing.

The Financial System in Rebalancing

China is now beset by a number of politico-economic cleavages that constitute both structural and social threats to the sustainability of its development. The structure and practices of the financial sector reflect the various dimensions of this "dual structure" (二元结构, *eryuan jiegou*) (Anonymous 2) that afflicts China's overall political economy: between coastal and interior regions; between capital- and labour-intensive industries, and between SOEs and small- and medium-sized enterprises. In this way, the banking system is reflective of and subject to the demands of the real economy (Anonymous 5). Yet the synergy between the financial system and the real economy that has facilitated this unbalanced growth strategy may be weakened as the socio-economic demands for more balanced growth within the real economy diverge from the political demands placed upon the financial system by the central government and China's overall political system. This dissonance will arise from an entrenched concern with actively managing the process of reform through control over the financial sector, a priority that increasingly will come into tension with the ever-increasing role of market-dynamics within the real economy. Thus, whilst the development of the financial sector remains connected to the needs of the real economy, it is likely to continue to struggle to keep pace with the real economic need for rebalancing. This section addresses a number of issues involved with and connected to the rebalancing efforts, in order to draw some of these distinctions and arrive at a clearer understanding of how the financial

system might be likely to conduce, or obstruct, the process of politico-economic rebalancing.

Debating the Form and Speed of Financial Reform

In recent years, two broad camps have emerged within the debate over financial reform. Advocates for more aggressive liberalization are clustered around the PBC and government think tanks such as the DRC and the Institute of World Economics and Politics at the Chinese Academy of Social Sciences (Anonymous 15). More conservative sceptics of rapid and/ or far-reaching liberalization remain associated with the National Development and Reform Commission (NDRC), the Ministry of Finance, and the Ministry of Commerce. Reflecting these divergences in policy emphases, the primary structural reforms emphasized by the twelfth Five-Year Plan as conceived by the NDRC were the creation of a mechanism for shutting down troubled financial institutions, the establishment of a financial safety net centred upon a multi-function deposit insurance scheme, and financial regulation coordination. In early 2010, the PBC was engaged in drafting a separate, though related, plan for the reform of the banking sector over the years 2011–2015 that contained a number of overlapping priorities, but differed in some key respects. The PBC emphasized greater market supervision of the banks and stressed the need to accelerate the introduction of market-determined interest rates (Wen and Zhang 2011).

However, the Financial Work Conference in January 2012 failed to produce any significant decisions, measures, or movement towards greater financial reform. Chaired by the premier, the conference is held every five years and generally lays the groundwork for upcoming reform. Whereas the 2007 communiqué used the word “risk” three times, the 2012 text used it ten times, indicating a more cautious attitude towards the challenges facing the financial sector in the upcoming months and years (Rabinovitch 2012d). Whilst there appears to be a general consensus within elite policy-makers that reform is necessary, such reform is not necessarily viewed as having to result in fully liberalized market structures (Anonymous 12). The ongoing negotiation within the CCP is representative of a debate as to how to structure the financial system so that it best serves a political economy whose fate remains intimately connected to continued political and social stability. It is telling that even in the pages of the “China 2030” report, the following appears: “China may not need to pursue the same structure (including the ownership

structure) and practices of financial markets as we see in most advanced economies these days” (World Bank and Development Research Center of the State Council 2012). Attitudes towards future steps remain couched within a framework of continued state management of core macro-economic policy-making tools, such as the exchange and interest rates. The debate concerns not just the pace of financial reform, but also the direction.

As a senior executive at a larger city commercial bank interpreted the current efforts, “China is buying time for reform, and is willing to pay for the necessary interim adjustments again if necessary with [foreign exchange] reserves” (Anonymous 9). There is limited concern within Chinese policy-making circles over the issue of non-performing private or public debt (Anonymous 17). Whilst it has been at the centre of western concerns over the fragility of the banking sector, as far as the Chinese government is concerned, the state is able to absorb the losses without too much of a problem. Even when local government debt is accounted for, the state remains comfortable with its fiscal position (Anonymous 10). Thus ultimately, households and taxpayers remain responsible for picking up this cost, and the rationale for this socialization of risk and loss has not significantly altered within policy-making circles. Whilst this continued reliance upon a high savings ratio means that SOCB have a vested interest in maintaining the status quo of a state guarantee, it would be misguided to characterize the SOCB as independently powerful actors seeking to pursue their interests against a policy leadership that is committed to reform. The complete interpenetration of financial institutional management, the CCP and the policy-making apparatus means that whilst the intra-governmental debates generating resistance to financial reform unfold through factions constituted either on an ideational basis, or on the basis of common material interests, these debates do not neatly split along formal organizational lines (Anonymous 21).

The most significant recent structural moves in the financial system have taken the form of pilot programmes for liberalization in the longstanding vanguard of Chinese financial innovation, the city of Wenzhou in Zhejiang province. In March 2012, the introduction of 12 specific measures to assess the effectiveness of greater freedom in financial activities was described in a statement released following a State Council executive meeting as being of pioneering significance for financial reform and economic development throughout the nation (*Xinhua* 2012a).

After significant turbulence in Wenzhou's financial ecosystem in late 2011 (Aredy 2011), this constitutes an effort to harness informal financial practices as a formally regulated alternative to state-directed commercial bank loans. It coincides with Wen Jiabao's calls in May for an urgent need to "break the monopoly" of the country's biggest banks (Rabinovitch 2012b). The experimentation in Chinese financial reform is now moving further south down the coast to the Pearl River Delta, with a plan for significant institutional change in Guangdong province having been approved in June 2012, and the third pilot financial reform zone established in Quanzhou in Fujian province, in December 2012 (Wang 2012).

Thus the highly cautious and variegated experimentalism of financial reform is evident in both geographical and temporal terms. These isolated and tentative pilot zones remain the locus of reform implementation, such an approach being considered essential to institutional stability through periods of change and transformation (Anonymous 18). Since control over ownership and policy is the basis of political control, the reform process is slow and passive. Each step of liberal reform will involve the relinquishing of some degree of control over the financial sector, thereby increasing the risk of losing broader control over the economy and society (Anonymous 7). As one government researcher put it,

the country is too big and too varied to try and get everything right ahead of time, and so this is why it is necessary to wait and see if something works before trying to expand it or taking it too far along the institutional path (Anonymous 3).

For similar reasons of pragmatism, reform is often linked to immediate circumstances, and precipitated when exogenous pressures and tensions build up. As one government researcher was informed by a colleague at the PBC, "there is no grand design. We are pushed into reform. We don't have a systematic strategy for it". Financial reforms are driven by outside circumstances, not by ideology (Anonymous 4).

Pathways to Rebalancing

Identifying the specific policy pathways to rebalancing depends on an acceptance of the premise that the existing unbalanced growth model generates, and has generated over the past two decades especially, a significant misallocation of capital. As Johansson and Wang observe, the crux of the link between financial repression and politico-economic im-

balance is that “when implementing repressive and distortive financial policies, the government is in effect allocating financial resources to certain sectors of the economy” (Johansson and Wang 2012b). Although rebalancing the Chinese political economy is a complex issue with a number of different dimensions, these dimensions are all in large part related to the bias in credit allocation towards urban-centric industrial sectors connected to the state-owned economy. With this understanding of the role of the financial system in contributing to politico-economic imbalance, then the underlying goal of rebalancing is to reduce the state share of GDP and to increase the household share therein. An increase in household consumption as a share of GDP might come about in two ways. The first is to decrease the share of disposable income that is saved, with a corollary increase in household expenditure. This might be achieved through policies that reduce the need to maintain high levels of financial assets and policies that provide a means of circumventing this need. Chinese households save primarily as a result of a weak social safety net (Chamon and Prasad 2010; People’s Bank of China and China Southwest University of Finance and Economics 2012) and thus improvements in social welfare programmes, combined with more effective job creation policies, should theoretically boost expenditure as a portion of disposable income (Ma and Yi 2010; Meng 2003). The second is to increase debt levels. Households might be encouraged to increasingly turn to consumer debt as a means of enabling expenditure without a direct reduction in liquid savings. The final mechanism for rebalancing is to increase overall levels of disposable income, with a corresponding increase in household expenditure regardless of the savings rate.

In terms of increasing household levels of debt, Chinese households have had access to opportunities for consumer credit that have steadily increased from the mid- to late-1990s. In 1997, the sum of finance extended to individuals, either to self-employed workers for business or for personal consumption, stood at only 50 billion CNY, which was equivalent to 0.7 per cent of outstanding bank loans. Household bank debt as a share of household disposable income was negligible at 0.9 per cent (China Banking Society 1998). Whilst the primary responsibility of the banking sector remains to intermediate household savings (Walter and Howie 2011), this picture shifted slightly over the next decade, and accelerated during the stimulus phase following the global financial crisis, such that the share of new bank loans extended to households reached 14 per cent in 2008 (People’s Bank of China 2009) and then 36 per cent

in 2010 (People's Bank of China 2011). As Lardy argues, there is evidence that consumer spending in China is not constrained by a lack of credit availability. Despite having the largest car market in the world, in 2009 only about 20 per cent of Chinese car buyers took out loans to purchase cars, compared to 50 per cent in Japan and 90 per cent in the U.S. Similarly, whilst households have access to up to two trillion CNY in credit lines, outstanding credit card debt was only 499 billion CNY in 2010 (Lardy 2012). This appears to suggest two things: firstly, there are other factors restraining domestic household consumption and secondly, that Chinese households are disinclined to use debt-financing in order to overcome obstacles to household spending (Anonymous 4).

Accordingly, the effective pathways to rebalancing are to reduce the household savings rate and to increase household income at a faster rate than growth in the state sector. On this basis, Michael Pettis has sought to identify five policy options for achieving a rebalancing of consumption to investment:

1. The reversal of wealth transfer by gradually raising real interest rates, gradually appreciating the currency, and gradually increasing wages;
2. rapid reversal of wealth transfer through the same policies;
3. direct transfer of wealth by privatizing state assets and using proceeds to boost household wealth;
4. indirect transfer of wealth by absorption by state of private sector debt; and/ or
5. rapid rebalancing through decrease in investment and policies to maintain employment (Pettis 2012).

Pettis' assessment of the economic constraints leads him to conclude that one or a combination of these policies is the only possible method of rebalancing the economy. He argues that the logical economic strategy is a combination of all of these options: raising real interest rates significantly over the next two years combined with an overnight 15 per cent appreciation of the currency. Beijing would then protect workers from the ensuing unemployment by instituting make-work programmes through SOEs and local governments, and initially paying for this through government debt. Simultaneously, it would begin to privatize on a large scale, using the proceeds to improve social welfare programmes and pay down public debt. Whilst this might constitute an ideal economic scenario from the perspective of optimizing returns to capital and rectifying problematic misallocation, there is evidence that this is not the ultimate

benchmark for the financial system from the perspective of the CCP and that financial reform is thus likely to diverge from such expectations.

Liberalization of Interest Rates

Wen Jiabao vowed in 2009 to “carry forward market-based reform of interest rates” (Wen 2009). Higher deposit rates allow individuals to earn more on their savings, providing scope for greater consumption; in theory, they also prompt banks to allocate capital more efficiently, since they are forced to seek higher returns on their investments. The governor of the PBC, Zhou Xiaochuan, has identified the first effect of interest rate reform as being the imposition of hard restraints upon financial institutions, thereby ordering them to adhere to the principles of market competition (Hu and Zhang 2012). Furthermore, there is consideration within policy-circles of differential marketization of interest rates based on maturity lengths. Within the pro-reform wing, one of the strategies that has been mooted is to first liberalize long-term deposit rates, followed by medium-term one-year rates, and then demand deposit rates. The reverse would apply to lending rates, however, with long-term lending rates remaining under close central bank management, while short-term lending rates could gradually be opened up to market competition (Anonymous 1). There is, however, also support within the central bank for the view that it would be logical to reform lending rates first. Changes to deposit rate regulation would come later with the development of alternative debt products as the floating limit for rates is broadened (Anonymous 13).

In the years 2009–2011, there was very little concrete action to ease financial repression. The real return on one-year deposits in fact sharply declined and the required reserve ratio was increased multiple times to rest at an unprecedented 21.5 per cent by December 2011 (Davis and Orlik 2011). In the first six months of 2012, steps have been taken to ease the financial repression that had intensified since the fiscal stimulus was implemented through the banking system. One of the most significant indicators of interest rate liberalization is the increased range of flexibility, as of June 2012, within which commercial banks can now deviate from this benchmark: to 20 per cent below the benchmark lending rate, as opposed to a range previously set at 10 per cent. The degree of freedom to award interest to bank deposits at a rate higher than the official level has remained unchanged at 10 per cent (Rabinovitch 2012a). Nevertheless, this coincided with a reduction in the benchmark interest

rate by 25 basis points, the first cut since November 2008 in the immediate aftermath of the global financial crisis. With inflation now at low levels, real deposit rates are no longer negative; however, this remains an incremental step that does not constitute structural reform, but rather an adjustment of policy within the existing role and function of the banking system as a state- rather than market-managed mechanism of financial intermediation. As Li Lin, vice-president of China Everbright Bank, one of the national joint-stock commercial banks, has commented, interest rate liberalization is not going to happen overnight. It will be a prudent and gradual transition (Rabinovitch 2012c).

This is a trend that seems likely to continue. Rather than a movement towards the open market-determination of interest rates, it is more likely that the PBC will continue to manage the spread between deposit and lending rates, but will do so in a way that will gradually force banks to increase their efficiency at offsetting the higher returns paid upon depositors' savings (Anonymous 20). This would involve a gradual easing of financial repression, involving cautious increases in the band of flexibility so as to lessen the interest rate spread between deposit and lending rates, combined with a reorientation of central bank policy to ensure that real deposit rates are not negative and that lending rates do not undercut the average potential return on capital of investment-worthy projects. Such steps would play a significant role in rebalancing, without the PBC being forced to cede authority over the levers of capital.

Institution of a Flexible Exchange Rate

Advocates for overall financial liberalization have focused closely upon the need for greater exchange rate flexibility, an issue that, whilst intricately embroiled within the broader issue of economic rebalancing, is seen as less sensitive than reforms directly related to domestic financial and industrial sectors. Zhou Xiaochuan expressed his view in 2004 that the exchange rate's stability should be maintained at an appropriate and balanced level (*People's Daily* 2004). Since then, following the sustained depreciation of the U.S. dollar, the Chinese currency depreciated by approximately 25 per cent leading to explosive growth in the current account surplus. Although the PBC allowed the CNY to appreciate between 2005 and early 2009, the current account surplus continued to increase, for various reasons (Goldstein and Lardy 2009). During the financial crisis, the CNY was re-pegged to the U.S. dollar until June 2010, before being allowed to gradually appreciate again, although on a

real, trade weighted basis the currency continued to depreciate throughout 2011 (Lardy 2012). Through the first half of 2012, increasing signs of weakness in global demand have prompted Chinese policy-makers to refocus on ensuring full employment in the manufacturing sector and the PBC has again begun to intervene in devaluing the Chinese currency; an action that was preceded by comments from Wen Jiabao that “the task of promoting full employment will be very heavy and we must make greater efforts to achieve it” (Davis and Wei 2012). Once global demand for Chinese exports begins to recover, China’s current account surplus will again begin to expand rapidly, thus further decreasing the likelihood of genuine movement towards “market-oriented interest rates”.

In September 2012, the PBC released the twelfth Five-Year Plan for the financial industry, which included a standard announcement of the marketization of the exchange rate as one of the objectives of financial reform (People’s Bank of China 2012). However, it is necessary to introduce an important conceptual distinction between movement of the exchange rate towards equilibrium and reform of the exchange rate regime itself. Recent views have been expressed that the exchange rate is already the closest to equilibrium as it has been since 2001, when the real exchange rate could be regarded as in equilibrium (*Reuters* 2013). Nevertheless, there is no indication that the policies underpinning the management of the exchange rate regime have undergone transformation or that the risks of regime liberalization have been accepted (Anonymous 14). Even if the exchange rate is in equilibrium, until there is a consensus upon reform of the policy of active management of the exchange rate, the potential need for cheap sterilization measures will continue to prove a significant obstacle to interest rate reform (Anonymous 15). That the exchange rate regime is not currently an obstacle to rebalancing is thus not attributable to the financial system, but rather is due to structural factors that render China’s growth engine no longer so heavily dependent on the capacity of the financial system to sterilize current account inflows.

Greater Channels for Financial Investment: The Growth of Non-bank Financial Institutions (NBFI)

The securitization of financial assets and the development of markets for trading them is one of the central issues to be resolved by Chinese financial regulators in the process of financial reform. Wealth management products have proliferated as a consequence of the financial repression,

but have been subject to a rapid and far-reaching regulatory response by the CBRC to reign in their growth (Rabinovitch 2011). The highly cautious and sceptical attitude of financial policy-makers and regulators to banking practices also extends to their increasing efforts to improve the viability of capital markets as a source of funding for a broader range of enterprises. The listings of the SHSE and SZSE remain dominated by large SOEs, reflective of the difficulties in obtaining listing permission and thus access to direct equity financing in the capital markets. Whilst platforms to increase funding sources for small- and medium-sized enterprises (SME) were initially contemplated by central government policy-makers during the 1990s, it took the better part of a decade for regulators to become comfortable with the potential volatility in capital markets (Anonymous 11). The SME board of the SZSE commenced trading in June 2004 and ChiNext, the growth enterprise market on the SHSE, opened in November 2009. Both experienced significant volatility, prompting Shang Fulin, the then-chairman of the CSRC, to state that the probability of irrational trading was a major concern and that risk would be closely monitored and controlled (*Xinhua* 2009). As part of the broader drive to provide a more hospitable environment for SMEs, there is an increasing willingness to increase the range of funding options for private and unlisted enterprises through such measures as over-the-counter (OTC) share trading platforms (Li and Hong 2012). Nevertheless, two features characterize such reforms: firstly, they remain highly experimental and limited in their scope of operation; for example any OTC platform will be limited to firms in certain sectors and in Shanghai and Wuhan only; secondly, the influence of strategic government policy remains evident, as new institutions privilege those firms and sectors, such as high-tech startups, included within the central government's specific promotion of seven strategic industries as part of its broader rebalancing strategy (*Xinhua* 2010).

The Need for a Financial Safety Net

The establishment of a sound deposit insurance scheme is viewed by many as an essential precondition to interest rate liberalization and a reduction in government influence within the banking sector. However, neither the twelfth Five-Year Plan nor the PBC's blueprint for financial reform contained a timetable for the introduction of a deposit insurance scheme or a specific method for dealing with problematic institutions. The latter issue raised the question of defining "exit"; however, one bank

manager has stated that “right now, we only have the government [making the decision]. There is no market [mechanism]. How then can we say ‘exit the market?’” (Wen and Zhang 2011).

Large banks are resistant to the idea of such reforms. Their deposits are guaranteed and an insurance mechanism would raise their costs. Furthermore, the absence of any recognition that banking financial institutions may potentially fail continues to reinforce the state-sanctioned moral hazard that has absolved them from responsibility for their lending practices (Anonymous 19). Thus, whilst the PBC issued calls several times during 2012 for greater concrete action on the establishment of such a scheme, the obstacles remain in allocating responsibility and apportioning the direct costs of operation, as well as managing the indirect costs to SOCB caused by a diminution of explicit guarantees of state fiscal support (*Xinhua* 2012b). After ten years of discussion, the absence of action thus far towards the establishment of any such scheme is indicative of the reluctance to contemplate a transfer of risk from the state to the private sector.

Opening up the Banking Sector

Another dimension of rebalancing within the financial sector concerns the lending practices within the banking system itself. The state is attempting to slowly reorient the flow of capital towards smaller enterprises and greater efforts to address the rural financing issue have been apparent this year. In Zhejiang province, reforms announced in May 2012 to apply to Lishui city are intended to speed up the development of rural banks, micro-credit companies and rural capital cooperatives, to guide private capital to enter the financial sector and to encourage the establishment of community banks and financial leasing companies (Zheng and Zhang 2012). Rural financial reform heralds potentially significant implications for boosting consumption, since the rural population still makes up over 50 per cent of China’s total population, but accounts for less than one third of consumption.

In contrast to structural and regulatory reforms, the basis for rebalancing through the banking sector’s lending practices remains that of “encourage and restrict” (鼓励限制, *guli xianzhi*) (Anonymous 6). Such efforts depend on the development of consensus within the central government. Whereas previously, the heads of large banks had been instructed to prioritize lending to the national team and government-led infrastructure projects, the same symbiotic relationship between the

Party, state policy-making apparatus and the financial sector can be utilized in order to foster rebalancing measures. Banks are now being asked to extend greater finance to SMEs and the household sector, reflecting a policy-making consensus that renders it difficult for bank executives to refuse or offload the risk (Anonymous 4). Thus the challenge of rebalancing involves a tension between two opposing politico-economic driving forces: the drive to accord a greater economic role in China's growth to broader Chinese society precipitates a drive to consolidate the authority to do so within a centralized state structure.

Conclusion

Perhaps the most telling sentences concerning the financial system in “China 2030” are its final ones:

Financial reform can progress successfully only when accompanied by institutional and organizational reforms. Liberalizing market rules without changing old institutions can deepen distortions. Unless the government's organization changes, its *modus operandi* of intervention/involvement in the financial system may not significantly change (World Bank and Development Research Center of the State Council 2012).

When asked to comment on the “China 2030” report, a senior administrator and scholar at the DRC had the following to say:

If western commentators are interpreting this report as saying that China will simply move along a path that will result in a financial system that resembles that of the U.S., then they are mistaken. China's Five-Year Plans are still at the heart of the reform effort, and there is little reason to believe that China's economic policy-makers are going to accept reform measures that will generate risks to or threaten the stability of the system, which, it is still believed, can only be secured through maintaining a significant degree of control by the state. It is not about just making money, but about ensuring that long-term growth can be maintained (Anonymous 7).

Stability is thus now more important than growth. After 30 years of rapid growth, there is the recognition that China has come a long way and that its current state of development is an impressive achievement. But as a result, rapid growth is to be commended and sought only insofar as it is necessary and helpful for maintaining social stability. In the current political climate, this emphasis upon stability and control is accentuated

(Anonymous 4). Whilst interest groups and differing policy views are engaged in a serious debate about reform, the significant potential risks of financial liberalization means that this debate is taking place within highly constrained parameters. China does not have a sufficiently strong leadership to take on the significant risks from rapid liberalization, especially not at the present time (Anonymous 8). Whilst policy-makers are looking for ways to reform the financial sector, the political risks of significant liberalization at the current moment remain greater than the economic benefits (Anonymous 4).

This article has thus argued that China's financial system is conceived of in ways that are different from those expected by a liberal model and, accordingly, where the rebalancing efforts conflict with the use of the banking system to maintain political control, one can expect that the financial system will continue to lag behind the real economy. It has presented evidence and analysis that suggests that the financial system plays a role within China's political economy that, whilst conducive to a particular growth strategy that was both appropriate and effective given China's politico-economic conditions at the commencement of reform efforts, now proves an obstacle to correcting the imbalances that have developed as a result of this growth strategy. The financial system, and in particular the banking sector, embodies a contradiction between responding to episodes of crisis and tension with a consolidation of state control over capital, and the need to resolve the current tensions within China's political economy by devolving this authority, not necessarily to other political actors or private sector firms, but to Chinese households operating within more dynamic and market-oriented sectors. China's current path of financial reform appears to be cautiously beginning to grant such greater authority, but is doing so within a system of limited market mechanisms operating under continued close state control.

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