



Chinese Financial Deregulations: Review and Prospects

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1、 Introduction

China's financial sector has undergone substantial changes over the past two decades.

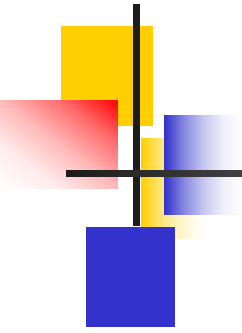
First, it has been transformed from a state-owned, mono-banking system to a diversified, modern financial system since the early 1980s.



Second, government controls over financial institutions, interest rates and exchange rates have also been relaxed.

Third, the credit plan has become more indicative in nature rather than binding.

Therefore, the process of financial deregulation in China has been extensive and complicated with a gradual approach.



This paper tends to review it systematically and evaluate the impact of China's financial deregulations on economic growth and the operation of the financial sector.

This provides a platform to analyze the efficiency of Chinese financial deregulation, consider the current problems, analyze likely future developments and develops a response to meet the future challenges.



2、 Overview on Financial Deregulation

2.1 Increasing Independence of the Central Bank and Institutional Diversification

The reform of financial sector, like other sectors, took a gradual approach, including three stages:



Stage I reform transformed the mono-bank system to a two-tier system with the PBC playing the role of central bank.

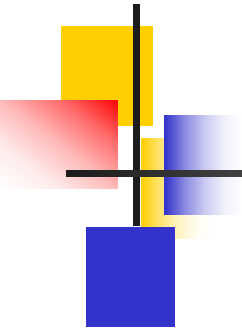
Stage II reform established three policy banks and improved the autonomy of SOBs.

Stage III reform created the RCBs and UCBs on the basis of the rural credit cooperatives (RCCs) and the urban credit cooperatives (UCCs).



2.2 The Evolution of Credit Allocation System and Removal of Credit quotas

Before 1978 the allocation of credit was arranged through the PBC and its branches according to the credit plan, which was prepared in the form of a source-and-use-of-funds balance statement to match the estimation of the demand for physical resources.



During the 1990s the overall trend has been away from direct controls and by 1995 only the major SOBs remained subject to any credit quotas.

The PBC removed the credit quotas for the SOBs in March 1998, replacing it with asset-liability ratios management principles.



2.3 Liberalization of Interest Rates

China took a cautious approach to liberalize the planned interest rates.

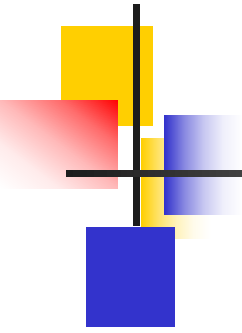
The measure adopted was to raise the interest rate and allowed considerable flexibility with respect to setting interest rates.



In 1979 an attempt was made to raise the interest rate to its pre-cultural revolution level.

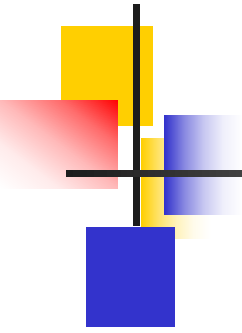
From 1980-1989, the government made nine upward adjustments to deposit and loan rates.

In late 1980s banks were allowed to adjust lending interest rates within a certain margin below and above the administered rate.

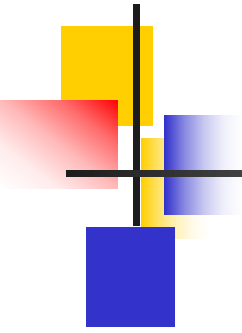


From 1990-1992, the government unexpectedly reduced deposit and loan rates three times.

Starting in 1992, the non-state financial instruments like corporate bonds and stocks began developing quickly.



In October 1993 the 3rd Plenum of the 14th CPC national congress pointed out that “the central bank shall promptly adjust benchmark interest rate according to changes in market supply and demand, and allow the commercial banks to flexibly set their own rate on loans and deposit within a specified range”.



From May 1996, against the background of a price slide and effective macroeconomic adjustment, the PBC has cut the deposit and lending rates on nine occasions.



2.4 Transition from Direct Control to Indirect Regulation

With the credit quotas on commercial banks eliminated in 1998, a new intermediate target system has been established which focuses on the monetary base as an operating target and the money supply as an intermediate target.

Instruments of monetary policies such as reserve requirement system, rediscounting operations and open market operations had made rapid progress.



2.5 Decentralization and Separation in the financial Regulatory System

**State Council Securities Commission
(SCSC) established in 1992**

**Chinese Securities Regulatory Commission
(CSRC) established in 1993**

**China Insurance Regulatory Commission
(CIRC) established in 1998**

**China Banking Regulatory Commission
(CBRC) established in 2003**



3. An Evaluation of Financial Sector Deregulation

3.1 Macro-Evidence

- **Rapidly Expanding Financial Assets**

Table below shows the changes of financial structure during 1980-2003.

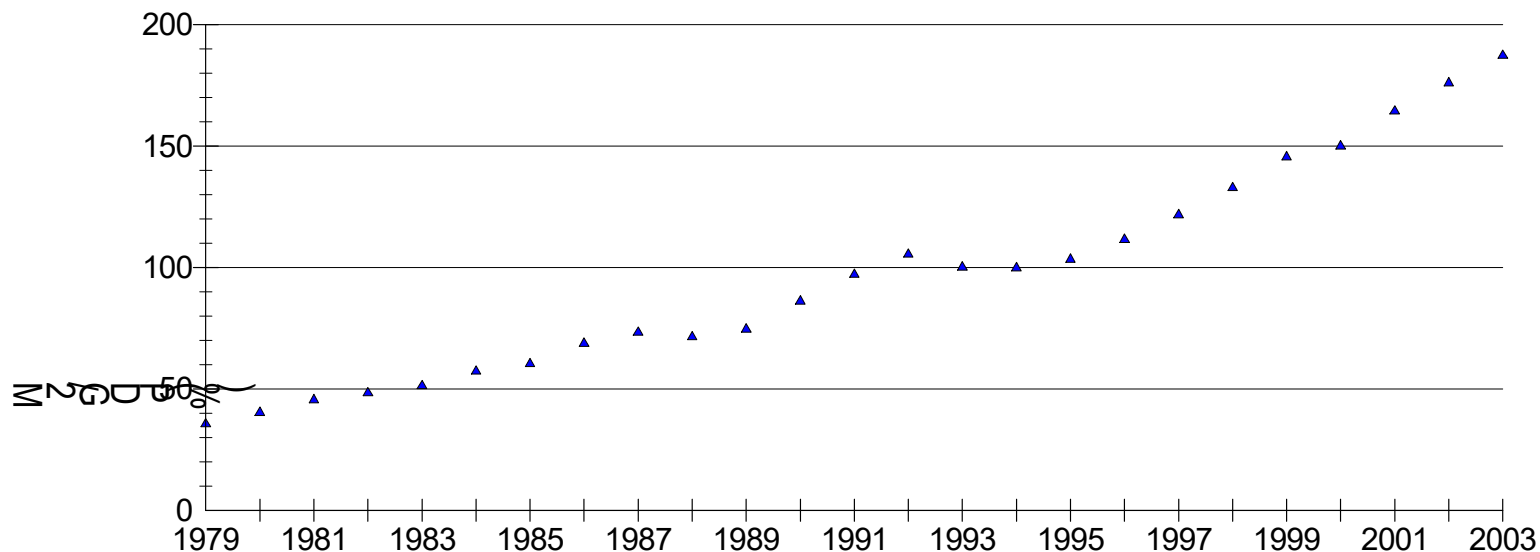
The Structure of Financial Assets (100,000,000 yuan)

Year	M0	Total Deposit	Total Loans	Borrowing by MOF	Bonds	Capitalization (A, B shares)	Insurance Premiums	Total Assets
1980	346.20	1661.20	2414.30	170.20	258.44			4850.34
1982	439.10	2369.90	3180.60	170.20	258.44			6418.24
1984	792.10	3583.90	4766.10	260.50	258.44			9661.04
1986	1218.40	5354.70	7590.80	370.10	339.60		42.35	14915.95
1988	2134.00	7425.80	10551.30	576.50	935.87	35.00	94.76	21753.23
1990	2644.40	14012.60	17680.70	801.00	1343.40	45.90	155.76	36683.76
1992	4336.00	23468.00	26322.90	1241.10	2540.15	1048.13	335.15	59291.43
1994	7288.60	40473.00	40658.30	1687.10	3927.59	3690.62	376.41	98101.12
1996	8802.00	68571.00	61152.80	1582.10	7379.61	9842.00	538.30	157868.01
1998	11204.20	95698.00	86524.10	1582.10	13822.26	19506.00	1255.90	229592.46
2000	14652.70	123804.00	99371.07	1582.10	21265.00	48091.00	1598.00	303635.22
2001	15688.80	143617.00	112315.00	1582.10	25161.11	43522.00	2109.00	343995.01
2002	17278.00	183388.00	139803.00	1582.10	29390.20	38329.00	3053.00	412823.30
2003	19746.00	220364.00	169771.00	1582.10	22603.00	42578.00	3880.00	480524.10

Sources: China Statistics Yearbook, China Financial Yearbook and People's Bank of China Statistics Quarterly bulletin.

Increasing Financial Depth While Imbalanced Financial Structure

Financial Deepening: M2/GDP (%)



Sources: ACFB various years and <http://www.stats.gov.cn>



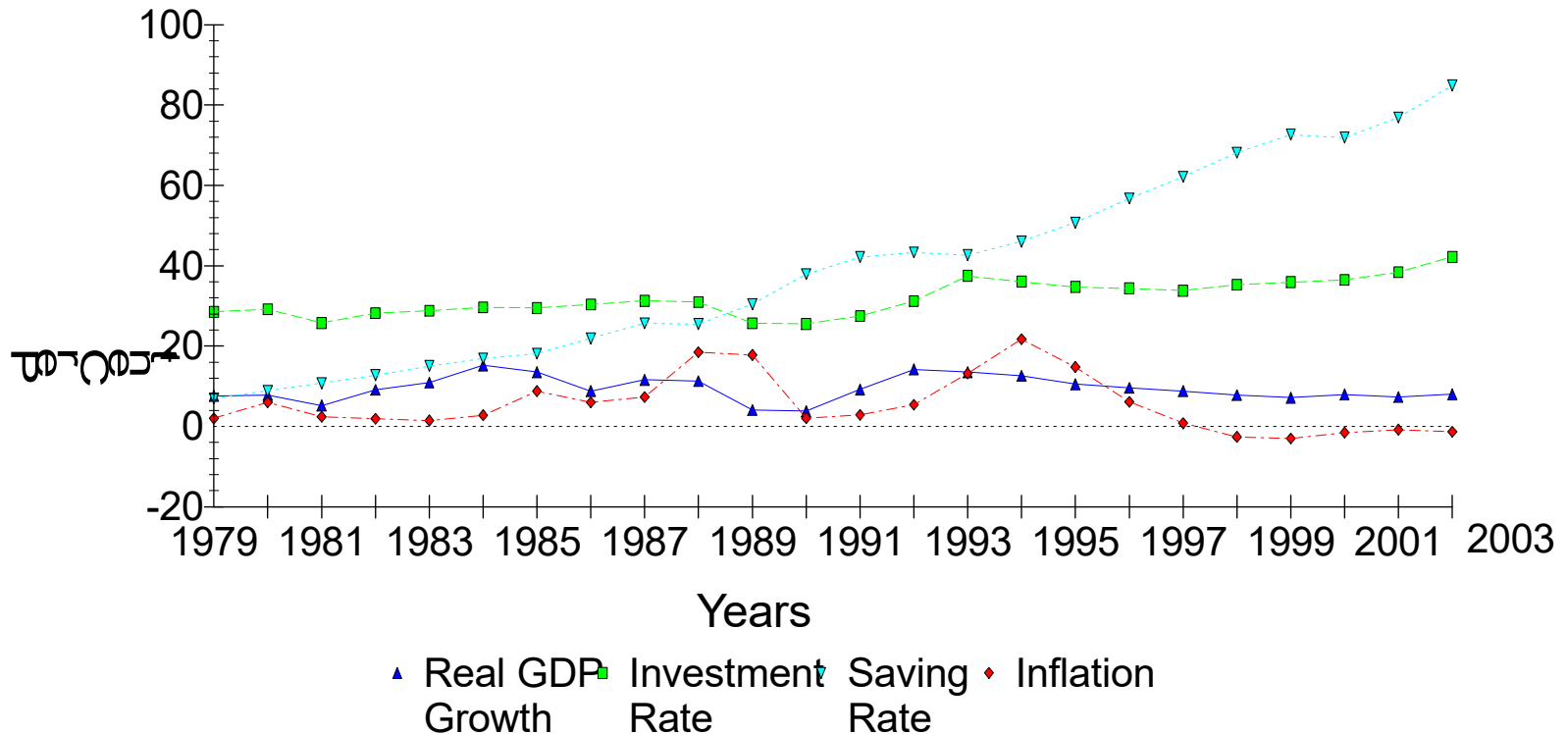
the Variation and Structure of Financial Interrelated Ratio (FIR) in China

Year	M2/GNP	L/GNP	S/GNP	FIR
1979	36.10	52.70	0.10	88.90
1981	46.00	60.40	1.20	107.60
1983	51.60	60.90	2.50	115.01
1985	57.80	70.00	3.10	130.90
1987	69.80	82.00	5.30	157.10
1989	70.60	84.90	7.40	162.90
1991	89.70	98.70	9.30	197.90
1993	91.10	95.30	19.40	205.90
1995	105.70	87.40	19.20	212.00
1997	124.40	102.40	38.20	265.10
1999	144.13	112.67	43.80	300.60

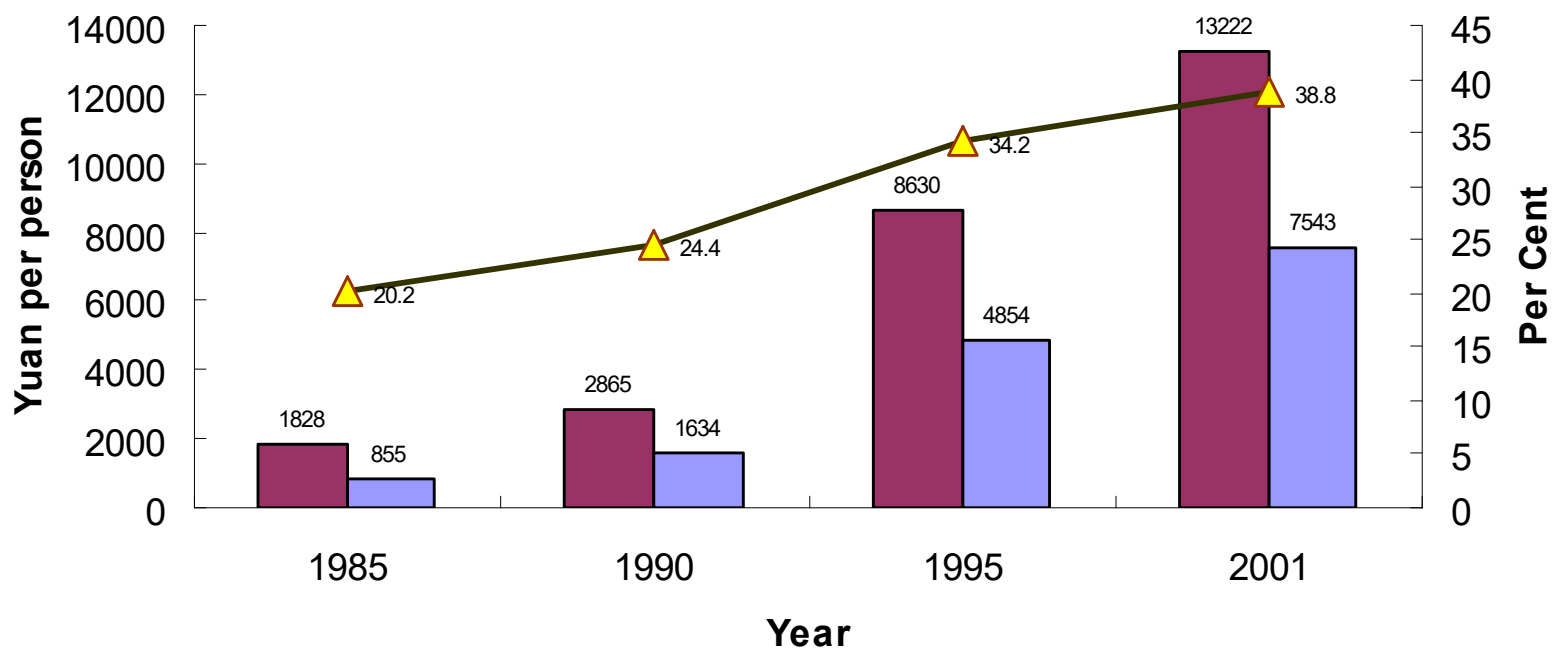
Sources: Zhang (1998).

High-speed Economic Growth but Widening Income Disparities

Real GDP Growth, Investment Rate and Saving Rate During 1978-2003



The productivity Growth in China

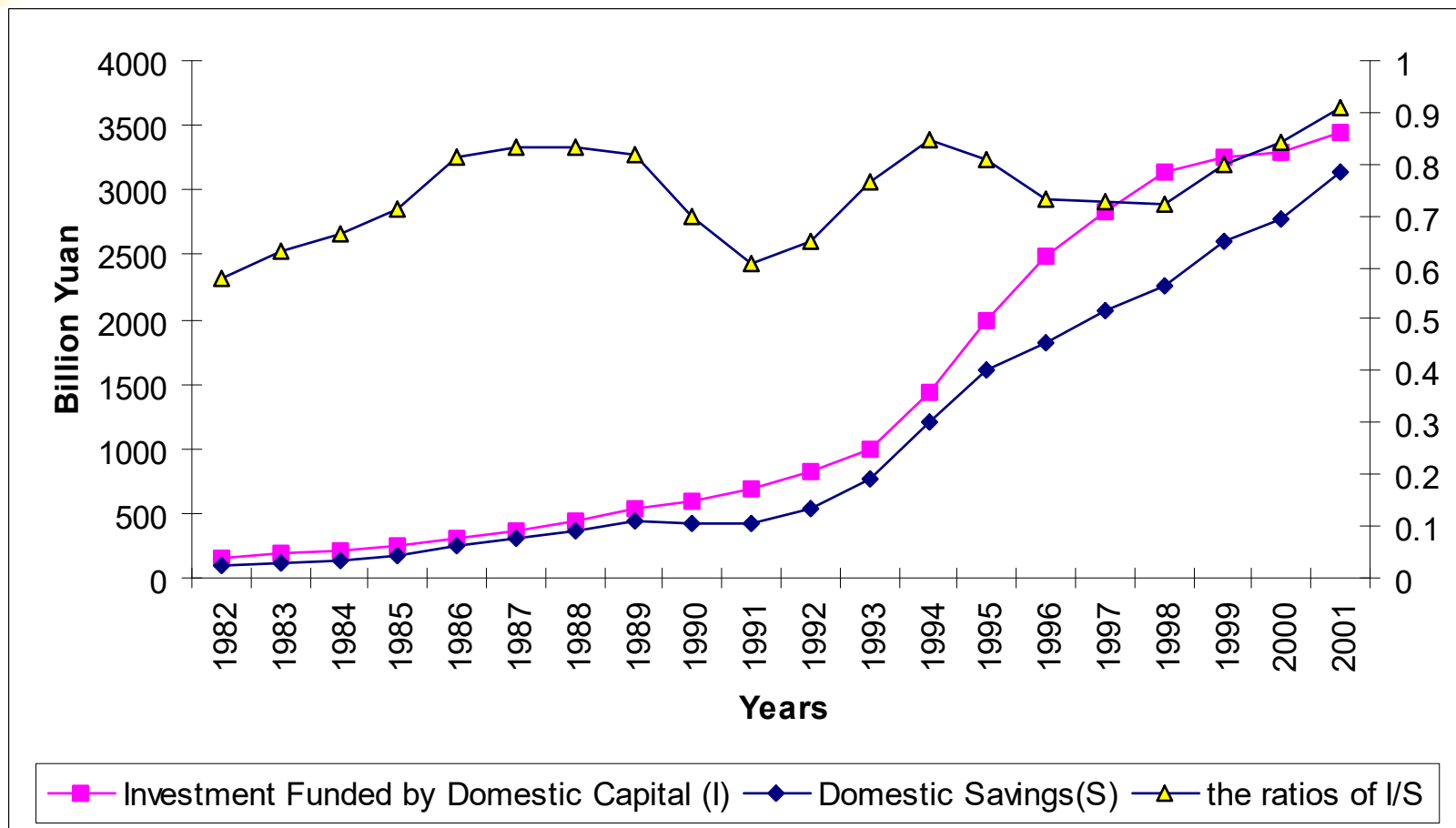


Income per person GDP per person Fixed investment/GDP (%)

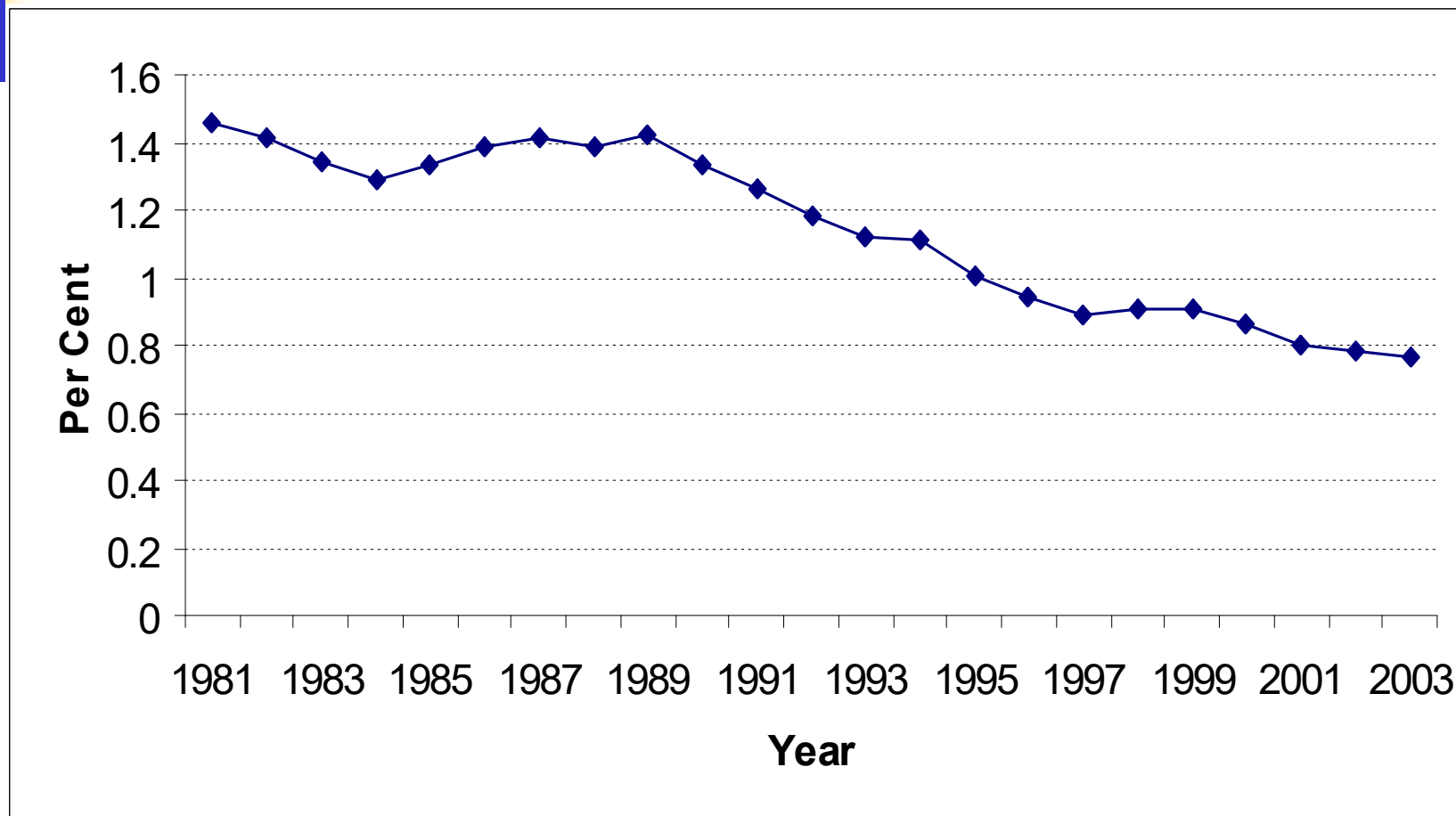
■ High Saving Rate while under-utilization

year	Government Budget		Domestic Credit		Foreign Capital		Self-owned capital and others	
	Amount	Share	Amount	Share	Amount	Share	Amount	Share
1981	269.76	28.10	122.00	12.70	36.36	3.80	532.89	55.40
1983	339.71	23.80	175.50	12.30	66.55	4.70	848.30	59.20
1985	407.80	16.00	510.27	20.10	91.48	3.60	1533.64	60.30
1987	496.64	13.10	871.98	23.00	181.97	4.80	2241.11	59.10
1989	366.05	8.30	762.98	17.30	291.08	6.60	2990.28	67.80
1991	380.43	6.80	1314.73	23.50	318.89	5.70	3580.44	64.00
1993	483.67	3.70	3071.99	23.50	954.28	7.30	8562.36	65.50
1995	621.05	3.00	4198.73	20.50	2295.89	11.20	13409.19	65.30
1997	696.74	2.80	4782.55	18.90	2683.89	10.60	17096.49	67.70
1999	1852.14	6.20	5725.93	19.20	2006.78	6.70	20169.80	67.80
2001	2546.42	6.70	7239.79	19.10	1730.73	4.60	26470.04	69.60

Under-utilization of Domestic Savings During 1982-2001



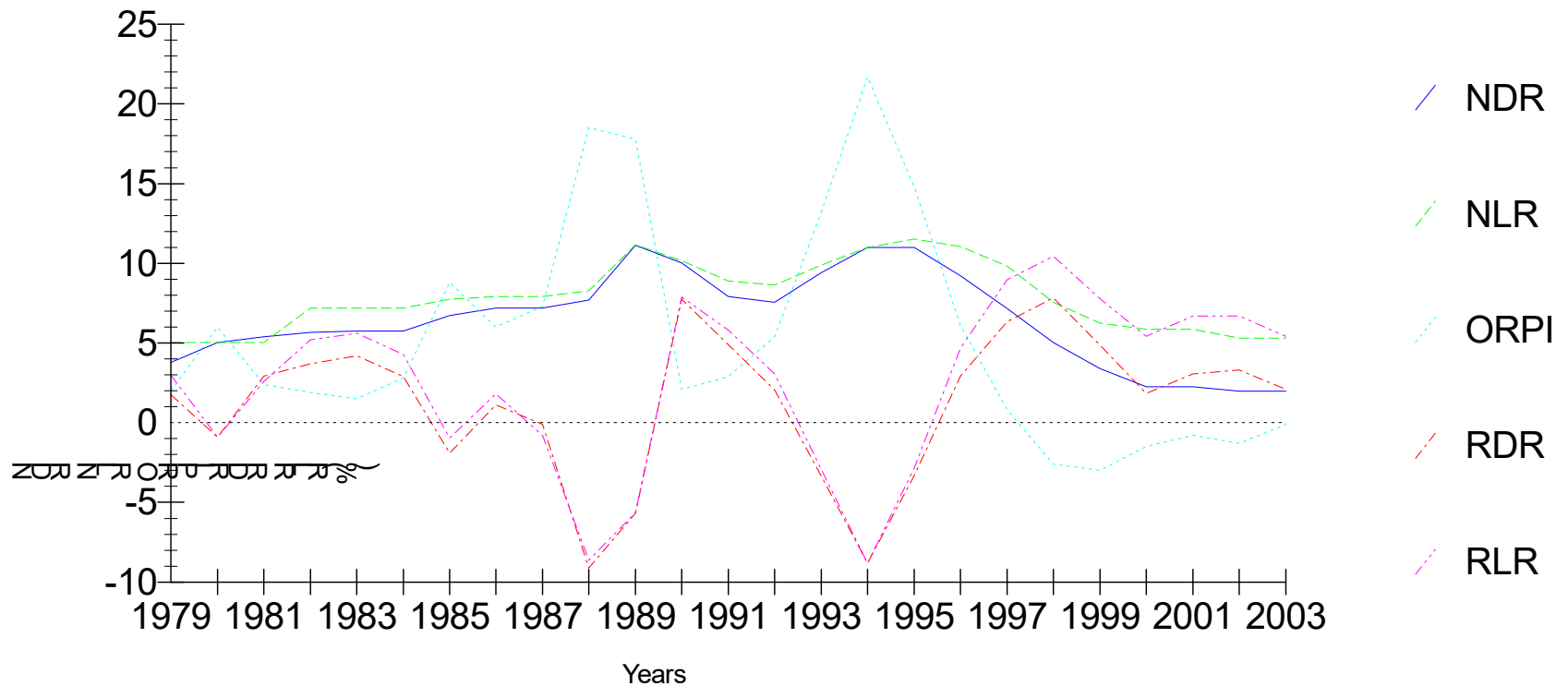
Loan-deposit Ratios During 1981-2003



3.2. Micro-evidence

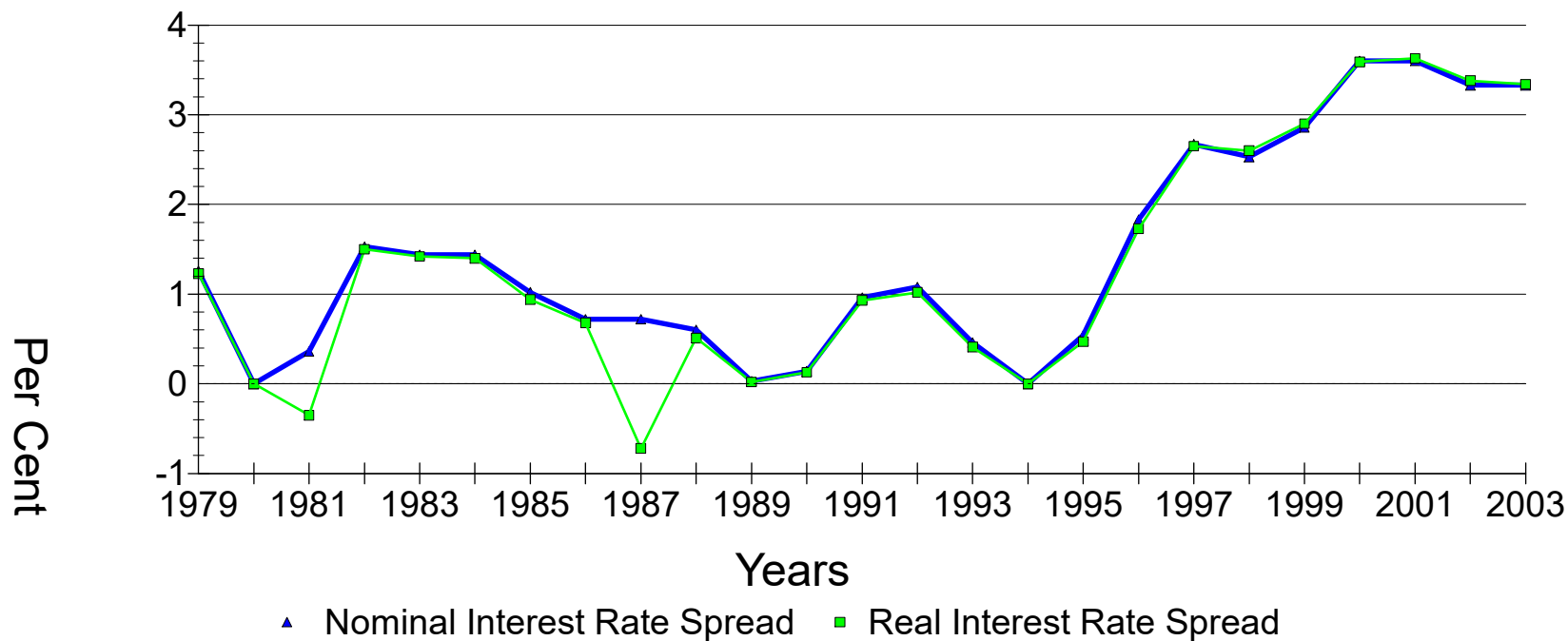
Rising Real Interest Rates

The Fluctuation of Nominal Interest Rate and Real Interest Rate



Trends of Nominal and Real Interest Rate during 1979-2003

Interest Rate Spread





Concentration in the Banking Sector and Rising Competition

The Market Share of China's Banking Sector 1994-2003

	1994	1995	1996	1997	1998	1999	2000	2001	2002	1H2003
Loans (% of Total Assets)										
SOBs	80.8	79.6	75.3	76.1	75.9	75.6	74.1	69.8	71.8	65.9
OCBs	19.2	20.4	24.7	23.9	25.1	24.4	25.9	30.2	28.2	34.1
Deposits (% of Total Assets)										
SOBs	na	na	68.7	68.9	68.7	69.5	68.4	66.8	69.9	65.7
OCBs	na	na	31.3	31.1	31.3	30.5	31.6	33.2	30.1	34.3



Herfindahl Index, 1996-2000

	1996	1997	1998	1999	2000
Herfindahl Index (deposits based)					
The number of SOBs and OCBs	14.0	16.0	19.0	20.0	17.0
The number of OCBs	10.0	12.0	15.0	16.0	13.0
SOBs and OCBs	22.8	21.3	21.0	21.1	20.4
OCBs	29.4	23.9	19.0	11.1	12.1
Herfindahl Index (asset Based)					
SOBs and OCBs	24.2	21.0	20.5	19.6	19.4
OCBs	26.9	20.2	17.8	14.6	14.7



Performance of the Banks

By measuring profitability, capital adequacy, loan-loss reserves relative to loans and NPLs, the performance and health of the financial sector has deteriorated in recent years.

- ① *poor profitability*

Profitability of the Banks

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Interest Income /Total Income (%)									
SOBs	85	97.3	96.3	97.7	97.6	96.7	96	—	—
OCBs	86.5	90	88.4	89.8	92.5	90.8	90.4	—	—
Income (%)									
SOBs	-	3.1	2.3	1.7	2.2	2.8	3.8	—	—
OCBs	7.4	7.3	9.3	6.6	5	8.6	8.4	—	—
Net Interest Income /Total Income (%)									
SOBs	3.1	1.7	1.9	2.2	2.3	1.9	1.8	—	—
OCBs	2.5	3.4	3.3	3.4	3.1	2.3	2.2	—	—
Interest Expenditure/Total Expenditure (%)									
SOBs	62	84.9	81.9	80.2	67.3	65.6	63.1	—	—
OCBs	72.5	70.4	67.3	68	60.8	59.6	55.3	—	—
Other Expenditure /Total Expenditure (%)									
SOBs	38	15.1	18.1	19.8	32.7	34.4	36.9	—	—
OCBs	27.5	29.6	32.7	32	39.2	40.4	44.7	—	—
Profit after tax/ Average Assets (ROA, %)									
SOBs	0.1	0.2	0.1	0.1	0.1	0.1	0.2	0.2	0.2
OCBs	1.8	1.7	1.6	1.4	1.2	0.8	0.6	0.4	0.3
Profit after tax/ total capital (ROE,%)									
SOBs	7.8	12.2	12.1	5.7	2.9	--	2.75	3.2	3.5
OCBs	12.2	—	--	--	--	--	11.6	11.9	11.4



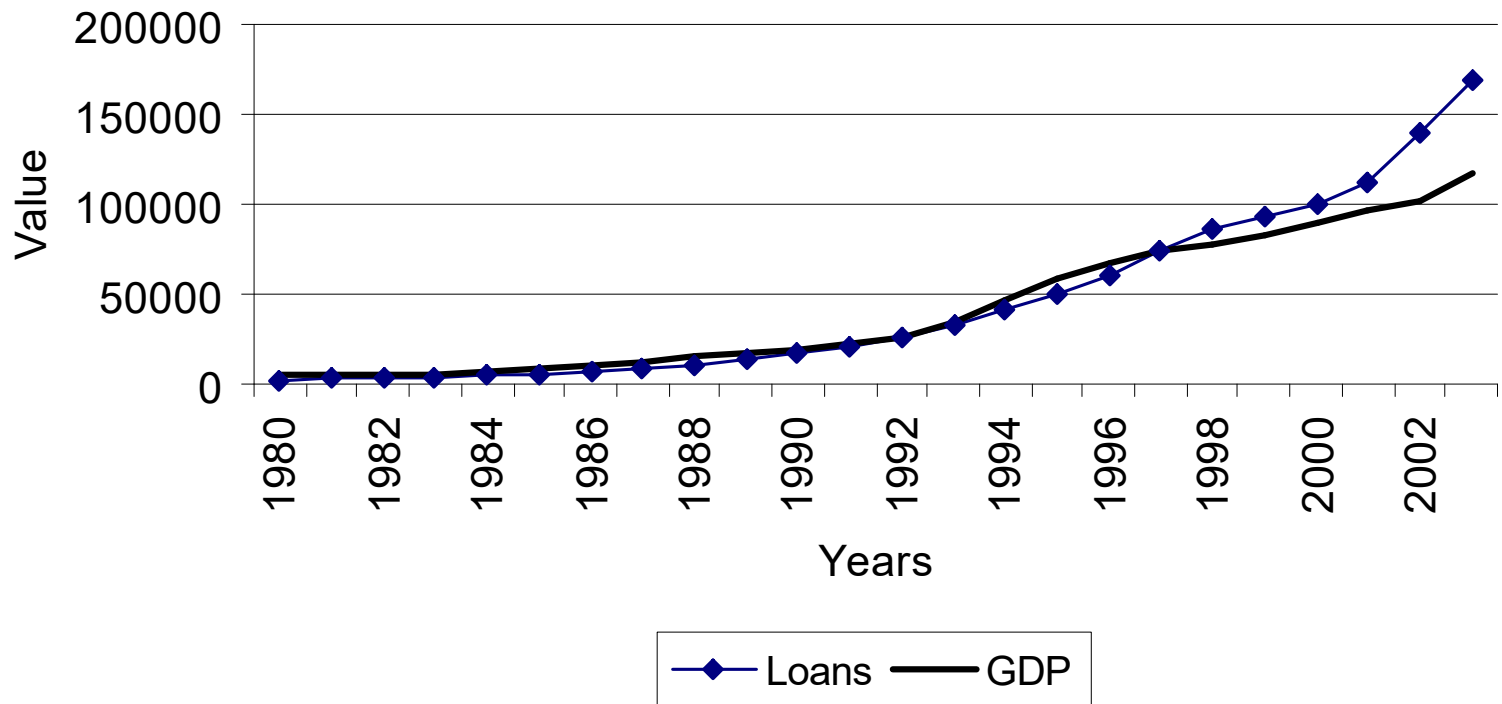
② *Low Capital Adequacy*

**Capital Adequacy Ratios and
Loan Loss Reserve**

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Capital Plus Reserve/ Total Assets (%)									
SOBs	3.5	3.3	3	3.2	5.8	5.4	5.3	--	--
OCBs	8.8	6.4	8.2	6.8	9.5	8.4	5.3	--	--
Loan Loss Reserve/Loans (%)									
SOBs	0.5	1.1	0.9	0.7	0.8	1.2	1	1.87	2.04
OCBs	0.6	0.7	0.9	1.3	1.6	1.7	1.4	3.49	2.69

③ *High NPLs*

The Growth of Total Loans and GDP in China





④ *Deficiencies of the Standard Evaluation of the SOBs' Performance*

First, the SOBs have been labeled commercial in name while different from the typical commercial banks in Western countries

Second, financial performance is a poor guide to internal efficiency.



Third, financial performance of SOBs is a poor guide to the development impact of lending.

Finally, Solely using measures of solvency such as capital adequacy ratios to determine the long-term soundness of SOBs is misleading



4. Lessons of China's Financial Sector Deregulation

(1) the poor and deteriorating performance of SOEs held back drastic financial reforms.

(2) the ownership of SOBs has not changed and the intervention by the central government in banks' resource allocation remains.



(3) the balance sheets of SOBs have remained weak.

(4) the SOBs did not follow international norms during the process of the transformation into genuine commercial banks



5. An Outlook

Some real challenges still lie ahead:

**Addressing the large amount of the
NPLs**

**Transforming the four SOBs into
genuine commercial banks**

**The competitive pressures on the SOBs
by foreign banks**

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