

Preface

China's emerging financial markets reflect the usual contrast between the country's measured approach toward policy, regulatory, and market reform, and the dynamic pace of rapid economic growth and development. But they also offer unusual challenges and opportunities. In the past five years, the pace of opening and reform has accelerated sharply. Recapitalization and partial privatization of the largest banks, and the allowance of some joint venture and branch operations for foreign financial institutions, are making rapid headway in developing and expanding financial services and improving access to domestic business and households.

This book provides the most extensive look available at the evolving Chinese financial system. It begins with alternative perspectives on the evolution of the financial system and the broad outlines of its prospects and potential contribution to economic growth.

Three articles review broad aspects of the financial system. Franklin Allen, Jun "QJ" Qian, Meijun Qian, and Mengxin Zhao lead off with overviews of the banking system and performance of the equity market and other institutions. They highlight the importance of alternative financing channels, governance mechanisms, and financial institutions and take note of the differences between this "non-traditional" sector and its more established western counterparts. Co-editor James Barth and contributors Gerard Caprio Jr., and Triphon Phumiwasana describe the growth and financial reform record of China and the sources of growth and its unbalanced nature; they also provide a history of the changing role of the financial system in promoting growth. In his essay, Albert Keidel emphasizes the dual financial system—the state-owned sector and the private sector; he explores how it has operated in the past, and the convergence problems it confronts as it transitions to a largely private approach to organizing financial firms and activity. In his view, the state-sector will remain important for at least twenty to thirty years.

In Part II, we turn to monetary policy and the foreign exchange market, with two articles on monetary policy and five on the foreign exchange market. Bernard Laurens and Rodolfo Maino from the International Monetary Fund describe the monetary policy procedures followed by the People's Bank of China and its evolution. They also provide an analysis of the direction of

future monetary and exchange rate policies. Jonathan Anderson, meanwhile, provides a sweeping overview of monetary policy, how policy is organized, the quantitative procedures employed, and the relationship of the central bank to financial markets and the future direction of monetary policy. Though similarities exist in the topical coverage of the first two articles, the different perspectives of IMF economists and Anderson, a global bank economist, generate a greater depth of understanding.

No discussion of the financial system would be complete without attention to the evolving foreign exchange regime and a discussion of the rationale for a slow approach to exiting a fixed exchange rate regime and the special problems of the current managed float. Following up on the monetary policy chapters, Priscilla Liang, Alice Ouyang, and Thomas D. Willett; co-editor John A. Tatom (two chapters); Jeffrey A. Frankel; and Jie Li, Jing Chen, and Liqing Zhang provide five analyses of China's controversial exchange rate policies and recent changes. All five chapters bear on the rationale for China's pace of rapid foreign exchange accumulation and the connection between financial opening and the freeing of the foreign exchange market. They also examine the difficulties of achieving fixed or managed exchange rates, while applying independent monetary policies and moving toward greater capital mobility. Liang, Ouyang, and Willett argue that China's currency remains substantially undervalued and that further appreciation is in the longer-run interests of both China and the rest of the world. However, they also point out that short-term and special interests provide major obstacles to needed adjustments. They note that exchange rate adjustments alone will not be sufficient to restore global balance but are an important part of the lowest-cost policy mix for doing so. Tatom focuses on the role of exchange rate stability in providing a nominal anchor to monetary policy. He argues that the exchange rate is not undervalued—but if it were, it could be corrected by inflation, without taking the risk of currency appreciation, capital inflows, and reversals. Frankel provides a useful new method to assess the changing exchange rate regime. He simultaneously estimates weights in a currency basket and a changing degree of flexibility of an exchange rate with a single currency anchor. He argues that, since mid-2007, the appreciation of the yuan against the dollar does not reflect new flexibility or an upward trend of the currency against its basket but rather an increasing weight of the euro in the Chinese currency basket. Thus, appreciation against the dollar reflects the appreciation of the euro against the dollar. In his second chapter, Tatom notes the role of capital outflow restrictions in preventing a managed exchange rate regime without creating inflation, financial repression, and banking sector losses. Li, Chen and Zhang trace the origins of pressures on China to build relatively large foreign exchange position, especially the role of the 1997–1998 Asian financial crisis. They explain the response of reserve hoarding and managed appreciation as responses to the demand for a new international financial architecture, and attempt to determine the criteria for

establishing an appropriate reserve level or for determining when reserves are truly excessive.

Part III presents six chapters on banking and bank regulation, including a review of the prospects for a regulatory approach to ensure access to banking services for such a large and diverse population and geography. The section leads off with a chapter by Allen Berger, Iftekhar Hasan, and Mingming Zhou, who examine the increasingly important role of minority foreign ownership of banking firms in China, and the importance for diversification, efficiency, and profitability of Chinese banks. They highlight the structural change in ownership patterns and its permanence, as well as the contribution of the new regulatory strategy to banking sector development. Tong Li reviews the current state of non-performing loans in China and the prospects for improvement in banking performance. The state created detailed mechanisms to deal with this problem in 1999, but problem loans did not end then. Moreover, the process of trying to deal with “toxic assets” is continuing. Richard C. K. Burdekin and Ran Tao provide an analysis of the bank loan growth, lending patterns, and performance among the largest state-owned banks, both before and after their initial public offerings in 2005–2006. Chung-Hua Shen, Qi Liang, and Xiang-Chao Hao study the determinants of location choice of foreign banks, in particular the role of market opportunity, labor cost and IT infrastructure. Perry Wong and Diehang Zheng review the impact of bank lending on housing prices, which is a widely noted linkage in developed and other developing countries. China has experienced some booms in housing prices in selected areas, and Wong and Zheng find that the link to bank lending is also critical in influencing these developments in China. Yufeng Gong and Zhongfei Zhou examine the role of regulations in improving access to banking services in China. They discuss the efforts of regulators to improve financial services for low-income and rural populations as part of a decades-long agenda of reducing poverty. A common theme of these chapters is the assessment of the inefficiencies of past and current bank regulation and the prospects for reform as China moves toward taking up its role as a global competitor in financial services with a strong, stable, and predictable currency.

Part IV provides a detailed look at the bond and equity markets. Haizhou Huang and Ning Zhu take a close look at the development of China’s modern bond market, and its prospects for success. Chung-Hsing Chen of Xinhua Finance provides an update on the Chinese capital markets, focusing on developments in the securities market. Chen describes the state of securitization on China and its prospects and current constraints. His update is followed by Jie Gan’s look at the development of privatization of state-owned companies and how that has proceeded in equity markets. Chen Lin, Clement Chun-Yau Shum, and Sonia Man-Lai Wong explain the importance and emergence of shareholder protection on China, and the prospects for further enhancement of shareholder rights. In the fifth chapter in this section, Honghui (David) Cao and Huazhao Liu examine the issues of segmented share markets and the impact of reform on the market behavior of large shareholders.

In the final chapter in the book, co-editor Tatom returns to the issue of growth and global convergence in China. A common theme throughout this book is the role of institutions in promoting efficiency, competitiveness, and growth in financial markets, and in the overall economy. Policy makers and market efforts to improve the functioning of markets will be key to China's leadership in the world economy and in its financial markets. China is the second largest economy in Asia and the largest of the emerging markets in Asia or the rest of the world. The country's recent progress and its continuing economic development suggest that China, and Shanghai in particular, could rival Asia's other financial centers within a decade or so—and could become the dominant financial center in Asia, perhaps rivaling the top tier of the world's leading financial centers. The analysis of the current state of the Chinese financial market and of the challenges and opportunities facing policy makers and industry leaders frame the issue of these possibilities.

This book is the eighth in the Milken Institute Series on Financial Innovation and Economic Growth. It is an outgrowth of a conference, "China: A Two-way Street," jointly sponsored by Indiana State University, Liaoning University, and Networks Financial Institute on January 24–25, 2007. The volume includes three updated papers by two of the co-editors, and a paper by Albert Keidel, that were presented at the conference or written for it. As a result of the success of the conference, the editors agreed that a more comprehensive look at China's financial markets was necessary and would be valuable to scholars, students, and policy makers in assessing the unique features of the Chinese financial system, the challenges it faces, and the opportunities that financial sector development present. The result brings together the ideas and analyses of 41 financial and policy experts, including scholars, industry and government advisers and leaders, and experts from international institutions. More than half of the contributors are Chinese and have had the advantage of front-row seats in the emerging Chinese financial markets and an understanding of the players and the process of change that is more difficult for outside analysts to obtain.

The editors are extremely grateful for the excellent assistance provided by Wenling Lu in the preparation of this book.

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<http://www.springer.com/978-0-387-93768-7>

China's Emerging Financial Markets

Challenges and Opportunities

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2009, XXII, 658 p., Hardcover

ISBN: 978-0-387-93768-7