Financial Sector Reform in China*

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Abstract

China currently maintains an exchange rate fixed against the US dollar and a (relatively) closed capital account, while exercising an independent, controlled interest rate environment. Domestic and international pressures have been mounting for the Chinese government to re-adjust the currency peg or allow more flexibility in the exchange rate and to free up the capital account to foster greater integration with global markets. Given the need for developing a more mature financial system to meet the needs of a growing market economy and with unrestricted foreign bank entry in 2007, there is also a need for less regulated and more market driven interest rates. To the extent that authorities seek to maintain exchange rate stability while easing capital controls, they must forsake monetary independence. This is the so-called macroeconomic policy “trilemma” constraining macroeconomic policy makers generally. The need for continuing reform of China’s currently fragile domestic banking system further influences the nature and timing of policy options. This paper reviews recent macroeconomic management performance in China and assesses the options facing policy makers for reform of the financial system given the current environment and subject to the constraint of existing institutional arrangements.

Keywords: China, banking, financial repression, exchange rate, capital

JEL Classification: G2, O16, E44

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Introduction

The Chinese financial system can be characterised as “over-banked”. The four large state owned commercial banks are largely responsible for deposit gathering and on-lending of China’s massive pool of household savings. Business funding is dominated by bank lending, with equity and debt markets poorly developed in China. The financial system is “repressed”, with caps maintained on artificially low interest rates and directed credit allocation, historically to the large, inefficient state owned enterprise (SOE) sector. Foreign banks, to date, have played only a small role in local currency business and in dealings with Chinese household and corporations. One result of this approach has been an inefficient and low profitability banking sector beset with high levels of non performing loans (NPLs). Capital controls, which had been planned to be liberalised in the late 1990s, have been kept relatively tight to help protect the fragile financial system and provide time for restructuring. There is also an urgency to this due to the full national treatment to be offered to foreign banks in 2007 under China’s WTO accession agreement.

Although extensive regulatory and prudential reforms have been cautiously instituted, along with moves to manage the NPL problem and commercialise the sector with greater involvement of the private sector and foreign institutions, there are pressing issues related to management of the macroeconomic policy environment which need to be addressed in China in order to achieve greater development of the financial sector.

Although interest rate levels were adjusted in October 2004 for the first time in nine years, the question of establishing the necessary conditions for conducting an effective monetary policy and allowing market determined interest rates looms large. As well, the interaction of strong inflows of foreign direct investment (FDI) and a growing trade surplus with capital controls has seen a massive build-up in China’s levels of foreign reserves over
the past few years. This has raised the issue of China’s pegged exchange rate (to the USD) and the extent and impact of an undervalued yuan. Foreign government pressure, primarily from the United States (US) along with sizeable speculative capital inflow (despite the controls in place) in anticipation of a possible revaluation by authorities, have added to this debate on China’s currency policy.

In assessing the relative merits of adjusting its exchange rate policy, liberalising the capital account and introducing a more market based interest rate regime, cognisance must be made of the constraints of the so-called policy “trilemma” facing policy makers generally. It is not possible to simultaneously conduct an independent monetary policy, maintain an open capital account and peg the exchange rate. Only two of the three choices are possible. In seeking to develop its financial sector and integrate the economy more into the global market place, the Chinese government has recognised the need for changes in these policy areas, but the trade-offs along with questions of timing and sequencing of reforms must be carefully addressed.

The following section of this paper reviews the macroeconomic policy framework and institutional arrangements which have shaped the current economic macroeconomic environment. This is followed by a section outlining the current macroeconomic situation in China and the implications this presents for ongoing reform in the financial sector. Policy options with respect to the exchange rate, liberalising the capital account and deregulating interest rates are then discussed in light of above considerations.
Macroeconomic Institutional Arrangements and Policy Framework

Since the opening up of the Chinese economy in 1979, the evolution of macroeconomic policy has been shaped by the institutional features and political realities facing policy makers. In turn, the economic environment that has emerged constrains and influences the nature and extent of policy changes that are needed in an increasingly globalised economy.

The macroeconomic environment in China is characterised by an officially closed capital account, a currency pegged to the USD, and what can be characterised as a repressed financial system: a system of directed bank credit, domestic credit controls, restrictions on borrowing and lending abroad and foreign bank entry, and regulated interest rates (McKinnon 1991; Heffernan, 2005).

While this financial repression has been aimed at limiting volatility and offering protection to a weak banking sector, in such situations the role of the financial system is greatly impaired, with savings decisions of investors distorted and allocation of capital tending to be inefficient with low quality investments widespread. Controlled interest rates make it difficult to price loans to reflect risk and has been a disadvantage to small and medium enterprises (SMEs) and new firms in the private sector, with SOEs in China favoured by the directed credit policy.

In China the result of such policies can be seen in an “overbanked” economy, a reliance on an immature bank-based capital market with weakly developed equity and debt markets, the establishment of a sizeable informal market as a source of funds and high levels of bad debts in the banking system.
By most measures the banking system in China is quite large, with the banks playing a significant role in intermediation reflecting a very high domestic savings rate, the lack of alternative assets for local investors and capital account restrictions which further limit investment opportunities (Prasad, 2004).

China’s banking system collects the bulk of China’s huge pool of domestic savings, equivalent to around 40 per cent of GDP (Asian Development Bank, 2004). In the mid-1990s, about 85 per cent of the total financial assets of households was held in bank deposits (Huang, 2003). By 2004 the figure was still 77 per cent which can be compared to a level of 26 per cent in the United States. The share of households in total savings is 70 per cent, with about half of China’s population having bank accounts.

China has bank lending currently equal to around 140 per cent of GDP, more than twice the levels observed in most industrial countries, as a result of official lending policies and what has been a lack of accountability and regulation generally in the financial system (Lee, 2004). The figure a decade earlier was 88 per cent (Chong, 2004).

The big four state owned commercial banks in China control about 70 per cent of bank deposits and make about 70 per cent of loans, accounting for 60 per cent of corporate financing in China, all of which tends to be done on a bilateral loan basis (Mellor, 2004; de Terra, 2004). SOEs account for 80 per cent of outstanding loans while producing just one third of output (The Economist, 2004a). This has resulted in the proliferation of informal and illegal banking activities and has created great difficulty for private companies in China.

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1 The level of intermediation by Chinese banks, as measured by M2/GDP, is amongst the highest in the world (Bonin and Huang, 2002). The ratio was 1.9 at the end of 2004 (Prasad and Wei, 2005). The high propensity of Chinese households to save which has underpinned the rapid growth of the Chinese banking system over the last decade reflects not only the lack of choices for investors, but also the periodic indexation of time deposit rates and a general labour market uncertainty linked to a trust in the stability of what is effectively a government-backed banking system. China’s savings more than doubled from 1997 to 2002 (Standard and Poors, 2004).
2 China’s savings more than doubled from 1997 to 2002 (Standard and Poors, 2004).
3 China has almost no companies with foreign currency debts.
to access credit. In the first quarter of 2005, bank lending (although down slightly overall) accounted for 99 per cent of business financing, reflecting a slump in an already moribund stock market and a reduction in offerings of government construction bonds.

Extensive reforms have been instituted in recent years to address many of the failings in the financial system. An important step has been a new regulatory regime for bank lending, a shift from a funds constraint to what is viewed as a capital constraint. Traditionally the banks have simply collected deposits and made (directed) loans. The main constraint was to ensure loans did not exceed a prudent proportion of deposits (around 75 per cent). This encouraged the development of a large scale deposit gathering network, a relationship-driven push for deposits and rapid growth of loans, with little attention to loan quality or profitability of asset growth. The result over the 1980s and 1990s was periodic boom-bust credit cycles and economic overheating.

The new regulations, from March 2004, require banks to meet a target of 8 per cent of total capital adequacy and 4 per cent of core capital adequacy by January 2007. These moves will remove a bias in lending towards the state sector.

A worrying result of the concentration of lending to the SOEs has been the burgeoning NPLs of the bank sector, particularly the commercial banks. Estimates vary, although there is agreement that levels have come down due to a mix of measures, including a shift of bad assets from banks to specially created asset management companies (AMCs), recapitalisation of balance sheets by government and through an expansion of new lending. Officially the level as of the end of 2004 was given as 13.2 per cent overall (and 15.6 per cent for the commercial banks), although Standard and Poors suggest a level of 35 per cent, excluding loans transferred to the AMCs and which are still part of public sector holdings (The Economist, 2005a; Mellor, 2004). This latter figure translates to around 45 per cent of GDP.

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4The difficulty in accessing bank finance has lead to firms seeking alternative funding avenues, a particularly
significant when compared to the bail-out of the S&Ls in the US which was equivalent to 4 per cent of GDP and the level of NPLs in Thailand in 1997 of 25 per cent (Kuo and Subler, 2004).

Under current arrangements and the lack of flexibility, the banks in China rely to an inordinate degree on net interest income from their borrowing and lending activities. This has been put as high as 90 per cent of total income (Liping, 2001). Even though the big four are ranked in the top 40 banks in the world (based on assets), they are not in the top 700 in terms of return on assets (The Banker, 2003). Profitability is a problem not only because of the lack of income options, but also because of the cost structure of the banking system.

Funds raised through the stock market corporate bond issuances are relatively small in China. Lending in 2003 was equivalent to about 26 per cent of GDP, compared to 1 per cent and 0.3 per cent of GDP raised on the stock market and via bonds respectively (Prasad, 2004). At the start of 2004 the capitalisation of the stock market was around 37 per cent (Lee, 2004). Access to the domestic bond market in China is restricted and bureaucratic. Corporate bond issues in 2003 were only around 45.2 billion Renminbi (RMB), compared to 8.9 billion in 2000 (de Terra, 2005). In 2004 the Chinese government bond market was worth around USD 500 billion equivalent, compared to an estimated US Treasury market of USD 8 trillion.6

Interest rate regulation and directed lending policies have resulted in increasing amounts of loans flowing out of the bank sector to the private loans market to meet the needs of SMEs and private enterprises (and more recently to the property market, fuelling a speculative bubble). One estimate suggests that around 0.8 to 1.2 per cent of GDP was diverted to the underground capital markets over a period of two months in 2004 (Ting, 5 The extent to which new lending has sown the seeds for increased NPLs in the future remains a concern. 6 In a well functioning financial market, the bond and equity markets impose fiscal discipline on firms and provide an alternative source of funds. Secondary trading in equity markets also helps information flows. The bond market provides a range of instruments to meet varying liquidity needs of companies and government.
While there are no precise measures available for the size of China’s informal market, some reports suggest that in some cities it is larger than the formal banking system. The China Daily in late 2004 reported that informal lending in Wenghou, Zhejiang Province, had reached 670 billion, increasing 23 per cent over a 12 month period. Based on this figure, the national market would be equal to at least 20-30 per cent of GDP. The diversion of funds from the banks undermines attempts by authorities to control lending in the absence of an effective monetary policy framework.

An over-riding concern for authorities in China is the health and stability of the banking sector, with the result that financial market reform is proceeding cautiously, notwithstanding the growing need for channels of capital (alternatives to bank financing) to be developed. In the current environment authorities are seeking to curb bank credit to restrain overinvestment in some sectors of the economy, manage the current (and potentially growing) NPL problem and create a sound financial system able to cope with the unfettered entry of foreign banks in 2007 under China’s WTO accession agreement. These concerns go to the heart of the major macroeconomic policy issues facing China.

As discussed below, a compounding issue for macroeconomic management is the interaction of the fixed exchange rate with strong export growth and capital inflow. A significant build-up in reserves has accentuated the problem of liquidity management, and raised concerns as to extent of currency misalignment and an optimal exchange rate policy. A related policy matter is China’s continued tight control on capital account transactions, despite recent, limited moves to free up capital flows. There is concern, for example, that greater freedom could, in the present climate, exacerbate currency pressures. Conversely,

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7 Underground banks pay around 7 to 10 per cent on deposits and charge around 10 to 20 per cent on loans.
8 Large outflows of bank deposits to the informal sector have resulted also from the existence of negative interest rates. For example, prior to the policy shift on rates in October 2004, deposits yielded 1.7 per cent compared to an inflation rate at the time of around 5.3 per cent.
there is a view that the full national treatment of foreign banks in the context of liberalising interest rates and/or an opening up of the capital account could precipitate a major crisis for domestic banks through a dramatic loss of funds. Meanwhile, external pressures are being brought to bear with respect to the exchange rate regime in China, quite apart from any considerations as to what is desirable from a domestic economy viewpoint.

The following section briefly reviews the current macroeconomic situation in China, highlighting those areas which are important in considering China’s resolution of its macroeconomic policy “trilemma” (Taylor and Obstfeld, 2003; Taylor, 2004). It is not possible to simultaneously conduct an independent monetary policy, maintain an open capital account and peg the exchange rate. Only two of the three choices are possible. China’s position is also viewed in the context of its external relations, particularly with the US. In view of the policy constraints, options with respect to the exchange rate, interest rate deregulation and the capital account are then assessed, with attention to the matter of timing and sequencing of policy changes.

**China’s Current Macro-economic Environment**

There was little capital inflow into China until the mid 1980s. Bank lending was the largest share of inflows over the 1980s although FDI was slowly growing in importance to its current dominant position (Thorpe, 2004). With regard to external debt, there has been little sovereign borrowing overseas until recently and SOEs have been discouraged from this market. While the external debt to GDP ratio has been stable for some time at around 15 per cent, the share that is short term has risen dramatically over the past few years. Currently it is

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9 An integral part of moves to improve the health of the banking system has been the introduction of greater regulatory and prudential controls and ongoing efforts to encourage foreign partnerships in local banks and the public listing of several of the major commercial banks in Hong Kong, commencing in late 2005.
around 45 per cent which does suggest some need for monitoring, although this figure does reflect sizeable levels of trade credits (Prasad and Wei, 2005).\(^\text{10}\)

The fixed exchange rate in concert with restrictions on capital outflows has meant that over the last several years, as a result of the surge inward foreign direct investment a growing trade surplus, the People’s Bank of China (PBOC) has had to buy up significant amounts of foreign currency in exchange for local currency (Table 1).\(^\text{11}\) This has been exacerbated by a significant rise in speculative capital inflows (despite tight restrictions). As a result, since 2001 foreign exchange reserves have ballooned (Hu, 2004a). Currently they stand at around 40 per cent of GDP, second only to Japan.\(^\text{12}\) While an earlier rise over 1994-1997 reflected FDI inflows, there was a decline in the rate of increase up to 2000 following the Asian crisis. The recent spurt reflects continuing FDI flows, an export boom and significant levels of speculative capital inflow—withstanding the capital controls in place (Ryan, 2004).\(^\text{13}\) About half of the increase in international reserves in 2003 can be accounted for by non-FDI capital inflows (Prasad and Wei, 2005). Reserves are rising at the equivalent of USD 17 billion a month (The Economist, 2005b). Around two thirds of China’s reserves are held in USDs, especially Treasury bonds.\(^\text{14}\) Given that China’s share of trade with the US, Japan and the EU is 36.5, 28.6 and 37.4 per cent respectively, the USD would seem to be currently overweighted in China’s reserves. US treasury bonds also earn around a relatively low 2 per

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\(^\text{10}\) The external debt picture also needs to be viewed in the context of any revaluation of the RMB, which would have a beneficial valuation effect.

\(^\text{11}\) China’s trade surplus in 2004 was around USD 40 billion. On services trade, China had a deficit for the year of USD 11 billion (WTO, 2005)

\(^\text{12}\) The eight major central banks in East Asia (excluding China) have amassed around USD 2.4 trillion in foreign exchange reserves (Goldstein and Lardy, 2005).

\(^\text{13}\) The fact that the flows are not larger is perhaps indicative that the capital controls on inflows are, in fact, relatively effective (Prasad and Wei, 2005). FDI outflows are still small although they have increased in recent years due to government support. These are primarily linked to raw material supply and upstream products for importing and processing.

\(^\text{14}\) China’s U.S. Treasuries holdings reached US$191.1 billion at the end of 2004, an increase of USD 4.4 billion from a month earlier, according to data released in January 2005 by the U.S. Treasury Department. This represented a third of the total USD 542.44 billion holdings in China’s foreign exchange reserves at the time (Diyi Caijing Ribao, 2005). The country’s actual holding of U.S. government debt is higher because its central bank has other investments through the Asian Development Bank and other institutions, which makes it difficult to arrive at an accurate number for the total value of U.S. Treasuries China holds.
cent. As discussed below, moves by China to diversify the composition of its reserves would have implications for the US economy.

The increase in inflows of short-term capital has stemmed from investors taking advantage of relatively higher interest rates in China and speculating on a revaluation. Capital controls on inflows have been circumvented in numerous ways including under-invoicing of export contracts, over-invoicing of import contracts, offshore borrowing by Chinese firms and households (including accessing of foreign currency credit cards of foreign banks), transfer pricing, leads and lags in settling contracts, varying terms on short term trade credits, savings remittances and tourist expenditures.\textsuperscript{15} Foreign banks have also been motivated to borrow offshore and lend to FIEs, mostly in RMB. To help curb this inflow, foreign banks are now subject to quotas on this borrowing, squeezing their source of funds and increasing their costs as they are forced to borrow domestically (www.chinaonline, 2004).

Overall, such flows might be expected to continue if expectations do not change and if current interest rate differentials remain. Thus the pressure on the authorities is likely to continue to build, requiring an effective circuit breaker as regards exchange rate policy.

The surge in reserves has pumped money into the domestic economy, although the PBOC has sterilised the inflow to some extent by borrowing from the banking system. In 2004 authorities drained two thirds of the increase in reserves via sterilisation. With more than 1 trillion RMB worth of bonds outstanding in China, sterilisation may be reaching its limits as commercial banks, who are the main buyers of government bonds, become reluctant to remain active in the market. Sterilisation also has a fiscal cost in that the rate of return on domestic (sterilisation) instruments is less than that earned on foreign reserve holdings.

\textsuperscript{15} Early collection of export receipts and increased use of trade credit for imports are consistent with an expected revaluation.
However controls on capital outflows (to alternative assets) and interest rate controls have served to facilitate sterilisation and contain the cost.\textsuperscript{16}

The resultant leakage into the economy helped fuel a rapid growth in money supply and subsequent credit expansion over 2003 and 2004.\textsuperscript{17} Growth of 40 per cent in fixed asset investment during 2003 caused overheating in some areas, with excessive lending blamed for soaring real estate prices and excess capacity in aluminium, cement, automobile and steel plants. As well, rapid expansion in production, especially by Chinese firms supplying the domestic market, has generated an accumulating surplus of manufactured goods leading to fears in some quarters of a future deflation. Supply gluts are a particular concern, seen as a potentially trigger for severe financial crisis. This has been driven not only by the ease of access to loanable funds but by poor lending decisions. Power generation, meanwhile has been running up against capacity constraints, with the investment boom causing shortages. Overinvestment has also clogged transport links and driven up raw material prices. Rapid expansion in automotive sector, steel, aluminium and construction materials has lead to serious overcapacity, with growth in some areas being choked by energy shortages. A general inefficiency in energy, land and capital usage resulted along with soaring raw material prices. Inflation also started to rise in mid 2004 as soaring costs fed into the prices of many consumer goods.

\textsuperscript{16} The government has also used the reserves to shore up the balance sheets of the major banks in recent years. This could become more important if the level of NPLs rises.

\textsuperscript{17} In 2003 the money supply rose by 20 per cent with bank lending up by 21 per cent on year earlier figures, with much of this going to low quality investment (Holland, 2004). Over the first quarter of 2004 lending by the commercial banks grew at an annual rate of around 21 per cent (with money supply growing at 19.2 per cent), feeding a growth in fixed asset investment of 43 per cent.
## Table 1

### Key Macroeconomic Indicators - China

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<tr>
<td><strong>FX Reserves (USD billion)</strong></td>
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<td><strong>Budget Balance (% GDP)</strong></td>
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<td><strong>External Debt (% GDP)</strong></td>
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<td>(10%)*</td>
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<td><strong>CPI (% pa)</strong></td>
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<td><strong>GDP Growth (% pa)</strong></td>
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<td><strong>M2 Growth (% pa)</strong></td>
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<td><strong>Credit Growth (% pa)</strong></td>
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<td><strong>Current Account Balance (% GDP)</strong></td>
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<td><strong>Trade Growth (% pa)</strong></td>
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<td>7.5</td>
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<tr>
<td><strong>FDI (Net Inflows) (USD billion)</strong></td>
<td>40.7</td>
<td>46.8</td>
<td>52.7</td>
<td>53.5</td>
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* Per cent of total external debt which is short-term.

# First four months.


Commencing in 2004, government instituted a range of policies to curb overinvestment in which had raised fears on inflation and concerns of a speculative bubble in real estate. The PBOC raised bank capital adequacy ratios and applied administrative lending controls to fast growing areas while publicly calling on banks to push more loans towards coal production, power generation and transport projects (Dolven, 2004; Lee, 2004; Wonacott and Wu, 2004).\(^{18}\) By the third quarter 2004, authorities had managed to control the growth in credit, but the experience has served to highlight again the cost of not having a more independent monetary policy.

This situation brings into sharp focus the difficulties for policy makers. The boom in China into mid-2004 has been lead by investment, resulting in strong growth in supply and also demand, but not a balanced outcome. Rather than “overheating” per se, the problem is overinvestment. Meanwhile the government is also seeking to switch public spending away

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\(^{18}\) In April 2004, the PBOC announced that most banks will be required to hold reserves equal to at least 7.5 per cent of outstanding loans and other capital commitments (a rise of 0.5 per cent). For some weaker banks the level was set at 8 per cent.
from areas stimulating demand towards support for reform in other areas of the public sector including social security, science and technology and wage support.

The use of targeted credit and administrative (quantitative) controls appears to be a preferred policy approach, albeit with some limited market measures, in the absence of a flexible exchange rate and a liberalised interest rate regime. Some mortgage rates and rates on car loans, for example, were raised in May of 2004 by banks and price caps have been imposed by authorities in some inflationary sectors, along with the curbs on lending to key overheating (Chung and Wu, 2004). Measures to rein in steel prices have included government moves to scrap rebates on some steel exports, restricting access to imported raw materials for some producers and imposition of tighter land controls. Government control throughout the whole production and distribution process for energy has exacerbated problems (Ng, 2005). Other measures aimed at controlling credit expansion include allowing exporters to retain foreign exchange earnings, giving Chinese institutions greater freedom to invest abroad and removing some export subsidies and import restrictions.

Other measures aimed at controlling credit expansion include allowing exporters to retain foreign exchange earnings, giving Chinese institutions greater freedom to invest abroad and removing some export subsidies and import restrictions. The approaches taken reflect the lack of sophistication in the Chinese authority’s ability to manage the financial system at present and a preference for direct controls. China has limited experience with the use of monetary policy. Interest rates had been fixed for nine years (until the adjustment in October 2004) and so the extent to which the economy responds to interest rate changes is still somewhat uncertain.

The Chinese decision to increase interest rates in October 2004 saw a rise in lending rates of 27 basis points on loans with a one year maturity to 5.58 per cent while deposit yields rose to 2.25 per cent from 1.98 per cent. Banks also now have more flexibility in pricing loans
with a longer maturity than one year. While lending rates are restricted to no less than 0.9 times the official rate, the cap on lending at more than 1.7 times the official rate has been scrapped. In the past banks were charging about 9 per cent compared to interest rates of 15-20 per cent prevailing in China’s informal lending market. The changes give lenders more freedom to fix loan rates and to take lending risk into greater account.\textsuperscript{19} This decision to raise interest rates suggests that the government recognises the need to change the cost of capital, not just fine tune access to lending through controls. The fact, however, that interest rate adjustments to date have been limited reflects a continued caution regarding the use of market prices in place of administrative guidance to control credit.

**Policy Options**

**External Pressures**

In 2004 the US ran current account deficit equivalent to 5.6 per cent of GDP. The annual US trade deficit was over USD 600 billion. In contrast to the late 1990s when the deficit was driven primarily by private capital inflows, the funding is now dominated by foreign central banks buying US Treasury paper.\textsuperscript{20} Amid concerns as to the sustainability of expanding US debt levels and focus on rising unemployment at home and China’s seeming power-house economic progress, there is a growing protectionist sentiment in the US, directed primarily at China. The ending of WTO quota restrictions on clothing and textiles at the beginning of 2005 which saw a surge in Chinese exports in these products provided a lightning rod for influential US (and EU) interest groups. While re-imposition of quotas has

\textsuperscript{19} In the fourth quarter of 2004, the proportion of loans with interest rates lower than the benchmark rate was 23.2 percent, up 2.4 percentage points from the previous quarter. Loans with interest rates higher than the benchmark rate accounted for 52.2 percent, up 2.1 percentage points from the third quarter. Only 24.6 per cent of loans were made at the benchmark rate, down 4.5 percentage points.

\textsuperscript{20} The eight major central banks in East Asia have amassed around USD 2.3 trillion in foreign exchange reserves.
been undertaken in respect of that particular issue, increasing pressure is being brought to bear on China to revalue the Chinese yuan to remove what is viewed as an “unfair” trade advantage. The question of China’s exchange rate policy is discussed in more detail below, but several points can be made in regard to this matter in assessing US-China trade relations.

In 2003 China accounted for 21 per cent of the growth in US exports, while for Germany and Japan the figures were 28 and 32 per cent respectively (Mellor, 2004). However, China’s share of the imports of the US and EU in particular is relatively small (Table 2). These figures also need to be considered in the context that around 50 per cent of China’s exports are undertaken by the so-called foreign invested enterprises (FIEs) (Thorpe, 2004). Moreover, while China’s exports have been growing strongly, so have its imports (Table 1 and 3). About half of China’s imports are employed in further processing and over 40 per cent of China’s exports embody imports (Prasad, 2004). Any revaluation of the RMB would mean relatively muted rise in export prices because of this high import content in exports. Also China’s labour costs relative to the US (and EU) are absolutely very low. What is apparent is that over the last decade, despite the fixed nominal exchange rate experiencing periods of appreciable over and undervaluation, China’s export growth has been maintained.

While the US-China trade imbalance in China’s favour was USD 162 billion in 2004 (about 27 per cent of the US total), overall China had a trade surplus of only USD 32 billion for the period, running significant deficits with other countries (reflecting the strong import of intermediate goods, including capital equipment and components). China’s current account surplus for the year was USD 72 billion. In 2003 China’s current account and trade surpluses were USD 46 billion and 25.5 billion respectively, indicating just how strongly performing has been the export sector. Lardy (2005) indicates that China has averaged an annual surplus
on its long term capital account of about 1.5 per cent of GDP. The overall picture on the balance of payments position suggests a currency that is not in equilibrium. This issue is taken up in more detail in following sections of the paper.

The US is at present compensated for its rising import level and job losses through increased investment (and profits) in China and also benefits from China’s financing of its current account (and budget) deficit which keeps interest rates low and consumer spending up. The US government, however, does need to stimulate growth elsewhere in the economy and reduce reliance on overseas savings. The USD needs to depreciate, but will a yuan appreciation achieve this, and to the extent necessary? Krugman (2005) argues that a revaluation by China will generate short term pain in the US, with rising interest rates, a fall in consumer spending and property prices and reduced employment in construction. The longer term benefit will be the improved competitiveness of the US economy. A revaluation by China would also ease some pressure on its overheated economy, lowering the bill for imported oil and other raw materials, and reduce some of the pressure for protectionist responses among its trading partners. Other Asian economies room would be given room to manoeuvre in revaluing their exchange rates, moves that have been resisted in order to avoid loss of global market share to China.22

However, given China’s overall share of US trade of around 10 per cent of US total trade, a revaluation by China of, say, 10 per cent would reduce the dollar's trade-weighted value by only 1 per cent (The Economist, 2005b). If it were matched by a similar rise in all other Asian currencies, then the dollar's trade-weighted index would fall by 3.7 per cent. This is small compared with the dollar's decline of 16 per cent since early 2002, let alone with what would be needed to cut America's current account deficit to a sustainable level. A report by

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21 Electronic products and IT products, for example, now comprise about one third of China’s exports, but domestic value added is only around 15 per cent of their value (Goldstein and Lardy, 2005).
22 Movements in other Asian currencies would also help in effecting a required overall USD adjustment.
HSBC has estimated that the dollar needs to fall by a further 30 per cent to reduce the US current account deficit to 2-3 per cent of GDP.

Table 2
China’s Market Share in Major Export Markets
(per cent of each country’s imports)

<table>
<thead>
<tr>
<th>Year</th>
<th>US</th>
<th>EU</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>0.0</td>
<td>0.6</td>
<td>1.4</td>
</tr>
<tr>
<td>1980</td>
<td>0.5</td>
<td>0.7</td>
<td>3.1</td>
</tr>
<tr>
<td>1990</td>
<td>3.2</td>
<td>2.0</td>
<td>5.1</td>
</tr>
<tr>
<td>1995</td>
<td>6.3</td>
<td>3.8</td>
<td>10.7</td>
</tr>
<tr>
<td>2000</td>
<td>8.6</td>
<td>6.2</td>
<td>14.5</td>
</tr>
<tr>
<td>2002</td>
<td>11.1</td>
<td>7.5</td>
<td>18.3</td>
</tr>
<tr>
<td>2003</td>
<td>12.5</td>
<td>8.9</td>
<td>18.5</td>
</tr>
</tbody>
</table>

Source: IMF DTS

Table 3
Relative Importance of China’s International Trade
(per cent of GDP)

<table>
<thead>
<tr>
<th>Year</th>
<th>Trade in Goods</th>
<th>Exports*</th>
<th>Imports*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>36.4</td>
<td>22.3</td>
<td>19.2</td>
</tr>
<tr>
<td>2002</td>
<td>48.8</td>
<td>28.9</td>
<td>25.9</td>
</tr>
<tr>
<td>2003</td>
<td>60.1</td>
<td>34.3</td>
<td>31.8</td>
</tr>
</tbody>
</table>

* Goods and Services

Apart from any currency realignment with the yuan, the outcome of protectionist measures in the US would be a falling USD and rising interest rates along with some mix of increased taxes and reduced government and private spending to ensure manageable debt levels (Childs, 2005). However, with any continued decline in the USD, the Chinese may be loathe to hold such a large share of their foreign assets in USDs. A significant switch out of USDs could lead to a sharp fall in the currency. How China chooses to manage its
macroeconomic policy options is an important element in dealing with the issue of global imbalances. However the US can not expect adjustment in a bilateral exchange rate to provide the solution to what are to a large extent domestic fiscal problems.

The Macroeconomic Policy Constraint

Financial sector reform involves substituting market oriented, indirect government policy instruments and prudential regulation in place of direct price, allocative and operational controls over financial institutions. The matter of reform of the macroeconomic environment is therefore crucial. This raises the issue of financial liberalisation which addresses questions related to exchange rate policy, capital account restrictions and the ability of authorities to conduct monetary policy in a deregulated interest rate environment.

The current reforms and restructuring under way in the finance sector in China are being undertaken in an environment of interest rate controls, a closed capital account and a fixed exchange rate. Impacting the reform process are pressures both from within and internationally for changes in all these areas. It is not possible, however, to simultaneously maintain an independent monetary policy, free capital flows and a pegged currency—the so-called “trilemma” for policy regimes. Only two of the three choices are possible. Any policy adjustments must also be cognisant of the state of the banking industry and the need to ensure a financial stability.

The remedy for distortions in financial markets is the elimination of interest rate controls and the encouragement of market-based credit allocation. In a globalised economy, it has become harder, however, to maintain stability in exchange rates and conduct an independent monetary policy directed to domestic objectives. A country’s interest rate will tend to follow closely that of the partner to which it has pegged its currency because of the

There is evidence that China is already diversifying its reserves and it is also encouraging its companies to globalise with greater outward FDI, all of which will reduce dependence on US treasury bonds.
impact of capital flows in an integrated capital market (even with significant reserves held by
the central bank). A country could choose to maintain an independent monetary policy in
these circumstances only under conditions of tight capital controls, which means foregoing
the benefits of integration. Monetary independence can be maintained with a liberalised
capital account, but only with a flexible exchange rate.

Of course, global capital market integration also carries some inherent risks for a
country. International shocks are readily transmitted and capital movements can be
destabilising for a country’s exchange rate environment and financial system.

As has been discussed above, given that the capital account in China is somewhat
porous in terms of inflows, and given the inward FDI and trade surplus, the resulting build up
of foreign exchange reserves has meant that control over the money supply has been limited
in the absence of market determined interest rates.

Ignoring the constraints imposed by the “trilemma” sows the seeds for financial crisis,
as seen in Argentina in 2001 and the Asian crisis of 1997. If China were to free up the capital
account while seeking to maintain a pegged rate, this would create severe strains for
managing monetary policy effectively. A float in such circumstances would allow for greater
interest rate independence. The question remains, however, the policy objectives which
China wishes to pursue and the timing and sequencing of policy shifts involved in achieving
these ends. The resolution of the “trilemma” remains a critical issue for China as it continues
its banking and finance sector reforms.

What are the benefits and risks for China from integrating more fully with global
capital markets? What are the relative merits of a fixed as opposed to a more flexible
exchange rate regime? How can China shake off the financial repression which has been a
central feature of macroeconomic management to date? These issues are considered in the
following sections of the paper.
Exchange Rate Policy

Some reports suggest that China (and other Asian countries) are pegging their currencies at artificially low rates and maintaining capital controls to keep exports competitive and fuel growth (The Economist, 2004b;). Goldstein and Lardy (2005) effectively debunk this view, showing clearly the difficulty for China from expanding reserves and the difficulty in effectively sterilising the increase in money supply this has entailed. While it is widely accepted that the Chinese currency, pegged since December 1996 at 8.28 to the USD, is undervalued there are conflicting assessments (The Economist, 2004a; The Economist, 2005c; Prasad and Wei, 2005). Both academic analysis and market analysts disagree as to the extent of any identified undervaluation of the RMB. Estimates range from 25-30 per cent down to only slight misalignment. Moreover, there is no consensus on the policy prescription for China in adjusting its exchange rate arrangements.

Two symptoms of undervaluation tend to be either a large multilateral trade surplus and/or high inflation. China’s overall trade balance is relatively modest, exaggerated if anything, by over and under-invoicing on exports and imports respectively. Inflation, particularly in certain sectors of the economy, has become a concern. This reflects a multitude of factors including a lax banking system fostering strong credit growth (not necessarily allocated efficiently) and infrastructure bottlenecks stemming from uneven growth, in part due to continuing government controls in many areas. A revaluation could help to curb the rapid growth in money supply and ease cost pressures coming from imports (Rajan and Subramanian, 2004). It would enable a more independent monetary policy. The fact that the US would view an adjustment favourably would provide political benefit to China, even if not addressing the real issues of US and global imbalances. However the political cost of conforming to US demands on the issue is apparent and real.
It is not likely that a weak currency is in China’s long term domestic interest because of its inflationary pressures and the threat that it does bring of retaliatory protectionism. An undervalued exchange rate also discourages investment in the non-traded sector of the economy and taxes domestic consumption. Childs (2005) has suggested that the current policy regime in China leaves the economy exposed to further overheating in view of a reported 3 per cent drop in the official RMB rate against China’s trading partners over the first five months of 2005. Some estimates have put the fall in China’s real trade-weighted exchange rate (adjusted for inflation differences with other countries) at 13 per cent since 2001, although this should be viewed in context of earlier developments (The Economist, 2005c). Between 1994 and 1997, it is estimated that China’s real effective exchange rate gained around 33 per cent, dragged up by a rising USD (Lardy, 2005). During the 1997 Asian crisis China chose not to follow the actions of most its neighbouring economies and devalue its currency, despite pressure from its traded goods sector. Over 1998-1999 the RMB then effectively depreciated 14 per cent, rising again by an estimated 13 per cent over 2000-2001 before falling again by 10 per cent over 2002-2003. From these figures it is apparent that the policy of fixing the currency in nominal terms since 1996 has not lead to stability in the real exchange rate.

However, a revaluation will also have domestic costs. It would hurt exporters and import competing sectors such as agriculture, an area already under competitive stress. It would see holders of US assets lose, including an erosion of the domestic currency value of China’s USD reserves. Goldstein and Lardy (2005) calculate that a 15 per cent revaluation of the yuan would mean a loss equivalent to around 6 per cent of GDP for China. However, the magnitude of such numbers also highlights the risk from continuing to amass USDs while maintaining the current peg arrangement. A revaluation has also been strongly argued against

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24 Historically, this can be viewed as similar to policies adopted by Japan and Europe following the Second
in terms of its likely adverse impact on China’s regional neighbours (Holland, 2004). It would also erode the value of the recent sizeable USD capitalisations of key banks in China (Holland and Lague, 2004). An export tax could be an alternative to a revaluation. It would be flexible and avoid the costs of a revaluation. It would also generate government revenue and be seen by speculators as a warning.

While some have argued for freeing up the exchange rate fully as quickly as possible given uncertainty as to the “correct” value of the currency, others have been more sanguine. Several options for revaluation have been canvassed (The Economist, 2005b). The least disruptive would be a widening of the trading bands or a switch to a peg against a basket of currencies. China already trades more with the European Union and Japan than with the US. Only around 21 per cent of China’s exports go to the US and it sources only 8 per cent of its imports from that country. These approaches could be linked with a small appreciation. An alternative is a one-off significant revaluation, coupled with a float or managed peg to a basket. Williamson (2004) advocates a two stage approach, a sharp revaluation (15-25 per cent) followed by re-pegging to basket with wide bands (+/–10 per cent). As suggested above, what constitutes significant varies according to market perceptions. A small move, however, would be unlikely to temper speculative fervour and could lead to a loss of confidence by the market in the ability of authorities to effectively manage the currency. A suitable policy response should be guided by institutional and market developments. A slower pace of reform will permit the foreign exchange market to deepen and there is likely to be less volatility. A quicker and larger move flags commitment and could serve to deter further destabilising speculation (albeit rewarding past speculative activity).

Karacadag, Duttagupta, Fernandez and Ishii (2004) indicate how the majority of exits from a fixed to a flexible exchange rate have been accompanied by crises and outline

World War.
strategies for an orderly transition. Institutional and policy frameworks matter, as does the matter of timing and sequencing of policy changes. It is necessary to build the management capacity of key players in the foreign exchange market along with better market information flows to facilitate rate formation and the development of risk hedging instruments.\textsuperscript{25}

Monetary authorities will also need to develop an alternative nominal anchor, such as inflation targeting. In China this would require suitable institutional capacity and macroeconomic management tools, including deregulation of interest rates. This brings again to the fore the question of the “trilemma” trade-off. As discussed below, the timing of capital account liberalisation in conjunction with exchange rate and interest rate policy adjustments is a major issue. Of course, if the economy has a hard landing as result of other moves currently introduced to slow growth, there is unlikely to be any adjustment to the exchange rate system for the time being.

\textit{Capital Account Liberalisation}

Theory proposes that international financial capital flows should provide for a more efficient allocation of capital, including a greater diversification of asset holdings for investors. Inflows should encourage improved economic growth performance by augmenting domestic savings, lowering the cost of capital, assisting technology transfer and facilitating the development of local institutions. (Prasad and Wei, 2005). Integration of global capital markets allows inter temporal trade, with lenders foregoing resources and consumption today to get more in the future and borrowers prepared to pay more later for a more immediate access to resources. Capital inflow should therefore facilitate consumption smoothing over

\textsuperscript{25} China has expanded foreign exchange trading by authorising eight new foreign currency pairs. Beginning in May 2005, seven foreign currencies will be paired against the USD along with trading in a Euro-Yen pair. The RMB will continue to be trade only against the USD, Hong Kong dollar, the Yen and the Euro. Such a move is in line with China’s gradualist approach, recognising that a more effective foreign exchange market is a pre-condition for effective exchange rate reform in China.
time, offsetting output fluctuations, although to the extent that inflows are asymmetric, drying up in less favourable times, this may not always be the case.

Transparency, prudential controls and regulations, a stable macro economy and supportive institutional environment are all critical factors in ensuring the benefits from capital liberalisation are achieved. Those that have engaged in reform stand to reap large gains (Taylor, 2004). China’s access to FDI has allowed more of the upside benefits while compensating for the poorly performing domestic finance sector and problems with SOEs (Huang, 2003). It has also allowed for continued restrictions on “debt” from overseas which can create difficulties in such circumstances. From China’s viewpoint, a healthy banking and financial sector, a strong legal framework and regulatory environment would allow more latitude with easing capital controls.

Capital controls, while restricting access to international markets, can prevent speculative attacks, with respect to both inflows and outflows. Excessive capital flows can cause currency and asset price volatility or, as witnessed in China (where controls have been porous and also not all-encompassing), loss of control of monetary conditions. Looking at inflows, at issue is the nature and composition of the capital. External debt (especially more short term debt) and portfolio investment are particularly problematic in this regard. Over-borrowing can occur when credit controls are eased and lending moving to speculative areas (for reasons such as of the lack of alternative investment opportunities domestically, the inability of banks to adequately assess credit risk and moral hazard and inadequate prudential and regulatory controls). This can result in asset bubbles and longer term debt servicing problems as witnessed in Scandinavia in the 1980s.

Controls also keeps funds within the domestic system, discouraging systemic crises as funds leaving one bank must go to another. In the extreme, a loss of confidence in institutions,
precipitated by the opportunity to move funds offshore, could lead to a run on the banking system.26

An opening of the capital account allowing firms (and households) to hold foreign assets could be expected over the longer term to see a net outflow in China as investors seek to diversify savings into foreign assets. Expectations regarding the exchange rate would presumably be a dominant influence in the immediate term. If interest rates were to also be deregulated, then any freeing of the capital account would require allowing more exchange rate flexibility.

**Interest Rate Deregulation**

The government has refrained from using a rise in interest rates in order to maintain consumer confidence and discourage (further) speculative capital inflows. A rise in lending rates, which would result from deregulation and a move to market determined outcomes, would reduce the profit margins of banks (as presently operating) and harm healthy sectors of the economy (Chan, 2004). In particular borrowers from lesser developed regions in China may be disadvantaged at a time when growth is just beginning to show some results. It would allow, however, for more effective use of monetary policy to control the pace of investment and growth. China does need to slow the economy to more sustainable investment levels, but in doing so it could exacerbate the NPL problem and efforts to clean up the balance sheets of banks and hence curtail further freeing up of the capital account. To the degree that a fixed exchange rate remains in place, rising interest rates would likely accelerate capital inflows putting more pressure on the RMB and creating opportunity for further credit growth sowing the seeds for future NPLs (Goldstein and Lardy, 2005). With the government running a large budget deficit-public debt is currently around 30 per cent of GDP-any rise in rates would

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26 A proper understanding of bank failures calls for an understanding of the policy and economic environment, the institutional framework, banking practices, the quality of supervision and the structure of incentives in place.
adversely affect the public sector already in need of tax reform to finance expenditures.\textsuperscript{27} While there is currently no problem in servicing this debt, Lardy (2004) flags the possibility of financial crisis if the economy were to deteriorate.

If interest rates are kept low, and in the face of continued lack of alternative investment opportunities domestically and offshore, then increasingly funds would be expected to flow to the informal sector.\textsuperscript{28} Fiscal policy in China tends to be an ineffective tool, constrained as it is by socio-political factors.

Persistent pressures for real exchange appreciation as evidenced in China tend to force adjustment through one channel or another. Even in an economy with capital controls and a repressed domestic financial sector, these pressures can be bottled up for only so long and create an inflationary environment (Rajan and Subramanian, 2004). For an independent monetary policy (with exchange rate flexibility) to be most effective, further institutional and operational improvements would be needed to establish a credible monetary policy framework and improve the monetary policy transmission mechanism. Stringent capital requirements and loan-loss provisions will help ensure bank viability and deal with the moral hazard problem for banks. Bankruptcy has to be a real threat.

Once rates are liberalised, banks face the problem of gathering and assessing information on firms in pricing for risk in the markets. Free interest rates of themselves will not guarantee efficient capital allocation under these conditions. Where there is uncertainty about rates and credit and lack of experience then imperfect screening can result, with highly productive customers excluded if information regarding the risk characteristics of individual

\textsuperscript{27}Government expenditure on capital construction was 13 per cent in 1978, but had fallen to 3 per cent by 1993 (Gao and Schaffer, 1998). As the economy was liberalised, loans to SOEs through the banking system began to replace budgetary appropriations as the main source of fixed capital expenditure (for roads, utilities and the like) up to 1997. However, following the Asian crisis the PBOC responded by seeking to maintain economic momentum through increasing expenditure on infrastructure, financed through the issuing of bonds. The budget deficit in 2003 was 2.9 per cent of GDP (The Economist, 2004). The government also continues to finance SOE reform and rural migration.

\textsuperscript{28}Presumably the enforcement of controls on capital outflows would be more difficult as well, particularly if inflation were to rise.
firms is missing or not widely available (i.e. adverse selection). In fact, funding may be encouraged to high risk activities if interest rates are high, with good investors leaving the market (Villaneuva and Mirakhor, 1990). Borrowers may be encouraged to choose riskier projects with higher associated returns (i.e. moral hazard problem). To address these problems, balance sheets of companies need to be cleaned up and made transparent (Fry, 1988). As part of this, bankruptcy laws and strong accounting and reporting procedures should be put in place. Stringent bank supervision is also needed.

Well developed equity and bond markets in China can improve the allocative efficiency of capital through exercising fiscal discipline on firms and helping in the generation and transmission of information flows in the market place. A decreased dependence on bank credit will reduce the vulnerability to interest rate shocks and the widening of capital markets will assist the development of risk management markets generally. Informal credit markets will also need to be brought under tighter supervision.

Such measures, along with a stable macroeconomic environment, need to be in place before interest rates can be completely liberalised. To the extent that such measures are incomplete or weak, some regulation of rates by authorities may need to be temporarily maintained. Certainly, fully opening up to foreign banks in 2007 creates an urgency for reform efforts in the area of interest rates.

**Timing and Sequencing Issues**

The early literature on financial development suggested that financial liberalisation should be undertaken rapidly and at the same time as reforms in fiscal and trade policies. Later work has introduced the concept of sequencing of reform, suggesting that financial sector adjustment should follow last (McKinnon, 1991). Moreover, domestic financial reforms should precede the opening up to global capital flows.
The experiences of Mexico (1994) and Thailand (1997) highlight the risk of liberalising the capital account before a shift from a fixed peg. This was an issue even with an economy experiencing favourable economic conditions as was the case in Poland in the 1990s. The Asian crisis was typified by a collapse of (overvalued) exchange rates arising from heavy capital outflow and a collapse of the domestic financial system causing a shortage of working capital and an output collapse.

In comparison with the above scenario, the situation in China can be viewed in many respects as being quite different. Overseas capital inflow is mainly direct investment, capital account transactions are (relatively) tightly controlled and the pegged exchange rate is considered to be undervalued rather than overvalued, with substantial foreign exchange reserves. However, this is a static view and ignores the possible effects of further inevitable liberalisation.

If exchange rate flexibility comes first, then the nature of capital account liberalisation is important. A move to ease capital controls should be later to avoid any capital flight and a consequent banking crisis. Precipitous removal of capital controls that restrict the capacity of domestic investors to invest abroad could cause an outflow of deposits from Chinese banks and destabilise the system. An open capital account leaves a country vulnerable to domestic and global investor sentiment, particularly if economic fundamentals are weak and financial markets are poorly developed and poorly regulated. (Kose, Prasad and Terrones, 2003).\(^{29}\) If the domestic banking system is fragile then controls may be viewed as necessary to limit volatility. Capital controls on outflows (and also inflows), in particular, should be removed gradually at a time when there is no pressure on the currency and institutional features are consistent with such a policy to avoid destabilising movements in capital.

\(^{29}\) Fischer (2003) takes a more sanguine view on the need to delay capital controls.
A question is whether interest rate liberalisation should precede liberalisation on the capital account. As discussed above, deregulation of interest rates requires a stable macroeconomic environment and a strong supporting institutional framework, including capital markets, legal and accounting frameworks, regulatory financial sector controls and the ability of banks to effectively assess credit risk. It may be necessary to maintain some interest rate controls until such time as the economy is mature enough. This may be necessary even after capital controls have been eased.

Stallings (2003) concludes that a crisis could result if efforts in this area are mismanaged. Also drawing on East Asia, he considers a situation where interest rates are liberalised in conjunction with the ending of directed credit, banks are privatised and proper prudential regulation and supervision is not in place. This could result in strong growth in credit, cronyism and excessive risk-taking in lending practices and inadequate provisioning for potential losses. This is likely to be particularly problematic in an expansionary macro-economic environment. A non-sustainable “bubble economy” would result and as firms became overextended and were unable to service loan commitments, both the real and the financial sectors would face a systemic crisis in the face of collapsing asset prices.

China needs to move relatively quickly to offset the currently misaligned exchange rate. Moving to a full float would not be practicable at this stage given the lack of ability for the domestic banks in China to effectively participate in a stabilising manner in currency markets. The result would likely be a de-facto managed currency by authorities. With a move to a regime along the lines proposed by Williamson (2004) in place, China should then continue its focus on restructuring and reform of the banking system and domestic capital markets. Deregulation of interest rates should be cautiously followed in line with the overall

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30 If these developments were linked to any liberalising of the capital account while maintaining a fixed exchange rate, it would lend itself to currency misalignment (overvalued) and disruptive capital flows.
health of banks and cognisant of general economic performance. Full liberalisation of capital markets would only follow much later.

**Conclusion**

China is faced with policy questions in respect of the choice of a suitable exchange rate regime, the (ongoing) liberalising of its capital account and removing the financial repression that has shaped the banking and finance sector of the economy. The current macroeconomic environment and institutional arrangements have been shaped by past decisions and these, in turn, constrain and influence the nature and extent of necessary ongoing reform. As well, there are external factors coming to play, including China’s trade and commercial relationships with its global partners and the unfettered entry of foreign banks into China in 2007.

China needs to allow for a more market based allocation of financial sector resources, particularly in regard to the domestic banking sector and equity and debt markets. Opening up the capital account to a much greater degree than at present can aid in this process. However, China needs to ensure that the domestic financial system is healthy enough and competitive enough to cope with the changes that will be introduced. This requires ensuring not only that the bad debts of the banks are effectively dealt with, but also that suitable supporting domestic institutional and regulatory supports are in place.

One outcome of recent developments has been a growing awareness of the need to address what is seen as an undervalued exchange rate. China has several options in respect of currency arrangements. However, any policy changes need to be considered in conjunction with possible changes to the capital account and to the introduction of more market oriented interest rates as well as in the context of the current economic and institutional environment.
Along with the extent of policy changes, the timing and sequencing of reforms need to be carefully considered to ensure that the financial system does not experience major difficulties.
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