

Efficiency and Stability of the Financial System in Mainland China

Summary of the 6th HKIMR China workshop

The 6th HKIMR China workshop, jointly organized by HKIMR and the Wang Yanan Institute for Economic Studies, Xiamen University (WISE), took place in Hong Kong during 16-17 October 2008. This year's workshop, which had a theme of "Efficiency and stability of the financial system in Mainland China", covered topics ranging from the relationship between financial markets and economic growth, institutional features of the financial system, the conduct and transmission of monetary policies, and linkages between Chinese and overseas financial markets. About thirty economists and professionals attended the workshop, representing institutions including: Tsinghua University, Peking University, Fudan University, Shanghai Jiaotong University, Chinese Academy of Social Sciences, Lingnan University of Hong Kong, the International Monetary Fund, the Bank for International Settlements, the People's Bank of China, Shanghai Stock Exchange, Financial Services Office of the Shanghai Municipal Government, the Hong Kong Securities and Futures Commission, the Hong Kong Monetary Authority, and Xiamen University. Against the background of ongoing global financial market turmoil, this timely workshop generated a great deal of interest and lively discussions among its participants.

1. The relationship between economic growth and financial markets in China

The development of the financial sector is closely related to economic growth. To study efficiency and stability of the financial system in the context of the global financial crises, we need to understand the macroeconomic outlook in China.

1.1 The macroeconomic outlook

Prof. Yang Li of the Chinese Academy of Social Sciences believes that China's strong economic growth will sustain in the medium term. The key to China's long term growth depends on whether investment demand can be successfully financed from national savings. In general China's strong economic growth will keep going because of the high saving rate, investment rate and trade surplus. On the supply side, the demographic dividend still exists and China's national saving rate will stay high. On the demand side, the continuing industrialization, ongoing urbanization and expanding globalization will keep sustain China's investment demand at high levels.

Prof. Li noted that the Chinese economy has slowed significantly since the second half of 2008 and the focus of macroeconomic policy has changed from "preventing overheating and inflation" to "protecting growth and containing inflation". To sustain the growth of aggregate demand, exports and domestic consumption are not dependable. With the still highly unequal income distribution, the growth of domestic consumption stays low. In addition, the current global financial crisis definitely will hurt China's exports. So investment will still be the main engine for China's growth. However, China now is near the completion of industrialization, so we should not repeat investing in capital-intensive industries that may contribute to another round of over-capacity in the future. It's important to be selective. For example, infrastructure and those

investments that are complementary to consumption should be put on the top of the agenda.

While both accommodative monetary and fiscal policies are important to promoting growth, according to past experience, fiscal policy and government investment are more useful to restart the economic boom from a recession.

1.2. Macroeconomic consequences of depositors turning into shareholders

With balance sheets data of listed companies, Dr. Tianqi Sun of the People's Bank of China studied the implications of a change in the liability structure of banks. With the stock market boom, households reallocated their portfolios and moved from holding deposits in banks to holding equity shares in companies. During 2004-June 2007, listed companies raised financing from stock market and yet their overall debt ratio has increased. Meanwhile, on the balance sheets of commercial banks, household savings moved from being a debt item to ownership interest due to the IPO of commercial banks. The result was the reduced debt and increased capital for commercial banks, which pushed the banks to make more loans. Therefore, one consequence of the deposits turning into equity is the enhanced capacity for the financial system to take on more debt, and from a monetary policy point a view, it also led to an increase of M1 growth and the decrease of M2 growth. These structural changes need to be taken into account in formulating macroeconomic policies.

2. Institutional features of the financial system

Professor Zhishu Yang of Tsinghua University presented his paper on the efficiency of bank loan in China. Dr. Yang found that, different from the developed countries, China's stock market read the news of obtaining bank loans as negative for a company. This discovery implied that the bank loans in China had low quality, and could not function as a positive signal of the company's management. Since the sample period extended only to 2004, participants of the workshop encouraged the authors to update the study to more recent years, which may have witnessed a vast change in banks' lending behavior.

Dr. Xinghai Fang of the Financial Service Office of the Shanghai Municipal Government and Dr. Fenghua Wang of the Shanghai Stock Exchange analyzed the relationship between institutional investors and stability and efficiency of China's stock market. Based on the trading data of Shanghai Stock Exchange, they found that individual investors are more speculative and myopic than institutional investors. The majority of investors in China's stock market are still individual investors. Although institutional investors blew up the bubble along with individual investors in the bull market rather than hold the bubble in check as expected, their selling during the bear market has quickly driven the market down to its rational levels. More efficient and rational than individual investors, institutional investors in general enhance the stability and efficiency of the securities market. Regarding policies, the authors recommended promoting the development of a variety of institutional investors, including private equity, hedge funds, QFII, insurance funds and social security funds, etc. They also called for the introduction of short selling mechanism and stock index futures. In fact, Shanghai has made some achievements in the business registration

and taxation for hedge funds.

However, the view that institutional investors have played a stabilizing role was challenged by a number of workshop participants, including Professor Yongmiao Hong of WISE, Xiamen University, who argued that institutional investors, mostly mutual funds who face immense trading pressures from unit holders, acted in a similar, if not more, destabilizing manner as individual investors by chasing in the bull and dumping in the bear. This could be because the mutual funds do not take a sufficiently long-term perspective as other types of institutional investors such as pension funds and insurance funds do. Mr. Jie Sun of the Hong Kong Securities and Futures Commission attributed the immature behavior of institutional investors in China to the following reasons. First, the pension fund in China is still to develop. Second, the lack of trust law in China's history makes it particularly difficult to regulate the funds. Third, most fund holders are state owned institutions and their behavior is different from private investors. .

Professor Guojin Chen of WISE, Xiamen University presented his paper on the mechanisms of bubble formation in China's stock market. He argued that heterogeneous beliefs of individual investors and the restriction of short selling are the two stylized facts in China's stock market. Through the mechanism of re-sale option, these two factors produce bubbles. In order to hold the bubble in check, he suggested to strengthen institutional investors and introduce short selling mechanisms.

Dr. Guojun An of the Chinese Academy of Social Sciences analyzed institutional factors that affect liquidity in the government bonds market. China's government bonds market is still under development. The term structure lacks diversity. There is no powerful institutional investor. There is no real market maker in the primary market. The market is not transparent enough, with too much speculative atmosphere. Poor pricing ability, and the lack of risk management instruments. To provide the liquidity to the market, the government should foster institutional investors, improve the rules of market makers, unify the national bonds market and strengthen the base interest rate function of the bonds. Some workshop participants commented that the development of bonds market is likely to be a spontaneous process, and for that process to be kick-started, it is important for government regulatory restrictions on its development to be removed.

Mr. Xiang Zhang of Peking University presented his research on informal finance in China, based on case studies of informal banking in Zhejiang province. He took a new institutional approach to analyzing the role of information and transaction cost in limiting the growth of private financial institutions. His conclusion is that the implicit or explicit support from government is the key for those private banking institutions to build their credit and success.

3. The conduct and transmission of monetary policy

Professor Yang Zhao of WISE, Xiamen University presented a paper on testing whether there is counter-cyclical monetary policy rule in China. Using monthly data of interest rate, M1, M2, inflation and industrial value added, he estimated a monetary policy rule with a VAR model. The main finding is that China's monetary policy is responsive to inflation rather than output. The

result is robust with various different proxies of monetary policy. However, Professor Zhao pointed out that the response of interest rate to inflation might not be symmetric during boom and downturns. Dr. Feng Zhu of the Bank for International Settlements discussed the paper and suggested that the authors incorporate exchange rate and other shocks into the model. Dr. Dong He of the HKMA commented that since the PBoC uses a variety of policy instruments and there is still segmentation of the credit market in China, interest rate changes alone may not be able to capture well the central bank's behavior.

Professor Xingdi Gan of Fudan University employed a VAR model to test regional disparities in the transmission of monetary policy. She found there was asymmetry in the effect of monetary policy across provinces. The eastern area is most responsive to monetary policy while the western area the least. The main reason for such differences lies in the industry structure. The secondary industry responds to monetary policy quickly and sensitively while agriculture responds little. With impulse response function analysis, Professor Gan found that different consumption patterns between the east and the west also led to differences in the impact of monetary policy. While a number workshop participants acknowledge the value of Professor Gan's findings, they did not endorse the idea of monetary policy catering to different geographical regions. With mobility of funds and increasing integration of financial markets in China, regional monetary policy targets are unlikely to be feasible. Regional disparities are better taken care of by fiscal policy.

4. Linkages between Chinese and overseas financial markets

The ongoing financial globalization and the current worldwide financial turmoil obviously make it more important and urgent to understand how China should manage and open its capital account step by step, and how the financial crisis could affect Chinese economy.

Dr. Dong He of HKMA presented a study entitled "the Chinese approach to capital account liberation: what do we learn from renminbi banking in Hong Kong?" Renminbi banking in Hong Kong provides an excellent case study of the likely approach that the Mainland authorities may take to making the renminbi convertible. Renminbi banking in Hong Kong can be viewed as an early form of non-resident convertibility and the initial stage of the emergence of an "Asian" or "euro" RMB market. The process demonstrated that convertibility of the RMB under the capital account should be best seen as a "spectrum" rather than a bi-polar state of "black" and "white". The Mainland authorities are likely to advance their agenda of capital account liberalization whenever they feel risks to financial stability domestically are controllable, but the process is unlikely to be a linear progression. The experience of renminbi banking in Hong Kong has also demonstrated that it is possible for the Mainland to design mechanisms, particularly through skillful management of nonresident bank account, to control risks associated with nonresident convertibility.

Dr. Tao Sun of the IMF presented a paper on how the events during sub-prime crisis affected the daily return and conditional volatility in China and Hong Kong's stock markets. With a GARCH model, Dr. Sun showed that China and Hong Kong's stock markets were not immune to the sub-prime crisis. Although daily return was not significantly affected by those events, volatility

(conditional variance) was heavily affected. Hong Kong was more affected by the crisis than Mainland China. Both the event-study methodology and empirical results of the paper generated keen interest among the workshop participants. In particular, the paper contains a detailed list of daily events encompassing the whole crisis period, which will provide a valuable source of information for future studies.

Mr. Eric Wong of HKMA presented a paper studying the foreign exchange risks of Chinese banks. Using the Capital Market Approach and equity-price data of 14 listed Chinese banks, the study finds that there is a positive relationship between bank size and foreign exchange exposure, which may reflect larger foreign-exchange operations and trading positions of larger Chinese banks, and their significant indirect foreign-exchange exposure arising from impacts of the renminbi exchange-rate movements on their customers. The evidence suggests that the average foreign-exchange exposures of state-owned and joint-stock commercial banks in Mainland China are higher than those of banks in Hong Kong, notwithstanding that their participation in international banking businesses is still limited compared with their Hong Kong counterparts. The authors also found that negative foreign-exchange exposure is prevalent for larger Chinese banks, suggesting that an appreciation of the renminbi tends to reduce their equity values. Professor Yongmiao Hong of WISE, Xiamen University provided detailed comments on the paper and made valuable suggestions for further improving on the empirical methodology.