

# Why Is Reform of China's Financial Sector So Important?

Capital is the lifeblood of any economy's strength and well-being, enabling the investment, research, and risk-taking that fuels competition, innovation, productivity, and prosperity. The financial system can be thought of as an economy's cardiovascular system – the institutional and technological infrastructure for the mobilization and allocation of the economy's lifeblood, investment capital.

Given the unique and critical role an effective and efficient financial sector plays in any economy, reform of China's financial sector is a *prerequisite* to China achieving its own economic goals of:

1) maintaining high rates of growth and job creation; 2) encouraging a structural shift from industry to services; 3) promoting the development of domestic consumer demand; 4) reducing poverty; and, 5) ensuring a more equitable distribution of opportunity and prosperity. Financial sector reform is also a prerequisite to meaningfully addressing issues that have complicated the U.S.-China economic relationship, particularly greater currency flexibility and reducing trade imbalances.

## Achieving China's Economic Priorities

- Maintaining High Rates of Growth and Job Creation: Maintaining exceptional rates of economic growth and job creation in China increasingly depends on an effective system for mobilizing investment capital. At present, China's weak banking system intermediates nearly 75 percent of the economy's total capital, compared to about half in other emerging economies and less than 20 percent in developed economies. Despite some improvements in recent years, Chinese banks' credit analysis, loan pricing, risk management, internal controls, and corporate governance practices remain inadequate. Meanwhile, China's

equity and bond markets are among the smallest and least developed in the world. More fully developed capital markets would provide healthy competition to Chinese banks and facilitate the development and growth of alternative retail savings products such as mutual funds, pensions, and life insurance products. And by broadening the range of funding alternatives for emerging companies, more developed capital markets would greatly enhance the flexibility and, therefore, the stability of the Chinese economy.

- Shifting from a Manufacturing-for-Export to a Services-Based Economy: Achieving China's desired transition to a more services-based economy will require that competitively priced capital and credit be channeled to the most promising emerging service businesses, and that the array of financial products and services emerging businesses require – loans, letters of credit, accounts management services, asset management, and insurance products – be made available.
- Activating the Chinese Consumer: Chinese households historically save as much as a third of their income, as compared to single-digit savings rates in the United States and Europe. This pronounced propensity to save is related to the declining role of the state and the fact that most Chinese depend on their families and private savings to pay for retirement, healthcare, and the economic consequences of accidents or disasters. Activating the Chinese consumer requires the availability of financial products and services – personal loans, credit cards, mortgages, pensions, insurance products, and insurance intermediary services – that will eliminate the need for such “precautionary savings” and facilitate consumption.

## Meaningfully Addressing Issues with the United States

A more effective and efficient financial sector in China is also a prerequisite to successfully addressing issues that have complicated the U.S.-China economic relationship, particularly further currency reform and meaningfully reducing the trade imbalance.

- Market-determined exchange rate: Chinese authorities have repeatedly argued – reasoning generally acknowledged by most foreign analysts – that a more rapid shift to a market-determined yuan is not possible given the underdeveloped state of China’s capital markets. More specifically, China’s banks, securities firms, and other businesses lack the expertise to develop and trade derivatives and other structured instruments used to hedge the risk associated with greater currency volatility. Sophisticated derivative products and hedging techniques provided by foreign financial services firms would clearly diminish such concerns.
- Reduction of trade deficit: Successful adjustment of China’s economy toward the production of ser-

vices and the activation of the Chinese consumer by reducing precautionary savings – goals that, as stated above, require a more open, competitive, and effective financial sector – are critical to successfully addressing international trade imbalances. Reorienting the financial habits of China’s population from precautionary savings to a better balance between savings and consumption, while progressively bringing more than a billion Chinese into the global economy, is the most powerful remedy to the U.S.-China trade imbalance.

The fastest way for China to acquire the modern financial system it needs to continue growing, enable a more flexible currency, and activate the Chinese consumer is to import it – that is, by opening its financial sector to greater participation by foreign financial services firms. Foreign institutions bring world-class expertise and best practices with regard to products and services, technology, credit analysis, risk management, internal controls, and corporate governance. In addition, the competition brought by foreign institutions would accelerate the adoption of such techniques and methodologies by domestic financial institutions.<sup>1</sup>

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<sup>1</sup> Treasury Secretary Paulson spoke directly to this critical point in announcing the Dialogue on September 21, 2006: “I am a very strong advocate of [China] opening up its capital markets to foreign investment. I believe that when they open up and let foreign competition in, the biggest beneficiary will be China, and it will mean more jobs in the financial services industry for the Chinese people. It will mean better training. It will mean more competitive capital markets that will have all sorts of other benefits for the economy...I can’t think of a single example anywhere of a situation where a country has a strong capital market system and they haven’t opened themselves up to competition.”