Financial system engagement and harmonization

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There could not have been in all of history so rapid a development in a functional financial system, and in particular of banking institutions, as in China over recent decades.

--Paul Volcker, preface to China's Emerging Financial Markets, 2011

During the 40 years since the normalization of U.S.-China relations, a key issue has been financial system engagement and harmonization. U.S. public and private institutions have played important roles in the reform and modernization of China's financial system. China's financial system, broadly understood, has also been a source of tension and conflict between the two countries from time to time. The first section of this essay briefly reviews the remarkable progress that China has made in transforming its financial system, to provide the context for engagement and harmonization. Each of the remaining two sections then focuses on an area of tension and conflict: exchange rate management and the trade imbalance in section 2; and trade and investment restrictions on financial services in Section 3. These two areas have been the primary topics for the strategic economic dialogue between the two countries. The engagement over the exchange rate and China's trade surplus has largely been successful, whereas China's ongoing restrictions on trade and investment in financial services are a remaining area of tension.

1. Context of Financial Reform and Opening

Since launching its *reform and opening (Gaige Kaifeng)* in 1978 China has turned in a remarkable growth performance, averaging nearly a 10% growth rate for four decades. At the

heart of reform was a gradual shift from a nearly totally planned, collectivized economy, to a mixed system in which private household agriculture, foreign investment, and a dynamic domestic private sector were keys to rapid capital accumulation and productivity growth. Alongside this private sector, there continues to be a large state-owned enterprise sector. The centrally owned enterprises are in heavy industrial sectors such as oil, minerals, and chemicals, as well as in modern services such as banking, insurance, telecom, and transport.

China's success has propelled it to a point where it is the largest economy in the world in PPP terms, the second largest at market exchange rates, the largest trading nation, and probably soon the largest international net creditor. Hence it is easy to forget that its financial institutions are relatively young. While the People's Bank of China (PBC) was established shortly after the founding of the People's Republic, it was placed under the Ministry of Finance and carried out both the function of a central bank (monetary policy) and the role of a commercial bank (taking deposits and making loans). Soon after, three specialized banks were created under the PBC to finance agriculture, foreign trade, and construction, respectively: Agriculture Bank of China (ABC), Bank of China (BOC), and China Construction Bank (CCB). With the launching of reform, the role of the central bank was transformed. BOC and ABC were separated from the central bank and established as state-owned commercial banks (SOCBs). This development shifted China to a two-tier banking system. A fourth state-owned bank, Industrial and Commercial Bank of China (ICBC), was started in 1984.

Still today, the four SOCBs dominate commercial banking in China. At their formation, these banks focused on their respective sectors: agriculture, industry, construction, and foreign trade. However, subsequent competition among them has blurred these distinctions. City-

owned commercial banks and joint-stock commercial banks (JSCBs) have also been established. Foreign banks up to today have only been allowed a small scope for participating in China's commercial banking sector, taking only about 1% of the market.

In the planned era, banks such as CCB lent at the direction of the government, in line with the plan. Since the shift to a market economy, these banks were supposed to make loans based on commercial considerations of credit-worthiness and financial viability of investment projects. The state still had some legitimate interest in directing credit to certain purposes, so in 1994 three policy banks were established, namely China Development Bank (CDB), China Export-Import Bank (CEIB), and China Agriculture Development Bank (CADB). The purpose of the move was to separate directed credit from commercial credit. In 1995, China's National Assembly passed two key laws to promote banking reform: the Law on the People's Bank of China defined the role of PBC as the central bank, and the Law on Commercial Banks established the four SOCBs as commercial banks. At the same time, China separated the banking, securities, and insurance industries.

While the idea of separating central banking from commercial banking is clear, in practice it proved difficult to get the big four SOCBs to lend commercially. It was natural for them to continue to lend to their traditional clients, large state-owned enterprises in the sectors to which they were dedicated, and it was difficult to quickly develop the new skill of assessing risk (Naughton 1998). Probably lending to any state enterprise in the mid-1990s looked relatively risk-free. However, many state enterprises produced poor economic results. This tendency was exacerbated by the East Asian financial crisis which hit China primarily through its exports. By 1998 it was clear that the SOCBs were developing large non-performing

loans, which peaked at 20% of banking assets. It was also difficult for the PBC, only recently given a central banking mandate, to develop the staff and skills to supervise the banks properly. China's banking crisis at this time was a bitter experience that cost an estimated 18% of GDP (Laeven and Valencia, 2012), which was used to cover bad loans in the SOCBs and to recapitalize them before their IPOs. Strategic foreign investors were brought into each major bank as minority partners to help strengthen their management before going public.

In 1999, four asset management companies (AMCs) were established under the auspices of the Ministry of Finance and PBC, with $20 billion in financing, to address the bad debts of SOCBs. Several years later, in 2003, China established the China Banking Regulatory Commission (CBRC) to supervise and regulate commercial banks. That freed up the central bank to focus on monetary policy and financial stability. The establishment of CBRC has not only allowed PBOC to focus on monetary policy execution, it also enabled CBRC to develop the specialized staff needed to supervise commercial banks effectively.

This background is important because it is a reminder that the key financial institutions in China are relatively young and that the banking crisis of 1998 was a costly experience that made China's leaders cautious about the pace of financial sector reform. During the late 1990s, many key structural reforms were carried out: loss-making enterprises were closed; millions of workers shifted from state enterprises to the private sector; fiscal reform re-centralized revenue collection and ensured that the government had adequate resources for public services; the urban housing stock was privatized; and China liberalized foreign trade and joined the WTO in 2001. These reforms set the stage for a golden age of Chinese growth in the first decade of the new millennium. China's exports grew rapidly, at more than 20% per year, and

this stimulated the expansion of the manufacturing sector, which became the engine of growth for the larger economy.

The global financial crisis in 2008-2009 was a large shock for China, primarily working through its export sector. China's exports dropped by one-third within a few months and the government estimated that 20 million workers were thrown out of work. GDP growth in 2008 slowed to 9.6% as the effects of the crisis began to be felt. China responded to the shortfall in external demand with a massive domestic stimulus. The stimulus was mostly aimed at investment and mostly carried out through credit, not on-budget financing, despite contrary advice from the IMF. In the years prior to the crisis, debt to GDP in China was quite stable. But, with the stimulus program, the growth of credit rapidly shot up above 30% and the debt-to-GDP ratio started to rise. The GDP growth rate in 2009 declined only a small amount from the year-before, but the composition was very different. The decline in net exports subtracted three-and-a-half percentage points from growth. But the growth of investment accelerated from 10.8% in 2008 to 19.2% in 2009. The investment boom was concentrated in local government infrastructure, real estate, and the heavy industry sectors that contribute to construction. This investment boom essentially made up the short-fall in demand from net exports.

Starting in 2010 China began to gradually withdraw the stimulus, but the growth of credit was still around 25% that year and real investment growth moderated but was nevertheless high, at 12.0%. Real GDP growth accelerated to 10.4%. Over the next few years GDP growth gradually slowed as investment growth decelerated. The growth of credit continued to be higher than the growth of nominal GDP throughout, with an increasing share

coming from an opaque shadow banking sector, that provided ways to channel credit to parts of the economy with limited access to the formal sector, often bypassing regulation that attempted to control credit allocation.

During this process of reform, two areas of tension developed between China and the U.S., in the realm of financial engagement. First, the U.S. was unhappy with China's intervention in foreign exchange markets and the associated accumulation of reserves, in the effort to keep the currency undervalued and to build a large trade surplus. Second, the U.S. was frustrated at the slow pace of opening up financial services in China to direct investment. These were the two main issues taken up in the Strategic Economic Dialogue started by Hank Paulson in 2006.

2. Trade balance and currency issues

In the early years of economic reform, China ran a trade deficit as is typical for a developing country that needs to import capital and technology. Chinese leaders, however, were determined not to see the country become overly indebted, something they associated with colonialism. The country switched from a modest trade deficit to a modest surplus at an early stage of development. Figure 1 shows the current account balance relative to GDP; this is the broadest measure of the trade balance including directly traded services as well as "factor services" – the main one being net earnings on capital. China went from an average deficit of about 2 percent during 1985-1989 to an average surplus of about 2 percent during 1990-1992.

The main capital inflows into China were foreign direct investment (FDI). A key part of China's reform was opening to FDI, but up until today it has maintained a positive list system that permits FDI in certain favored sectors and restricts it in others (more on this below). For the balance of payments, FDI

provided a modest, steady inflow during the 1990s. Other parts of the capital account were kept severely closed, especially capital outflows. During the 1990s China accumulated reserves at a steady but unspectacular rate. Its reserves provided an asset to match the FDI liabilities. Throughout the 40 years of reform, China was only a net debtor for a very short period, 1986-1989 (Lane and Milesi-Ferretti 2007). For the whole reform period China's current account balance averaged just above 2 percent.

In the early years of reform China had a multiple currency system in which foreign exchange certificates (FEC) were required for certain international transactions. FEC were denominated in yuan but traded at a premium to domestic currency. This was an awkward system subject to inefficiency and corruption. The currency was unified and the unified rate devalued in 1994. Then began a long period in which the currency was pegged to the U.S. dollar at the rate of 8.3:1. A pegged exchange rate is a reasonable choice for a poor developing country trying to establish macroeconomic stability and credibility with foreign partners and the domestic audience alike. While China pegged to the dollar, it had substantial trade with other Asian partners such as Japan, Taiwan, South Korea, and Europe. And these areas all had currencies that fluctuated against the dollar.

In examining whether a currency level is appropriate or not, it makes sense to look at the trade-weighted, or "effective" exchange rate. Figure 2 shows the evolution of China's effective exchange rate from 1994 to today. While pegging to the dollar in 1994 provided stability in the yuan in one sense, ironically it resulted in fairly rapid appreciation of the effective rate between 1994 and 1998. It turns out that this was an appropriate path for China because the country had commenced its rapid productivity growth in tradables. The problem with a fixed exchange rate in an economy with rapid productivity growth is that the country becomes competitive in more and more sectors and starts to run a trade surplus. China avoided this initially as the dollar was appreciating from 1994-1998. However, after 2001 the dollar began to depreciate, and China chose to follow it down. It can been seen in Figure 2 that China's effective exchange rate depreciated 20 percent between 2002 and 2005.

It was shortly after this that China started to run large current account surpluses, nearly 6 percent of GDP in 2005, rising to nearly 10 percent in 2007. There was a certain amount of pride in China at this export prowess in the mid-2000s, but large trade surpluses are not necessarily a good thing for a developing country. And of course they have to be matched by someone else's deficit, leading to trade friction and questions about sustainability.

China had the very large trade surpluses for only four years, 2005-2008, and it is a mistake to think that it was the result only of exchange rate under-valuation. But the exchange rate was crucial because it had so many spillover effects in other areas. To maintain the 8.3:1 peg against the U.S. dollar, in the face of rising trade surpluses, the central bank had to buy excess dollars and keep them as reserves. The reserves grew to $4 trillion. These are low-return assets and having more than a country needs for stability has real costs. The central bank was basically borrowing from Chinese people in domestic currency and lending to the U.S. treasury at low interest rates. It was clear that the currency would eventually have to appreciate, so the central bank was setting itself up for capital losses. It was also reluctant to raise Chinese interest rates to levels that would have been appropriate for a fast-growing developing country because that would complicate its sterilization task. So, the effort to maintain the peg led to financial repression in China that encouraged investment and a housing boom, at the expense of consumption.

The undervalued exchange rate was a great stimulus to the export sector. But it created inflationary pressure on the prices of non-tradables and on assets, especially housing. In the heyday of the surplus, 2005-2008, China kept its fiscal policy very tight, and put off needed expenditures in health, education, and infrastructure. That was the real cost of the trade surplus. China was making a lot of stuff for Americans and getting paid with IOUs, while under-spending on its own domestic needs.

The costs of undervaluation were becoming apparent by 2005, and China moved off the peg that year. It began a period of gradual appreciation against the dollar. Referring to the effective exchange rate in Figure 2, starting in 2005 it appreciated steadily until 2015. Over that decade it appreciated more than 50 percent. This apparently corrected the earlier undervaluation and accounted for ongoing productivity growth. China's trade surplus dropped during the global financial crisis, and then continued to drop further, reaching 1.4 percent of GDP in 2017. The IMF and most economists consider it fairly valued as it is keeping any trade imbalance at a very modest level.

The fluctuations in the effective exchange rate in the past few years are interesting. Starting in 2014 the U.S. dollar began appreciating, probably because the U.S. was recovering faster than other advanced economies and the Fed was signaling that it would start to normalize interest rates. Initially, China followed the dollar up and in Figure 2 there is a sharp appreciation in 2014. But by the middle of 2015 Chinese leaders began to worry that the appreciation was too much. So they wanted to signal to the market that they were de-linking from the dollar, but they did it together with a 2 percent "mini-devaluation" of the yuan that roiled markets globally. Eventually the authorities did a better job communicating that they planned to manage the currency with respect to a basket. They managed it back down towards trend, and have kept it relatively stable since then.

While China keeps the vast majority of its foreign reserves in U.S. dollars, it has become an increasingly vocal critic of a dollar-dominated global financial system. China's central bank governor, Zhou Xiaochuan, wrote an article in 2009 criticizing the dependence of the world on the dollar and launching a period in which China actively promoted the internationalization of its currency (Zhou 2009).

Initially there was steady and rapid increase in measures of internationalization, such as the yuan's share in global payments (Figure 3). However, the growth came to an end in the middle of 2015, and since then China's share has declined modestly. Up until 2015 there was an expectation

that the Chinese currency would continue to gradually appreciate, so that by itself created some incentive for agents to be willing to accept yuan. However, once the expectation of appreciation disappeared, there was not much attraction to holding RMB.

How do we understand the stalled progress in the emergence of the yuan as a major currency? China's prospects to be the largest economy in the world in about ten years have not changed, and that is one factor influencing the internationalization of currencies. But other factors that are relevant for reserve currency status are coming increasingly into play. Prasad (2015) identifies factors relevant to reserve currency status, in addition to market size: open capital account; flexible exchange rate; macroeconomic policies; and financial market development. At the moment, China has limitations on capital account openness and exchange rate flexibility that severely limit the usefulness of holding RMB. It is not surprising that the initial enthusiasm over RMB internationalization has waned to some extent: China is a long way from meeting the conditions to be a major reserve currency country.

While the yuan is far away from being a major international currency, China in 2016 did get it included in the IMF's basket currency, the "special drawing right," along with the big four: dollar, euro, yen, and pound. This was a reasonable, forward-looking decision on the part of Fund management and shareholders. The yuan will eventually be a significant currency. To be included China had to agree to some technical reforms about setting the daily fixing of the currency and allowing foreign central banks access to various markets in China. Foreign central banks can now usefully hold yuan, and that points the way to the kinds of reforms that would be needed so that ordinary foreign investors in the future can also hold and trade yuan.

In summary, steady engagement between the U.S. and China has led to greater flexibility in the currency and an end to excessive trade surpluses – an important step forward in the relationship. On

the other hand, China still has a long way to go with financial market development before its currency will become an important international player.

3. Foreign direct investment in financial services and other sectors

A key part of China's reform was opening up to direct investment from abroad. There is ample evidence that FDI accelerates technological advance in developing countries and enhances overall growth. Multinational firms bring frontier technology, brand names, connections to markets, and management experience. Throughout the 1960s and 1970s there were a lot of restrictions on direct investment throughout the developing world, fearing that these foreign companies would dominate domestic markets and prevent the development of strong domestic firms. However, it turned out in practice that there were beneficial spillovers from MNEs to domestic firms. Foreign firms come to rely on domestic suppliers, mostly private firms in the case of China. The MNEs help upgrade the capacity of the domestic suppliers by insisting on quality control, sharing certain technology, and often providing finance. Over time, most developing countries have come to welcome FDI.

In China's case, the regime for foreign investment has gone through four phases, starting with the promulgation of the Equity Joint Venture Law in 1979 (Jing and Song 2003). This law permitted foreign investment through joint ventures, typically with state enterprises. That restriction plus regulation of foreign exchange resulted in a rather small initial flow of FDI into China, most of it coming from Hong Kong. The second stage, 1986-1991, was characterized by extending the FDI openness to more locations in China and enacting a Law on Wholly Owned Subsidiaries. This set the stage for the third period from 1992 to 2000. Creating a legal framework for wholly owned subsidiaries, combined with more market-oriented attitudes following Deng Xiaoping's Southern tour, ushered in a period of rapid inflow of FDI, including from the developed economies. China joining the WTO in 2001 marked the beginning of a fourth phase in which more sectors were opened and FDI really took off (Figure 4). (FDI is

depicted as negative entries because it is a financial liability for the country; China's outward direct investment (ODI) is shown as a positive item on the same graph.)

While China's policy has been to gradually open up the economy to foreign investment, it has always retained a policy of requiring joint ventures in some key sectors. In financial services such as investment banking, the equity cap has been less than 50%. The aim of this restrictive policy is to build up the capacity of domestic firms. The OECD calculates an FDI restrictiveness index for its members plus key developing countries. The earliest year for the index is 1997. The first panel of Figure 5 shows the index for China – total and some key sectors – as well as South Korea as a comparator. Keep in mind that Korea is at a much higher stage of development than China. In 1997, China and Korea were measured to be quite similar. China was slightly above 0.6 for the whole economy, on a scale in which 1 equals completely closed and 0 is completely open. Korea was modestly more open with an index slightly above 0.5. China had some completely closed sectors such as communications and media, and some highly restricted sectors such as transport and financial services.

By 2016 Korea had become almost completely open. For the whole economy, the index around 0.1 is similar to the OECD average. Telecom is much more open and financial services almost completely open. China overall had become significantly more open, reaching about 0.3 on the index. China's opening occurred in steps: there was significant liberalization in preparation for joining the WTO and in the immediate aftermath of accession. Then followed a ten-year period in which there was no further reform. Finally, in the last few years there has been further significant liberalization as well as promises for additional moves in automobiles and financial services. Thus, the story for China is mixed: it is more open than Korea twenty years ago, and China is about 20 years behind Korea in terms of development so that is a reasonable comparison. On the other hand, the whole world has become more open to direct investment. China's restrictiveness today is about twice the level of the other developing country members of the G20. The gap is even more extreme in financial services. Virtually all of the developing

countries in the G20 have opened up financial services to direct investment, while China is still at 0.5 on the OECD index. Direct investment in financial services leads to a more robust and resilient financial system. Opening up to direct investment is not the same as opening the capital account to portfolio flows. So, China is outside the norm on financial openness, and this remains a sore point in U.S.-China relations. Especially now that Chinese banks and other financial institutions are going global. They use the protected Chinese market to build up their capabilities and assets, and then compete with American firms globally.

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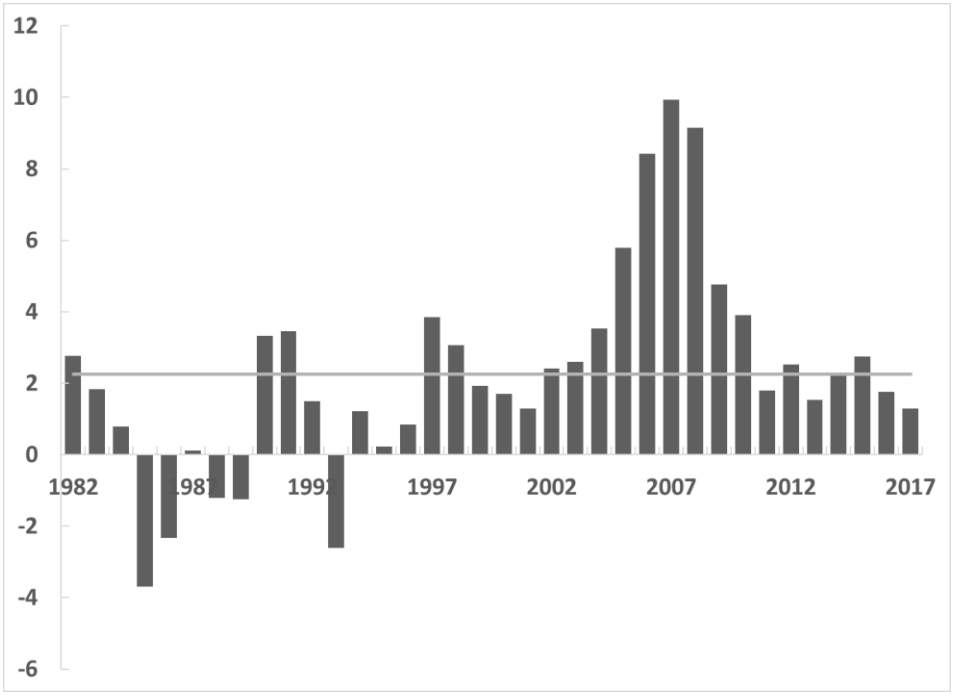
Figure 1. China's Current Account Balance (% of GDP)

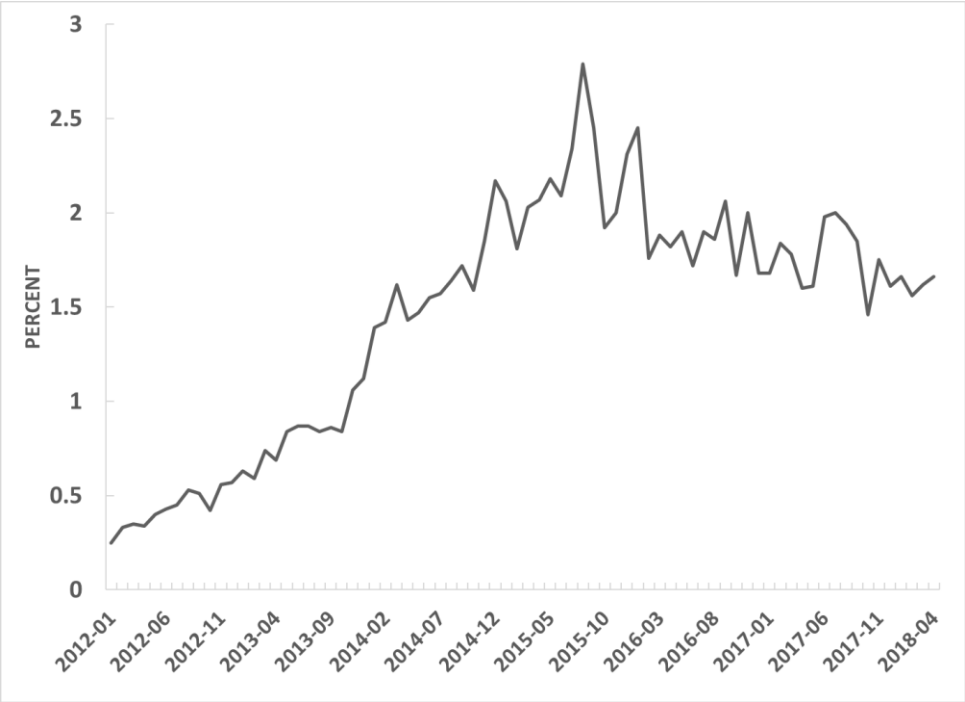


Source: World Development Indicator (WDI), The World Bank.

Figure 2. China's Effective Exchange Rate (Index, 2010=100)

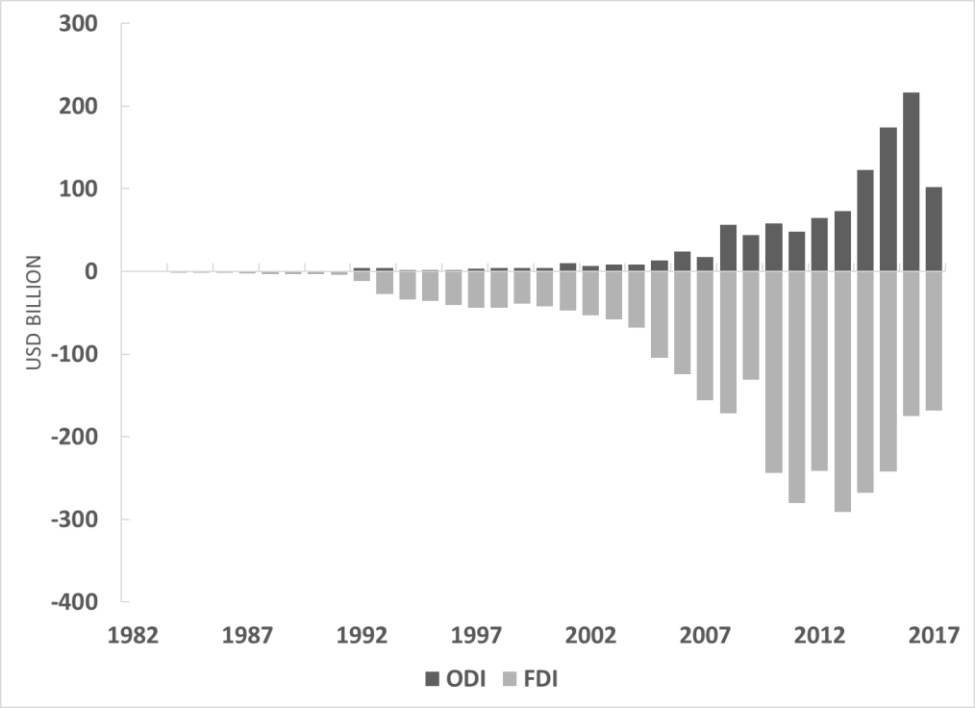
Source: Bank for International Settlements.

Figure 3: RMB's share as a world payment currency



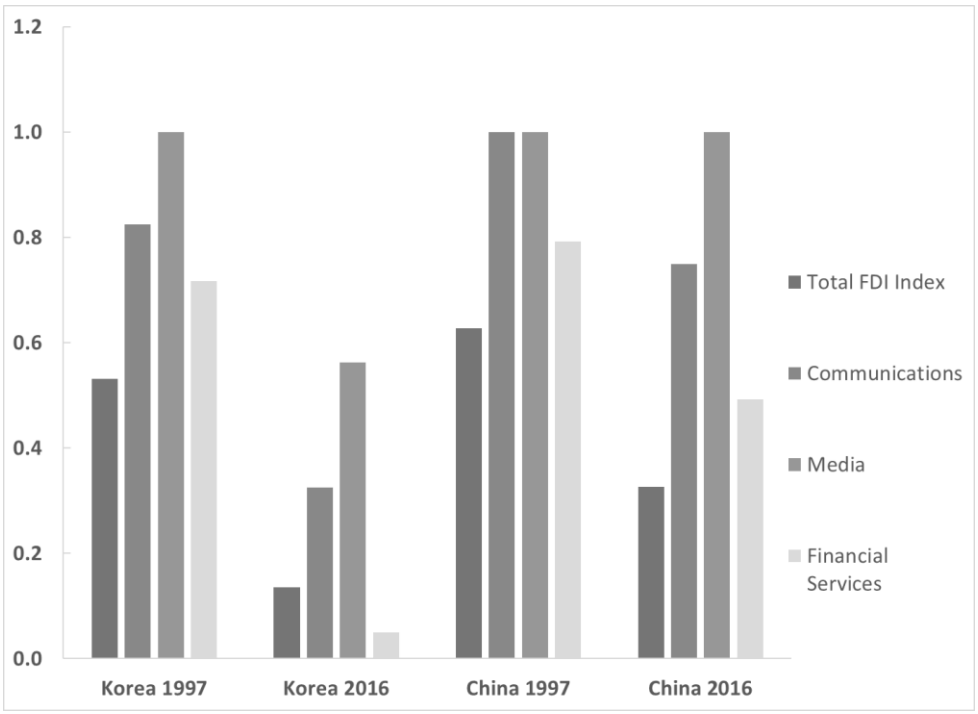
Source: SWIFT RMB Tracker.

Figure 4: China's FDI and ODI



Source: WDI, The World Bank.

Figure 5: FDI Restrictiveness, Korea and China, 1997 and 2016 (Index, 1=completely closed)



Source: OECD FDI Restrictiveness Index.