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The Unfinished Agenda of Financial Sector Reforms

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The Unfinished Agendas of Financial Sector Reform

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The agendas for financial sector reforms in China and India are unfinished in different ways and for different reasons. Both systems are relatively conservative in their structure and oversight and the global financial crisis served to strengthen confidence in the wisdom of that conservatism. Both financial systems are also works in progress: China's equity and bond markets are immature while India's tax and institutional restrictions need to be addressed in order to meet the needs of increasingly complex economies by mobilizing savings and allocating them to productive uses.

Mature financial systems play a special role in complex modern economies because financial information is asymmetric, that is, borrowers and lenders do not know each other and lenders know much less than borrowers about the risks they will repay. Financial institutions mobilize and pool the savings of households and enterprises, and screen borrowers and issuers of bonds and commercial paper to ensure that they are able to repay in full and on time. By facilitating payments in economic exchange the mature financial system facilitates and sustains growth by attracting required capital, processing information about enterprises and investment projects and directing savings to productive uses by innovative growth firms.

Global finance has gone through a revolution in the past thirty years as advances in telecommunications and computer technology have made it possible to move capital around with a key stroke. As the global financial crisis illustrated in stark fashion, finance is now borderless. In the largest advanced industrial economies, financial innovations have proliferated and gained such complexity that neither managers nor regulators are able to stay ahead in protecting against the risks to investors and consumers. In response to the severity of the 2008 banking crises governments in Europe and the United States temporarily nationalized their most troubled banks.

While the roots of that crisis were inadequate regulation given the deep integration of financial markets, as well as innovation and complex financial instruments, these are not the standards towards which emerging markets should aspire. This note supports 'plain vanilla' reforms which produce sound regulation, liquid markets and financial institutions and instruments of sufficient diversity that enterprises can make long term investments and manage such risks as interest and exchange rate volatility and future ability to repay. It is also important to distinguish between market-based

institutions as the most efficient way to organize and deliver such services and the failure of oversight institutions to anticipate problems and manage them on a timely basis.

The financial systems in China and India are smaller than one might expect in the light of their large populations and rapid growth. One reason is historical. For half of the last century they cut themselves off from world financial markets by erecting barriers to capital flows and the entry of foreign firms and, more recently, by managing their exchange rates. China's financial system was nationalized after the revolution and a single government bank issued currency and collected deposits. Even today, after many years of reform, while China's enterprises can reinvest their savings in their businesses, households have few alternatives to bank deposits paying low interest rates set by the state. India's savers have more options, but many households mistrust formal finance, preferring tangible assets of gold and land.

Governments still have strong ownership and conservative regulatory roles. Banks in both countries are largely state-owned (something still true in a majority of developing countries) despite evidence that countries with large state involvement have slower financial and economic development than countries that do not (LaPorta 2002). The official institutions that support and regulate financial markets are under-developed. Neither central bank is independent. In China, the People's Bank of China (PBOC) reports to the State Council. The Reserve Bank of India (RBI) is legally responsible to the central government, but has more de facto independence because of the central government's declining political clout. Regulation lacks transparency in that in China six regulatory agencies share sometimes overlapping responsibilities and in India such responsibilities are distributed among a plethora of agencies both inside and outside the financial system.

Measured by the amount of capital required to produce an additional unit of GDP, the McKinsey Global Institute has estimated that India and China use forty percent more capital than Japan did at a similar stage of its development (MGI 2006). Governments remain heavily involved because they use financial institutions as instruments to achieve significant political objectives: the Party's central goals being jobs and political stability in China, and access for rural savers and small businesses in India.

The purpose of this note is to examine the importance of further financial reform as the two future giants' economies become more complex, and to suggest priorities for reforms with particular attention to the challenges of creating financial channels for small and medium-sized enterprises, the potential innovators and main sources of future employment and incomes.

Financial Reforms and Future Economic Growth in China and India

Financial Reform and Growth in China

Within the broad political constraints both governments are pursuing reform agendas, China faster than India where further liberalization encounters repeated political delays.

As is well known, bank reform has been the major feature of China's financial system modernization since the late 1990s. These reforms have facilitated rapid industrial growth but more change is needed to aid China's current agenda of economic rebalancing.

When China joined the WTO in 2001 the government used a commitment to open the banking sector to foreigners by 2007 as a way to encourage restructuring to become commercially viable. Accumulated bad loans were removed and the banks took on strategic foreign investors to obtain expertise more than capital and listed on the stock exchanges in Hong Kong and Shanghai. These moves encouraged changes in mindset and management by exposing directors and managers to international competition and the inevitable pressures from international investors and analysts for greater transparency and focus on efficiency and profitability, rather than the bureaucratic and political goals of growing market share.

Competitive pressures grew in other parts of the banking system as the three large policy banks were restructured, as city commercial banks were allowed to diversify geographically, and as the rural financial system was strengthened by carving a new Postal Savings Bank out of the national post office and allowing villages and townships to set up banks following an initial 6-province pilot project. The intensive restructuring and positioning succeeded in creating more competitive efficient financial institutions; non-performing loan ratios improved dramatically; from a high of 28.6 percent in 2000 NPLs dropped to 1.6 percent by end-2009 (See http://www.cbrc.gov.cn).

By 2007, with their newly raised capital and the economy and exports booming, the big banks were also flush with cash and the ICBC and the Bank of China had joined the world's top ten banks measured by tier one capital ratios. They were also encouraged to "go abroad" to develop global capabilities by following their customers into Southeast Asia and Africa; by taking small equity stakes in UK and US banks in order to learn advanced banking technologies and products; and by obtaining banking licenses to enter the US market.

While early equity investments abroad were not particularly successful the real test is the ability of the domestic financial system to weather significant economic adversity such as the Chinese economy experienced in 2008. Current signs suggest local governments, until recently forbidden to issue bonds, largely implemented the stimulus through the use of thousands of informal financial vehicles to borrow from the banks. These loans are now coming due.

In addition, banks' efficiency and competitiveness are still deeply influenced by China's larger economic policy framework. Since the 1997-98 East Asian financial crisis the exchange rate has fluctuated in a very narrow range. The exchange rate has been stabilized by the central bank's acquisition of large foreign exchange earnings from exports and FDI inflows and its sterilization of the resulting liquidity.

The central focus on exchange rate stability has reduced the independence of

monetary policy. Interest rates are administered rather market-determined. The central bank sets banks' deposit and loan interest rates, paying savers low returns and allowing the banks healthy spreads by setting higher lending rates. Allowing market-determined rates would be risky, as the fixed exchange rate is vulnerable to speculative capital inflows, which would put upward pressure on the exchange rate and require more sterilization. Administered interest rates and administrative guidance reduce commercial banks' appetite for risky credits because they on the generous spreads between deposit and lending rates as a significant source of income; borrowers also tend to be large well-known corporates with government connections (see Dobson and Kashyap (2006) for illustrations of the spreads).

Incentive structures of bank management and directors have been modernized since 2004; but they have not changed sufficiently to make the banks' heavy reliance on corporate customers, many of them government-owned or –controlled, a thing of the past. By the large banks' own published financial statements corporate customers still account for between 70 and 80 percent of their loans. The implication is that banks are exposed, not to firms with burgeoning profitability, but to government-owned and connected firms whose profits are likely to be less certain in an economic downturn.

In summary, China's domestic financial system suffers from lack of diversity and depth; it is bank-dominated, lacking a deep government bond market as well as a non-state corporate bond market and transparent equity markets. The continued relative immaturity of the domestic financial system is a drag on China's ambitions to see Shanghai become an international financial center by 2020 and the *renminbi* to become one of the world's reserve currencies (Dobson and Masson 2009).

Financial Reform and Growth in India

India's financial system benefits from its established system of financial regulation and a well-developed legal system. Yet the financial system has some policy constraints similar to those in China: government ownership of banks is still at high levels and political factors influence how banks must allocate their capital as well as the interest rates they can charge. Unlike China, which for years has had the advantage of fiscal balance, India's public sector accounts are riddled with deficits (in gross terms consolidated government deficits were more than 10 percent of GDP, both at the beginning of the decade and again in 2009-10 – although there was improvement in mid-decade). Much government spending is oriented towards consumption subsidies and the deficits have constrained governments' ability to undertake infrastructure investments.

Significantly, public sector deficits are a factor in crowding out funds available to the private sector. India's banks are required to acquire government bonds as a designated liquid share of their capital base (which has declined to 24 percent) and they must direct 40 percent of net bank credit to "priority sectors" such as small scale industry, with 18 percent of the total directed to agriculture and 10 percent to loans for housing and education. The first requirement contributes to stability in their capital bases but produces low returns (except when bond yields are high). The second requirement has

similarly ambiguous impacts. While banks have created thousands of rural branches to attract rural savers, small low-income borrowers are costly and high risk to service and few loans are made.

Not surprisingly, banks are not the best means of achieving social goals and there are undesirable unintended side effects: rural savings in the government-owned banks are transferred to government consumption through the required investments in low-risk public sector bonds which crowd out (higher-risk) productive investments. A number of studies have also demonstrated that PSBs are less efficient than non-PSBs and account for a higher share of non-performing loans.

In summary, despite steady progress much remains to be done to turn the two domestic banking systems into efficient managers of risk. The conservative approaches have ensured that the financial systems have not damaged growth prospects, *but they have not enhanced them either*. Instead they finance industries of the past and deny formal finance to entrepreneurs and industries of the future. China is vulnerable to continued slow growth in OECD export markets and to declining asset values in the stock market. As investors meet margin calls by disposing of other assets, their value will decline and banks' non-performing loans will rise. But China's financial resources are sufficient to handle such problems.

International Interconnectedness

This section would be incomplete if it did not recognize both governments' international ambitions for their financial industries. As their economic size and dynamism in the world economy have increased, so have two-way financial flows and interest in greater international roles. India has examined Mumbai's potential as an international financial center that would follow the trail blazed by IT services to export financial services to the rest of the world. Shanghai has been targeted as an international financial center by 2020.

While deeper international integration is desirable it has to continue to be carefully managed. The Expert Group which recommended Mumbai as a future international financial center argued that changes are needed to free up market forces and reduce government intervention. Recent studies of East Asian financial integration have also noted the almost unassailable advantages accruing to New York and London because their dynamic and innovative international financial institutions have been first movers in their fields and have developed both sophisticated products and risk management techniques that India and China as followers are unlikely to overtake any time soon.

India may have the technological and institutional capabilities to develop offshore financial services but slow liberalization of trade and FDI flows and notorious difficulties of doing business undermine Mumbai's attractiveness. In contrast, now that China is the world's top merchandise exporting nation, among its top importers and a major destination and source of capital flows, a more international role for the Chinese yuan is inevitable. Yet the yuan is likely to remain a regional currency based on China's

rising regional trade ties. The depth and diversity of domestic financial markets is constrained by credit distortions in the banking system which hampers development of a competitive domestic enterprise sector, and active household participation in the debt market has not yet occurred. Equity markets show more development in recent years but foreign participation is still heavily restricted and questions persist about the transparency and governance which are essential to deep equity markets.

Further Financial Reforms Required

Additional reforms are required in both countries. In China the managed exchange rate regime reduces China's options to adjust both internal and external imbalances. The Chinese authorities have encouraged capital outflows, partly to moderate nominal exchange rate appreciation but the overall balance of payments is in large surplus and attracts international pressure to allow a greater role for market forces. There are few doubts that if this were to happen the yuan would appreciate in nominal terms.

Domestic reforms are also required. Can governments continue to afford the financial system inefficiencies as both economies become more complex and market-oriented? McKinsey Global Institute researchers have estimated, for example, that if Chinese enterprises obtained their funding in the way that other countries do, with lower cost bond markets supplying 60 percent (instead of 3 percent) of enterprise finance and banks supplying only 40 percent, enterprise funding costs would decline by $14 billion a year (MGI 2006).

At least four areas of reform would increase financial system efficiency: reduced government ownership and intervention, more domestic competition, improved financial institutional infrastructure and upgraded regulatory oversight.

- Reduced government intervention

Majority government ownership emphasizes political rather than commercial incentives in the financial systems. China is experimenting with private ownership in smaller institutions located outside of the major urban areas, but the government gives no indications of reducing its stakes in the large state-owned banks. Looking to the future, it is reasonable to expect, now that all the major banks have been restructured, the freer play of market forces will be allowed. When borrowing and lending rates are deregulated (for which no date has been set), interest spreads will shrink. When deposit insurance is introduced (another reform that is under discussion), investor and depositor monitoring will intensify as the implicit blanket guarantee is modified and removed. Banks are already facing more competition from non-bank financial institutions. As margins shrink and balance sheet growth declines, pressures to consolidate China's banking sector are likely to grow.

India's experience with "new private" banks has shown that they turn in superior growth and financial performance. Revision of the rules on government ownership to reduce such ownership stakes below 51 percent of total equity has been delayed due to

political opposition in the wake of the global financial crisis. Yet creative suggestions have been put forward for more incremental reforms, such as creating stronger and more independent boards that include private investors (not necessarily foreigners) taking strategic stakes; and allowing bank mergers so that smaller and less efficient banks can be taken over by those with more profitable business models.

- Allow more competition

More competition to promote efficiency and innovation can be encouraged by such means such as allowing foreign players to compete, developing corporate bond markets, and wider availability of risk management products such as plain vanilla derivatives, futures contracts and options. China has made good use of foreign participation in the big banks and to a lesser extent in the stock market where foreign institutional investors are permitted to invest in equities on a restricted basis. India is more ambivalent about foreign participation in banks through FDI, but has permitted wide use of foreign portfolio finance and foreign stakes in brokerage firms. Foreign ownership in the insurance sector is also held at low levels. Recent RBI discussion papers, though, anticipate growing acceptability of foreign equity stakes in banks: through controlling stakes in weaker private banks that need to be restructured and through setting up wholly-owned subsidiaries. FDI in new private banks is also envisaged, with stakes of 49 percent or less in the first five years when 74 percent paid up capital limits are permitted.

Corporate bond markets are another promising way to increase competitive pressures on banks by providing lower cost longer term finance. Politicians and regulators in both countries have been reluctant to free up private sector corporate bond issuance because of concerns about dishonest or misleading information from issuers and poorly informed retail investors. A litany of the institutional weaknesses was outlined in 2005 by China's central bank governor: bankruptcy laws have only recently been adopted; default procedures are not yet based on market principles; investors lack the transparency afforded by credit rating agencies, modern accounting standards and transparency by issuers; market discipline has not been established and investor education is insufficient (Zhou 2005). A recent PBOC report on capital account liberalization focuses on corporate bond market reforms to increase the capacity to absorb expected financial inflows. These reforms include market-determined interest rates, a unified corporate bond market and a deeper government debt market.

Bond market reform is also under debate in India where two blue ribbon panels on the financial system, the Mistry Committee report on Making Mumbai an International Financial Center (2007) and the Rajan Committee on Financial Sector Reforms (2008), urged reforms to increase supply and demand and improve the functioning of the marketplace. Some issues such as governance and technical change can be addressed administratively. But legislation is necessary to change costly forms of taxation, institutional restrictions on insurance, pension funds and banks, and foreign investment and is unlikely without a crisis or catalyst. One catalyst has been the growing demand for long-term infrastructure finance which has seen rising issuance and turnover.

- Upgrade financial market infrastructure

In China, improved financial market infrastructure would help address some of the deficiencies outlined by Governor Zhou: electronic payments systems; credit rating agencies to provide investors with information on listed companies; information and disclosure regulations that are vital to evaluating and managing risk. India's national stock exchanges have adopted high standards for disclosure and transparency. Further liberalizing listing and disclosure regulations to allow firms to take advantage of favorable market conditions would be beneficial to companies seeking finance from institutional investors. Exit remains a problem for borrowers and issuers. Bankruptcy laws have been passed in China but are not yet being enforced and bankruptcy in India suffers from the more general problem of the overburdened legal system.

- Smart regulation

Governments in both countries have mixed objectives for the financial systems, using them to achieve political and social objectives. Government ownership in China ensures banks serve the over-arching goal of supporting fast growth; the cost of capital is kept artificially low to borrowers and so capital has been over-used for industrial purposes, infrastructure and housing. Household depositors have borne the costs in terms of foregone returns to their savings. How much longer can China afford the consequences of these mixed objectives? The Indian government uses the financial system to support its inclusiveness objectives; practices that waste capital as evidenced by higher NPAs in the state banks and crowding out of private sector investment.

Regulatory arrangements should be driven by the necessity for soundness and efficiency. Yet financial regulators are not independent in either country. China's banking regulator must satisfy both PBOC and the State Council before it can implement regulations. India has a plethora of overlapping agencies that includes RBI, the National Housing Bureau, as well as overseers of cooperatives, insurance and securities. While India's consolidation of monetary and regulatory policy within RBI looks prescient in the context of concerns about macro-prudential stability in the wake of the global financial crisis, neither government appears to be much concerned about addressing the issue of mixed objectives for banks by using more direct means to achieve social objectives.

Financial Inclusion

Across countries, there is general agreement on the principle that the general population should have access to banking services and that banks should not erect artificial barriers to low-income households' access to bank or credit union deposit accounts and credit services. In India evidence of low access, particularly in rural areas, and financial problems of farmers have been deemed to be sufficiently serious to require mandatory priority lending quotas for banks. In China, now that modern financial services are available to urban households, attention has turned to making both deposit and credit services more readily available and accessible in rural areas.

Experiments with micro-credit, credit unions and finance companies – and with privately owned institutions – seek to solve these problems. But some recent work examining the behavior and experiences of low-income households and businesses suggests significant design issues. Sometimes conditions for markets to exist on their own are missing, which suggests a role for government. In other cases there are flaws in design or in basic assumptions underlying policies. Work by World Bank and university-based economists reveal, for example, that handling a small amount of money in a bank entails a fixed cost (Banerjee and Duflo, 2011). Allen et (forthcoming) show that small and medium-sized businesses tend to rely much more heavily on financing from non-bank, non-market sources, with bank loans running second. The advantage of alternative financial mechanisms is that bank finance is relatively costly and difficult to obtain. One means to get around these difficulties is through design: such as the use of no frills bank accounts and electronic transfers, not least by governments when making transfers for NREG, food and fuel subsidies.

Financing the Future: SME Finance

A closely-related related issue in both countries is finance for the fast growing small and medium-sized enterprises (SMEs) that will do much to determine each country's economic future. China's future growth engine is its numerous small entrepreneurial institutions that now account for nearly two-thirds of industrial production. Yet they are unable to access formal bank finance because they lack collateral – as one senior banker framed the issue: "The big banks are like pawnshops; they demand real collateral (real estate or capital equipment) from borrowers and lots of it." Available evidence indicates that the plethora of non-state enterprises must obtain their financing from non-bank informal sources, most notably from people they know or from non-regulated informal financial institutions.

Surveys of startups and SMEs show that they rely on informal financing from family and friends, and to a lesser extent, on banks. Once they become established, they rely on retained earnings. To make a growth leap they must go to private credit agencies (PCAs) instead of banks. PCAs cover a wide range of institutions, from credit associations and shareholding cooperatives to underground money houses which charge high interest rates (See Allen et al 2008). Li and coauthors (2005) studied financing patterns of private enterprises and found that businesses owned by CCP members were more likely to obtain bank loans. In other words, bank loans depend on who you know.

More recently, finance companies have been permitted to extend loans if they do not have bad credit or criminal records. Legalizing PCAs, which have thrived in coastal provinces like Zhejiang despite their underground status, would increase competition for the state-owned banks and bring credit channels for SMEs under CBRC oversight.

Each of these developments signals a shift that is consistent with China's overall rebalancing strategy. Increasing the availability of loans to capital-starved SMEs will help to stimulate the growth of non-capital-intensive light (and presumably labor-intensive) manufacturing industry and with it job creation.

India's challenge was framed by the 2007 report on finance in the unorganized sector which contributes 30 percent of GDP but receives 5-6 percent of institutional credit. OECD (2007) reports a survey in Uttar Pradesh which found that banks took 33 weeks to process loan applications and required bribes (which were larger if the loan came from a government scheme) to grant loans. Money lenders were much more responsive and willing, even to make loans for consumption purposes. Of course these loans cost more. India's small enterprises' size is restricted by labor market regulations; they also face restrictions on their access to bank financing because of the quantitative requirements of priority lending policies and government-mandated interest rate caps. Most borrowing from these institutions is also for consumption smoothing rather than for investment (see http://nceus.gov.in)

Suggested solutions range from a National Fund to support such enterprises (announced in 2004 with the National Common Minimum Program) to expanding formal bank lending through local agents rather than expensive branches to service these clients. Allen et al (forthcoming) examines the complex linkages among legal and business environments and finds that despite its well-developed legal system on the books, in practice is slow and inefficient and subject to government corruption. SMEs tend, therefore, to prefer informal financial channels.

Conclusion

To sustain high growth rates as the economies become more complex, savings will need to be allocated more by market forces than government direction. Governments should withdraw from ownership and intervention in favor of oversight roles. Reforms have reduced the risks of systemic banking crises but have positioned neither banking system to drive efficient growth. The continued immaturity of China's financial system is likely to undermine efforts to promote the yuan's international role. In the wake of the global financial crisis, both governments may be content to stay behind the risky technology frontiers in finance -- but at the risk of lagging behind, denying finance to those enterprises that will sustain long term growth by producing more "bang for the buck", that is, higher GDP growth from any given savings rate.

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