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Banking Watch

China

Hong Kong, 07 December 2012
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Asia

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Taking stock of financial liberalization

- **After a period of stagnation in financial sector reforms during and in the immediate aftermath of the 2008-09 global financial crisis, the liberalization process appears to be regaining momentum.**

  The authorities have launched a batch of reform measures since the beginning of this year, including steps toward interest rate liberalization and greater flexibility in the exchange rate. Following the release of a five-year plan for the financial sector last September, the new leadership in China has signaled that it will press ahead with liberalization measures in the financial sector and other areas of the economy in the coming years.

- **Recent liberalization measures aim to alleviate financial repression, spur economic development, and maintain financial stability.**

  The reform measures in the financial sector aim to address impediments to growth and distortions. For example, existing entry barriers to private capital in the banking sector and interest rate controls have prevented competition, and have solidified the monopoly standing of a handful of large state-owned banks. Various forms of financial repression have also given rise to a number of financial vulnerabilities such as the property market bubble and shadow banking activities.

- **Some of the liberalization measures have already taken effect, while others are still pending.**

  A limited degree of interest rate liberalization has already resulted in higher deposit rates as banks seek to attract deposits. And a widening of the daily trading band for the RMB has resulted in enhanced currency flexibility. However, progress of the pilot programs for financial reforms in Wenzhou and Qianhai has been disappointingly slow.

- **With financial liberalization expected to continue, it will be important to for the authorities to pay due regard to the sequencing of reforms.**

  We think that China should follow the conventional wisdom to prioritize the liberalization of domestic financial system over the reform of exchange rates and the opening-up of capital account. However, some tail risks might hold up the progress.

- **While financial liberalization may put pressure on net interest margins and overall profits, it should also bring new business opportunities.**

  Retail banking and SMEs businesses are expected to prosper, benefiting banks with relevant experience. At the same time, new competition may arise from IT companies through e-commerce. Efforts to increase the proportion of "direct finance" (bonds and equities) should boost investment banking opportunities and help banks to diversify the range of wealth management products they offer to clients. Foreign banks may also be able to take advantage of new business opportunities as China's enterprises pursue more OFDI to increase their global footprint.

Introduction

On September 17, the authorities announced the 12th Five-Year (2011-2015) Plan for the financial sector. It follows as a subcomponent of the broader Fiver Year Plan released last year, and was designed through the collaboration of five government agencies: the People's Bank of China (PBoC), China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), China Insurance Regulatory Commission, and State Administration of Foreign Exchange (SAFE).

The Plan aims to continue ongoing financial sector liberalization by gradually abolishing interest rate controls, opening the capital account, encouraging financial innovation and strengthening the financial regulatory framework. However, there is no timetable for the achievement of these objectives. A new feature of the Plan is the establishment of two quantitative targets covering value-added of the financial sector, set at 5% of GDP (up from 4.4% in the past decade), and direct financing (bond and equity issuance), set at 15% of "total social financing" (TSF) by the end of 2015 (up from the average level of 11% during 2006-2010).

At its recently concluded National Party Congress in November, China's newly appointed leadership set ambitious targets, calling for a doubling of GDP and household income during the decade from 2011-2020, and reinforced the commitment to continue reforms in financial sector.

Financial repression: a drag on sustainable growth

Although the economy has continued to grow strongly in recent years, China's financial sector is still replete with various forms of financial repression. This repression encompasses: i) high entry barriers for private capital in the banking sector; ii) controlled interest rates to protect banks' profit margins; iii) underdeveloped domestic bond and equity markets; and v) still-limited currency flexibility and lack of capital account convertibility. Such forms of financial repression not only impede an efficient allocation of capital in the economy, but also undermine financial stability.

Encouragingly, even before the announcement of this new 5-year plan, the authorities had already been accelerating the pace of financial liberalization. Though November of this year, a large set of new policy initiatives have been implemented to correct some forms of financial repression (Table 1). Although many of these new policy initiatives are incremental improvements on top of the previous ones, some breakthroughs have taken place in the interest rate liberalization and the change of exchange rate regime.

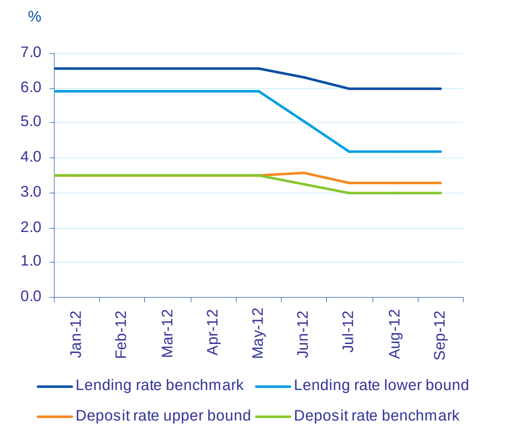
Enhancing interest and exchange rate flexibility

At core of this new round of financial liberalization are steps to expand interest rate and exchange rate flexibility, as well as a pilot program in Wenzhou where private capital is being encouraged to enter the banking sector and certain restrictions of capital account are relaxed to permit individual overseas investment.

As is typical, the authorities are acting cautiously in pushing forward these liberalizing measures. With effect from last July banks, banks have been allowed to offer a 30% discount of the benchmark lending rates to borrowers (previously 10%), and a 10% premium over the benchmark deposit rate to savers (previously no premium was allowed) (Chart 1). A widening of the daily exchange rate band has also been implemented incrementally, with the most recent widening occurring in April, from +/- 0.5% to +/- 1% around the daily fixing rate (Chart 2). In pushing for progress in sensitive areas such as opening up the banking sector to private capital and easing capital account restrictions, the authorities chose to introduce pilot programs in Wenzhou and Qianhai.

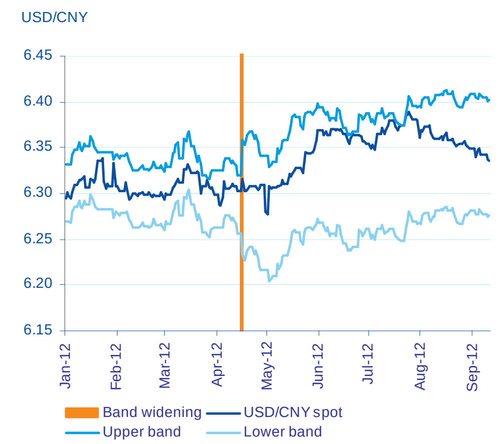
What has been the effect of these reforms so far? The widening of the RMB daily trading band has resulted in greater two-way fluctuations against the USD. With respect to interest rates, the announcement of enhanced flexibility caused small and medium sized banks, which have relatively weaker bargaining power with their clients, to make full use of the 10% premium in order to attract deposits. The large state-owned banks also raised deposit rates, but to a lesser extent. However, the lending rates offered by banks still remained at the benchmark ones just as before. On the other hand, it was reported that the real progress of the pilot programs in Shenzhen and Qianhai disappointingly lagged behind the schedule, which was at least partially attributable to the prudent attitude of the local government officials.

Chart 1
Interest rates are liberalized to enhance the efficiency of the banking sector



Source: Bloomberg and BBVA Research

Chart 2
The daily trading zone is expanded to allow for a larger extent of exchange rate flexibility



Source: CEIC and BBVA Research

Associated risks are large but manageable

The current round of financial liberalization efforts is multi-faceted. They cover a range of areas such as bank ownership, interest rates, the exchange rate regime, the capital account and the domestic bond market. The authorities have expressed an interest in pursuing reforms simultaneously on all fronts as a catalyst for the broader reform effort. While this is commendable, over time, the issue of sequencing is likely to become more important, especially as the liberalization process enters a more advanced stage. This would be necessary to avoid the pitfalls of poorly sequenced liberalization efforts, as experienced in other country cases (for example, in Latin American Debt in the 1980s).

The conventional wisdom in the literature on financial liberalization is that domestic liberalization should precede external liberalization. [1] And within external liberalization, reform of the exchange regime should be completed prior to liberalization of the capital account. Otherwise, a premature opening-up of the capital account could lead to volatile and destabilizing capital flows, exacerbating domestic financial sector if weaknesses.

Even seemingly cautious moves like the limited pilot programs adopted so far carry risks. Financial deals are often done electronically, and it can be difficult to control cross-border speculative flows. Therefore, the pilot region might attract nationwide capital inflows aimed at taking advantage of these liberalizing measures to increase their investment return, which as well can cause the financial disturbances in the domestic financial sector. In this respect, the government needs to implement some specific regulations to insulate the pilot regions from others.

Another risk associated with the current financial liberalization is its emphasis on the broadening the finance channels for SMEs amid the ongoing economic downturn. As the economic slowed down, the SMEs appear much more vulnerable than any time, which pose a risk to the new unveiled financial instruments backed by the assets of SMEs.

[1] See, *"The Liberalization and Management of Capital Flows - An Institutional View"*, *IMF, November 14 2012,* http://www.imf.org/external/pp/longres.aspx?id=4720

Overall, the risks associated of the current wave of financial liberalization are still manageable but they are bound to become larger and more complex as the reforms deepen. The authorities should pay attention to the potential risks and adopt a systemic approach to push forward the reforms so that the stability of the entire financial sector would not be endangered by liberalizing policy initiatives.

Sequencing is key

Although no specific timetable is provided in the five-year plan for the financial sector, we anticipate that the reforms to accelerate compared to the previous period of stagnation during and in the immediate aftermath of the 2008-09 global financial crisis. Such acceleration could take place after this coming March when the newly selected party leaders will take over their administrative functions. Reforms are likely to focus on themes such as diversifying the ownership of banks, liberalizing interest rates, enhancing the regulatory framework, opening the capital account, and further internationalization of the RMB.

The current stage of liberalization has reached a critical phase in the sense that most of the "easy" reforms have been implemented. A noted above, the sequencing of further policy initiatives will become increasingly important, with the liberalization of the domestic financial system to occur ahead of the reform of the exchange rate regime and the opening-up of capital account, with a view to minimize financial risks. It is highly unlikely, for example, that the RMB could become an accepted international currency on the scale of the USD, Euro and JPY unless China's domestic capital market is sufficiently liquid and deep.

Lifting interest rate controls and leveling the playing field

The key to liberalizing the domestic banking sector is to abolish the control of interest rates and allow market forces to play a greater role. Since the floor on lending rates is currently non-binding, it should be relatively ease to liberalize lending rates fully as a first step. Optimistically, this could take place within the next couple of years.

The liftingof the cap on deposit rates (which is binding), on the other hand, is more challenging and may not be finished by 2015, the ending year of the current five-year plan. However, we still anticipate that deposit rate flexibility will be expanded by then from the current level. To coordinate with the relaxation of deposit interest rates, a nationwide deposit insurance scheme should be established to avoid adverse outcomes as banks compete for deposits. The establishment of such a deposit insurance scheme appears to be in the pipeline, and if all proceeds smoothly, we anticipate its completion in the next three years.

In parallel, the de facto monopoly of the large state-owned banks should be broken by allowing more private capital and foreign banks to enter the domestic credit market, especially for those targeting the SMEs and household as their primary potential clients. This is equivalent to leveling the playing field for all the financial institutions. Not only does it help to bolster up the economy amidst the currently heightened external uncertainty but also it will contribute to rebalancing China's economy toward domestic demand and aligning the growth on a sustainable track. It is expected to be a continuous process over the next five years.

As stated in the five-year plan, the authorities will take great effort to develop the domestic equity and bond markets so as to provide diverse options for people to park their savings. Toward this end, the authorities can allow more entities including local governments and private enterprises to issue their bonds to deep the market depth and increase the liquidity. They may also unify the previously segmented inter-bank bond market with the exchange bond market and open the merged one to foreign investors to a larger extent.

A flexible exchange rate is the prerequisite of capital account liberalization

Ideally, as noted above, the rigid exchange rate regime should be reformed prior to the opening up of capital account. The current global economic slowdown have presented China good chance to increase the flexibility RMB's price against other foreign currencies while not necessarily led to the large magnitude of appreciation and dent the competitiveness of its huge-sized export sector. We anticipate that the authorities will further expand the daily trading band of the RMB in the next few years. Although there are more uncertainties stemming from the external environment, it is not a wild speculation that the exchange rate will become float by the end of 2015.

The opening-up of the capital account should be the last step of financial liberalization. The authorities are gradually increasing the quotas of the specific cross-border capital flow programs such as Qualified Foreign Institutional Investor Program (QFII), Qualified Domestic Institutional Investors Program (QDII) as well as the RMB-QFII and RMB-QDII but unlikely become totally convertible under the capital account by end-2015.

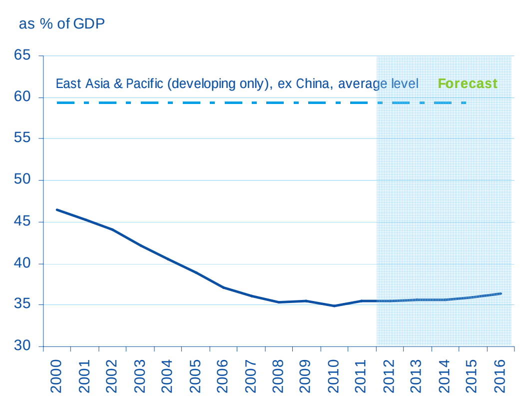
One caveat is that the above projections are based on the assumption that there is no materialization of tail risks over the next five years such as the deterioration of European debt crisis and steep slowdown in US growth. That said, the authorities might halt the reform process if adverse events were to occur, such as a hard-landing of the domestic economy or external volatility..

Opportunities for banks

Based on the list of reform priorities laid out in the financial sector plan, along with the new growth targets established by the 18th National Party Congress (NPC), it is possible to identify business opportunities that may be available to banks as a result of the liberalization process. First and foremost, the Plan stresses the role of the financial sector in adjusting the economic structure and rebalancing the economy toward domestic demand, especially domestic consumption (Chart 3). Moreover, the NPC's target of doubling GDP and household income, if successful, will additionally bring 200-300 million Chinese people into the middle class (with annual income higher than 10,000 USD 2010) by 2020. This should be viewed as good news for banks who have their expertise in retail banking businesses. It also opens the way for more non-banking financial institutions, such as consumer finance companies and auto finance agencies, to pursue fast development. These developments are likely to occur as households become wealthier due to the rapid pace of economic growth, which should, in turn, create numerous opportunities in wealth management and pension businesses.

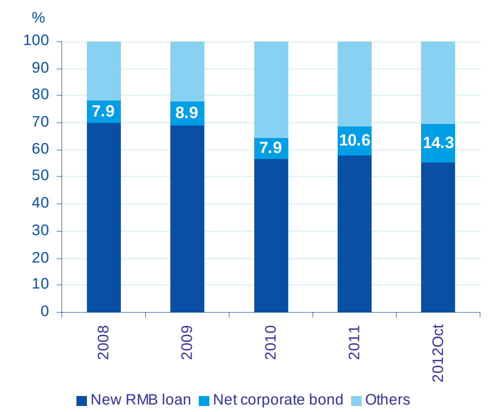
Second, if interest rate controls are lifted as anticipated, banks' funding cost will increase substantially. This could encourage them to turn to small-and-medium-enterprises (SMEs) and households in search of higher-yielding loans as to increase interest margins, albeit at the cost of assuming higher risk. Banks with greater experience in these segments of the market are likely to benefit. Nevertheless, banks could face fierce competition from E-commerce firms focusing on online trading platforms.

Chart 3
Though rebalancing toward consumption will take time, it offers opportunities for banks



Source: CEIC and BBVA Research

Chart 4
The proportion of bond financing has been increasing



Source: CEIC and BBVA Research

Third, the target of increasing the proportion of direct financing (up to 15% of the total social financing as stipulated in the Plan) would give a boost to investment banking businesses (Chart 4). At the same time, however, it might also divert banks' large corporate clients to the bond market to meet their funding needs. Moreover, the expanding bond and equity markets (as a consequence of promoting direct financing) can also enable retail banks to offer much diversified financial products to their retail customers.

Finally, while the Plan is silent with respect to foreign financial institutions (except in opening the insurance sector), capital account liberalization and RMB internationalization will still bring new business opportunities to foreign banks with an international presence. The Plan aims to push forward the two-way opening up between domestic and international capital markets and to facilitate China's outward FDI. As such, foreign banks can help their overseas customers tap into the Chinese capital market and vice versa. Furthermore, foreign banks can also participating in financing China's outward FDI projects and provide other forms of financial services like financial advice.

Table 1 Selected important steps in financial liberalization

Reform	Date	Regulator	Key Points
Wenzhou Financial Liberalization	March 2012	State Council	Allow private lenders in the city to operate as investment companies with the goal of increasing small and medium enterprise (SME) finance. Wenzhou residents are allowed to invest in nonfinancial companies overseas.
Exchange Rate Band Widening	April 2012	PBoC	The daily band for the renminbi /US dollar exchange rate increased from +-0.5 % to +-1 % around the fix daily rate set by the PBoC.
Enlargement of QFII Quota	April 2012	CSRC	Increased the quotas for qualified foreign institutional investors to $80 billion from $30 billion.
Over-the-Counter (OTC) Market	April 2012	CSRC	Creation of a new OTC market primarily consisted of SMEs, which is aimed to broaden the finance channels for SMEs, especially high-tech companies.
Qianhai Pilot Program	June 2012	State Council	Companies in Qianhai will be encouraged to sell renminbi bonds in Hong Kong and to experiment with cross- border loans in the Chinese currency.
SME Bond Market	June 2012	CSRC	Creation of a high-yield (aka junk bond) market for SMEs through private placement.
Interest Rate Benchmark Band Widening	June/July 2012	PBoC	Allow 10% of premium for deposit rates and 30% discount for lending rates.
Enlargement of RMB-QFII Quota	November 2012	PBoC ,CSRC and SAFE	Increased the quotas for RMB qualified foreign institutional investors to RMB 270 billion from RMB 70 billion.

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