

How Will Reform of China's Financial Sector Help Its Citizens?

Over the past 25 years, China's economic model of industrial, export-led expansion has produced an average annual growth rate of nearly 9 percent, transforming China into the world's fourth largest economy, and lifting some 400 million out of poverty. Despite such remarkable progress, the pace and structure of China's economic growth has produced significant problems, both economic and social.

The country's fixed investment- and export-driven development – more factories to produce more goods for world markets – has left China vulnerable to economic slowdown elsewhere in the world (particularly in the United States), and to rising energy, materials, and labor costs. The manufacturing and export focus of the economy has also led to widening disparities between rich and poor, made worse by the closing or privatization of state-owned enterprises, which had provided most healthcare services in China. There are, in effect, two Chinas – a wealthy elite and a developing middle class along the coast, and 800 million poor in the central and western interior. The worsening wealth gap and the resulting social dichotomy have led to increasing political instability. Reports indicate that as many as 100 significant incidents of protest occur in China every day.

Almost immediately after assuming leadership at the 16th Chinese Communist Party Congress in 2002, President Hu Jintao and Premier Wen Jiabao sought to distinguish themselves as the “putting-people-first administration.” They also articulated the notion of a “scientific viewpoint of development,” by which China's economic growth is to be bal-

anced with social priorities such as a more equitable distribution of income, poverty reduction, education, improved medical care, and environmental protection. Such adjustments were necessary, according to the new leadership, to establish a more sustainable course for China's long-term economic growth and to achieve a more “harmonious” – which is to say, a more equitable and stable – society.

These priorities became the framework of China's 11th Five-Year Plan, which was ratified by the National People's Congress last Spring. The Plan seeks to address the twin problems of an economy perceived as being too dependent on external demand and the social consequences of the widening wealth gap by pursuing a shift in production from industry to services, discouraging internal investment for the purposes of producing exports, and facilitating the development of domestic consumer demand.

The critical importance of an open, competitive, and effective financial system to the achievement of China's economic goals is clear. 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. More developed capital markets would also enhance access to bank capital by smaller businesses and consumers – banks' natural customer base – who are too often crowded out by large companies forced to rely on banks for funding. 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.

Achieving the 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. Similarly,

increasing domestic demand by activating the Chinese consumer will require 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 “precautionary savings” and facilitate consumption. As but one example of the potential impact of modern financial products, of China's 1.3 billion people, 480 million use cell-phones, but only an estimated 1 million currently have a credit card.

In sum, a more modern, open, and competitive financial system would greatly enhance the productive capacity and stability of the Chinese economy and facilitate the achievement of China's economic goals of maintaining high rates of growth and job creation, encouraging a structural shift from industry to services, promoting the development of domestic consumer demand, reducing poverty, and ensuring a more equitable distribution of opportunity and prosperity. Research conducted by McKinsey indicates that genuine reform of its financial system would expand China's economic output by as much as 17 percent, or an additional \$320 billion a year.¹

¹ See “Putting China's Capital to Work: The Value of Financial System Reform,” by Diana Farrell, Susan Lund, and Fabrice Morin, The McKinsey Global Institute, May 2006.