

# **Building a long-term sustainable development mechanism for China's financial sector**

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Market-oriented reforms have brought efficiency, but they have also resulted in instabilities of institutions. To reserve this harmful trend, concerted efforts have to be made at both macro and micro levels. Using the financial sector as an example, this paper explains how to assist economic agents to reset long-term goals and gain global awareness.

## **I. Improving the state of the financial sector to achieve an optimum interaction between that sector and the economy**

The following major problems are to be found in China's financial sector:

First, public ownership still dominates the sector. There is no clear and definitive legislation or protection regarding other forms of ownership and their participation in China's financial sector. Managers and shareholders do not enjoy key positions they are entitled to in corporate governance or receive sufficient information from the boards of directors.

Second, the sector's self-adjustment mechanism has been badly affected by the following factors: near monopolistic state ownership; lack of withdrawal mechanisms for financial institutions; a weakening of the financial institutions' budgetary constraints and flawed financial supervision and regulatory systems.

Thirdly, the external environment has seriously damaged the equilibrium and development of the financial sector.

From the point of view of the ecology, in order to build a long-term mechanism for sustainable development, we must reorder the financial sector and its logical structure, both of which have been undermined. Macroeconomic policy-makers can start by doing the following:

1. Accelerate the diversification of ownership in the sector, permit various investors to invest, enhance property rights and strengthen the position of shareholders and their role in the financial system.
2. Following free market principles, accelerate the introduction of laws regarding bankruptcy of financial institutions and deposit insurance and establish self-adjustment mechanisms in the sector based on these laws.
3. The legal system should clarify creditors' rights in order to provide a good social environment based on credit and regulations which in turn will benefit the equilibrium of the financial sector.
4. The financial supervisory and regulatory system must provide financial institutions with timely, comprehensive and accurate risk assessment. It needs to determine the critical level of risks faced by these institutions and implement effective and timely corrective measures.
5. Carry out market-oriented financial reforms, including the loosening of financial supervision and controls, lifting access restrictions on private capital, encouraging financial product innovation to prevent monopolies, expanding competition and ensuring that financial institutions are on an equal footing where free trade and competition are concerned.

## **II. Reduce the risk of an economic bubble and create a stable and predictable financial environment**

In recent years, both China's real estate market and the stock market have been overheating. There

are several reasons for this phenomenon: 1) the organisation of Shanghai World Expo 2010 and the Beijing 2008 Olympic Games have led to excessive investment in certain sectors and resulted in localised production overcapacity; 2) a number of external factors have caused an imbalance in international capital flows which has exacerbated China's economic bubble; 3) the disparity in the supply and demand of financial assets has driven prices up.

To prevent an economic bubble, we should slow down the rapid increase of surplus capital in the balance of payments and the excessive accumulation of foreign currency reserves. China's currency should become more flexible.

To absorb the economic bubble, the monetary authority should pay more attention to the capital market and to the construction a sound financial system. First, sound financial institutions provide essential resistance to the impact of an economic bubble. Second, a sound financial market is crucial to avoid it. We must continue infrastructure construction, set up a diversified and multi-level capital market, promote the coordinated development of different markets and improve the performance and efficiency of China's financial markets. Last but not least, a sound economic structure is the cornerstone of such a strategy, so we should optimise the economic structure and change our economic growth pattern from an extensive one to an intensive one.

### **III. Optimise the financial structure, prevent excessive competition and eliminate the financial "vacuum"**

Optimising the financial structure is not only conducive to an orderly financial market, but it can also provide an impetus for economic growth. This is demonstrated by the following three aspects:

- 1) Building a new financial structure to meet the long-term financing demands.  
Experience shows that the open financing model with the China Development Bank as its main institution, may be representative of the new financial structure. Open financing should provide diversified services with limited political intervention. It should adopt a "gradual transition" method similar to that of reforms in other fields. As the economy develops it will eventually take up commercial financing, but will continue to function as a market regulator when the market cannot fulfil its role. When the economy is well developed, open financing will be withdrawn and give way to market influence.
- 2) Improve the rural financial system. There are three characteristics to financing in agriculture and rural areas: small amounts, high frequency and high-risk. Improving risk management is a crucial part of rural financial reforms that must include the following: i) a diversified financial system to meet the relatively scattered and small-scale financial needs of the rural population and of agricultural enterprises; ii) a multi-level risk compensation system to include agricultural insurance, credit insurance and deposit insurance; iii) the creation of diversified rural financial products in line with rural economic development.
- 3) Set up a financing system for small and medium enterprises (SMEs). We should improve the financial system which serves SMEs as well as the capital markets and expand direct financing channels for SMEs. We also need to further improve the financial underwriting system and mechanisms to provide risk guarantees for them.

### **IV. Build a well-coordinated and interactive mechanism between both banks and enterprises and Chinese and foreign financial institutions**

- 1) Coordinated bank-enterprise relations.

Well coordinated bank-enterprise relations include not only mutual trust between banks and their customers who take out loans, but also between banks and other customers, including depositors. The following principles should be observed:

- i) Improved corporate governance. Commercial banks should build a modern ownership system based on shareholding and profit maximisation as its main goal. The system should be safeguarded by transparent management and internal/external supervision.
- ii) Improved innovation. We should increase investment in science and technology, attach great importance to the development of financial products, work out a long-term plan that is compatible with modern financial developments and ensure that financial innovations occur in a smooth and efficient manner.
- iii) Improved personnel training and mechanisms for talent selection. Banks should constantly improve their staff screening, selection, and training processes as well as incentive mechanisms for meeting the needs of staff and providing them with greater career opportunities. They should promote a strong business culture in order to retain capable staff and attract others.

## 2) Coordinated relations between Chinese and foreign financial institutions.

Positive market interactions between Chinese and foreign banks can be achieved.

Foreign banks provide advanced management concepts, rich management experiences and advanced scientific and technological advantages. They can become good models for China's financial sector and stimulate efficiency improvements.

Cooperation between Chinese and foreign banks will expand enormously with the opening-up of China's financial sector, as well as in a variety of fields such as credit cards, currency exchange, asset securitisation and evaluation, clearing, and syndicated loans. The participation of foreign banks will improve China's banking system and promote innovation.

## **V. Encourage financial enterprises to carry out their social responsibilities**

China's financial institutions, and banks in particular, have three main social responsibilities: 1) to support large-scale and infrastructure projects, 2) to promote harmonious economic and social development, and support the implementation of the state's regional, industrial and investment policies, and 3) to promote a "people-oriented" social development concept, supporting national policies on re-employment and strategic plans on education and training which are significant for the sustainable development of the national economy.

Financial institutions will have to pay to shoulder their social responsibilities. If the cost is too high it may be detrimental to their business. Sound development and operations, financial stability and growth are the prerequisites for these institutions to carry out their social responsibilities.

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