Current Status of Financial Development in China

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Zheyi Liu[†]

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1. Introduction

After the implement of reform and opening up policy in 1978, financial system of the People's Republic of China has experienced huge development, from a mono-bank system based on the Gosbank of the Soviet Union to nowadays gradually mature multilayer market structure with various financial tools. The development of financial system in China is both the prerequisite for, and important indicators of, a modern market economy. A sound and effective financial system promotes the development and improvement of market-oriented resources allocation, resulting in the optimization of social resources.

Along with the achievements of financial development in China, challenges also begin to emerge during the process of its development. For example, for a long time, the indirect financing has taken the preponderant position in the whole financial system. This let the financial system exposure to the financial crisis. However, the diversification of financial risks from the banking sector could be achieved if the capital markets are active and viable. This paper comprehensively analyzes the current development status of China's financial system including the capital

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I am very grateful to my supervisor, Professor Inatomi, for his valuable comments.

market. Through descriptive analysis and data comparison, we attempt to summarize the characteristics and find the problems for current financing system of China.

The remainder of the paper is organized as follows. Section 2 briefly reviews the history of achievements of financial development in China. This paper divides the history into two stages: from the year 1949 (when People's Republic of China was founded) to 1978 (when China implemented the important reform and opening up policy), and after the year 1978. Section 3 discusses nowadays development status and the potential challenges of the financial system in China. Section 4 focuses on China's capital market and analyzes its role in supporting economic growth. Section 5 concludes the paper.

Data used in this paper comes mainly from various issues of Statistical Yearbooks (*China Statistical Yearbook, Almanac of China's Finance and Banking* and *China Securities and Futures Statistical Yearbook*), *Annual Reports* of China's regulatory institutions and relevant literatures.

2. Brief Review of the History of China's Financial System

2.1 Development During 1949-1978

After the foundation of the People's Republic of China in 1949, China was under a highly centralized planned economy. Accordingly, its financial system was a mono-bank system. The main characteristic was that the People's Bank of China (PBOC), as the only bank in China, served as both the central bank (managing and allocating the funds) and a *commercial bank* (absorbing deposits and issuing loans) without profit motive. PBOC was owned by the central government and controlled under the Ministry of Finance. During that period, central government not only arranged all the production and sales of enterprises, but also determined all the infrastructure investment scales. Therefore, the bank was responsible for both organizing and financing; in fact, it only played the role of the government's accountant and cashier. Inside the banking sector, all the property of the branches were unified by the head office of PBOC; all the absorbed deposits were transferred to the head office that would extend the credits according to the loan plans and instructions. There were no non-bank financial institutions or financial market during that period.

Although there had been some minor adjustments inside this single bank-based financial system and some financial institutions shortly existed in this system, actually, PBOC was still the only financial institution. For example, in 1955 and 1963, China Agriculture Bank had been founded twice, mainly handling short-term agriculture loans and financial allocation of agriculture.

However, since the functions of this institution and PBOC were not clearly distinguished, they contradicted in some aspects. Consequently, China Agriculture Bank was reincorporated into PBOC in 1957 and 1965 respectively.

This mono-bank system has not satisfied the marketization goal of the reform and opening up policy. Therefore, after 1978 along with China's economic reform, the reform of the financial system also gradually launched.

2.2 Development After 1978

2.2.1 The Formation of Specialized Banking System

By the end of 1979, the PBOC departed from the Ministry of Finance and became a separate entity, while three state-owned banks took over some of its commercial banking businesses: The Bank of China (BOC) was given the mandate to specialize in transactions related to foreign trade and investment; the People's Construction Bank of China (PCBC), originally formed in 1954, was set up to handle transactions related to fixed investment (especially in manufacturing); the Agriculture Bank of China (ABC) was set up in 1979 to deal with all banking business in rural areas; finally, the fourth state-owned commercial bank, the Industrial and Commercial Bank of China (ICBC) was formed in 1984, and took over the rest of the commercial transactions of the PBOC. Till then, PBOC got rid from the general banking business and was established as China's central bank taking the responsibility of financial management.

2.2.2 Fast Growth of Financial Intermediaries

China's commercial banking system had been further expanded in 1980s. Regional banks, partially owned by local governments, were founded in the Special Economic Zones in the coastal areas. A network of Rural Credit Cooperatives (RCCs) was set up under the supervision of the ABC in rural areas. Urban Credit Cooperatives (UCCs), counterparts of the RCCs, were also founded in the urban areas. Non-bank financial intermediaries, such as the Trust and Investment Corporations (TICs), operating in selected banking and non-banking services with restrictions on both deposits and loans, emerged and proliferated in this period.

The policy finance and commercial transactions were formally separated. In 1994, three policy banks were founded: State Development Bank (SDB), Agricultural Development Bank of China (ADBC) and Export-Import Bank (EIB). Specialized banks' policy-type services gradually transferred to these three policy banks.

In 1980, People's Insurance Company of China (PICC) restored its domestic insurance business.

From 1988, the diversification pace of China's insurance market continued to accelerate. Two national insurance companies (China Pacific Insurance Company and China Ping An Insurance Company) and some regional insurance companies were also set up in succession.

Shang Hai Stock Exchange (SHSE) and Shen Zhen Stock Exchange (SZSE) were established in 1990 and then grew very fast during most of the 1990s. The establishment of SHSE and SZSE was the symbol that China's stock market had stepped into regulatory stage of development, and it also meant that China's financial market has opened its door to foreign financial institutions. Trust and Investment Corporations (TICs), financial corporations and many foreign banks were also set up in China, which greatly enriched China's financial market.

2.2.3 The Opening-up of Financial Markets

In early 1990s, due to the shortage of foreign currency and tight control of foreign exchange, China undertook a pilot scheme to issue Ren Min Bi (RMB)-denominated shares to foreign investors aimed at attracting foreign capital to the securities market. These shares, known as B-shares, are domestically-listed shares, denominated in RMB but subscribed to and traded in US or Hong Kong dollars by overseas investors. Later the listing of domestic companies in Hong Kong (H-shares) and New York (N-shares), and the listing of China's companies incorporated overseas in Hong Kong (red chips), further opened China's financial market to the outside world.

In China, institutional investor began to emerge in the late 1990s although their scale and significance in the financial system were limited. The first two mutual funds (Guo Tai and Nan Fang) were established in 1998.

The pace of opening-up China's capital markets entered a new era after China was admitted to the World Trade Organization (WTO) in December 2001. By the end of 2006, China had fulfilled the commitments made to open-up the securities market at the time of its accession to the WTO. In 2003, a few Qualified Foreign Institutional Investors (QFII) entered the asset management industry, and they have been operating through forming joint ventures with Chinese companies. At the end of 2007, the total market value of securities held by 49 QFII reached 200 billion RMB. QFII have already become important investors of China's capital markets. The Qualified Domestic Institutional Investor (QDII) program, launched in May 2006, allows licensed domestic institutional investors to invest in overseas markets. The introduction of the QDII program helped to balance the supply and demand in the foreign exchange market, and provided Chinese investors with opportunities to invest in international capital markets with a broader range of products.

2.2.4 The Establishment of Regulatory and Supervision Framework

In October 1992, China Securities Regulatory Commission (CSRC) was established to oversee the securities market on behalf of the State Council. In November 1997, China's financial system adopted an approach to separate the operations and supervision of the banking, securities and insurance industries. In April 1998, the CSRC became the regulator of the national securities and futures markets. It also developed a regional supervision system by absorbing the provincial securities regulatory offices. With a total of 36 regional offices across the nation, a centralized supervisory framework was established.

In 1998, China Insurance Regulatory commission (CIRC) was established. From then on, insurance regulation was separated from the financial supervision system of PBOC, and CIRC took the responsibility to supervise the national insurance markets. Later in 2003, China Banking Regulatory Commission (CBRC) was established to regulate the whole country's banks, financial asset management companies, TICs and other deposit-taking financial institutions. Till then, China's financial system was dividedly regulated and supervised by CSRC, CIRC and CBRC. PBOC was mainly responsible for coordinating these three commissions, acting as the lender of last resort and controlling money supply.

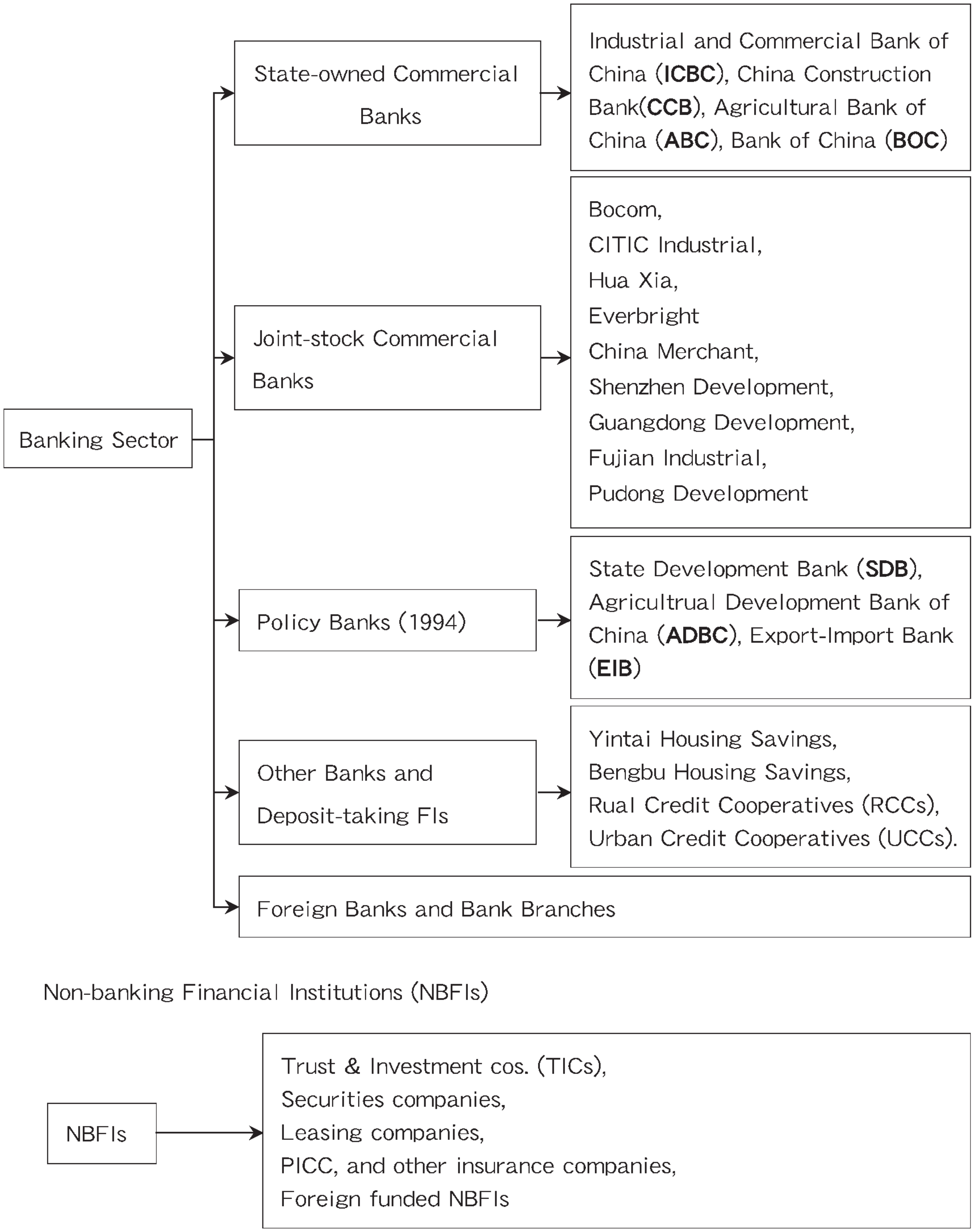
2.3 Structure of China's Financial System

Figure 1 depicts the current structure of the entire financial system of China. Banking sector is dominated by four state-owned banks that are commercialized in 1995. The big four state-owned banks include the Industrial and Commercial Bank of China (which provides working capital loans to state industrial enterprises), China Agriculture Bank (specialized in agricultural lending), China Construction Bank (which provides funds for construction and fixed asset investment), and the Bank of China (specialized in trade finance and foreign-exchange transactions). In addition to the big four state-owned commercial banks, there are also several minor players that include three policy (or development) banks (Export–Import Bank, Agricultural Development Bank, and State Development Bank), second-tier commercial banks (e.g., CITIC Industrial Bank), and regional banks such as housing savings banks, city banks, and other institutions such as Trust and Investment Corporations (TICs) that capture smaller portions of the lending market.

3. The Whole Country's Financial Development

After reviewing the development history of China's financial system, in this section we discuss its nowadays development status and the potential challenges.

Figure 1　China's Financial System



Sources: China Banking Regulatory Commission

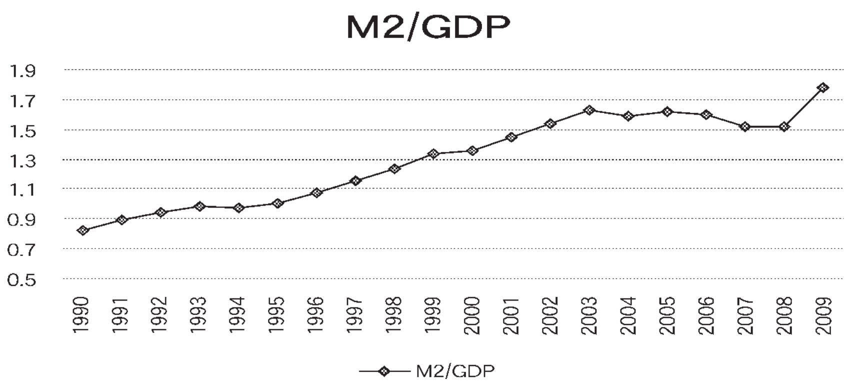
3.1 Scale

3.1.1 Monetary Ratio Keeps Increasing

Financial deepening refers to the increased provision of financial services with a wider choice of services geared to all levels of society. Financial deepening generally means an increased ratio of money supply to GDP. Mckinnon (1973) proposes to use the percentage of the broad money to Gross Domestic Product (M_2/GDP) to measure the monetary ratio. It refers to liquid money. The more liquid money is available in an economy, the more opportunities exist for the continuous growth.

Figure 2 shows that since 1990 the ratio of Money and Quasi-Money (M_2) to the GDP keeps the trends of upward only excepting very few years. In 1990 this monetary ratio is only 0.82, and it rises to 1.78 at the end of 2009. Compare to the ratio of developed countries in 2009[1]: Japan is 2.24, United States is 0.88, France is 1.43 and Germany is 1.93. It is clear that China's ratio is as high as that of developed country and ranked in the leading position of the world.

Figure 2 Monetary Ratio



Source: Author's calculation based on *China Statistical Yearbook* (2010)

The high monetary ratio suggests that the process of China's financial deepening is fast. This could partly explain that the transition from planed economy to market-oriented economy leads to an increasing proportion of the monetary transactions. Besides that, China's financial market is under-developed, and financial tools and financing channels are so limited. As a result, people have no choice to invest their surplus cash. Meanwhile, the reforms of employment, education and Medicare system these years further increases people's uncertainty. People are willing to hold currency to prepare for the living costs when they are out of employment, to save money for

1) The data is from the World Bank website.

children's higher education, and to pay family members' medical expense in case of the emergencies. Even when their income has increased, but they are still more willing to hold currency and deposit their money than to invest.

3.1.2 Scale of Financial Institution Largely Expanded, and Improvement of Efficiency Needed

Table 1 summarizes the number of institutions and their respective employees according to the different types of financial institutions. After the reform and opening up of China in 1978, developments during these 30 years changed China's financial system from a mono-bank system to a diversified system, which separates the policy finance and commercial finance. Now it is an integrated structure of financing which bases on state-owned commercial banks and coexists with various financial institutions.

Table 1 Financial Institution of China in 2008

Type	Number of legal institutions	Number of employees
Policy Banks	3	56,483
Large Commercial Banks[2)]	5	1,483,250
Shareholding Commercial Banks	12	167,827
City Commercial Banks	136	150,920
City Credit Cooperatives	22	7,080
Rural Credit Cooperatives	4,965	583,767
Rural Commercial Banks	22	38,526
Rural Cooperative Banks	163	633,370
County Banks	91	1,629
Finance Companies	6	45
Rural Fund Mutual Cooperatives	10	52
Enterprise Group Financial Companies	84	4,879
Trust Companies	54	4,916
Financial Leasing Companies	12	552
Auto Financing Companies	9	1,539
Money Brokerage Companies	3	144
Assets Management Companies	4	8,907
Foreign Financial Institutions	32	27,812
Postal Savings Bank	1	116,759

Source: *Almanac of China's Finance and Banking* (2009)

Although the variety and quantity of the financial institutions expands largely, the efficiency and the power of financial system are not accordingly increased. Along with the reform in financial sector, a large amount of foreign institutions come into China, and the proportion of

2) Five large commercial banks refer to Industrial and Commercial Bank of China (**ICBC**), China Construction Bank (**CCB**), Agricultural Bank of China (**ABC**), Bank of China (**BOC**) and Bank of Communication (**BCM**). In 1987, BCM became the first state shareholding commercial bank.

other types of financial institutions is gradually increasing. However, bank credits continue to occupy a dominant position, especially the state-owned banks remain in an absolutely monopoly position. The total assets held by Big Four SOBs were 29,848 trillion RMB, ranking the first in the whole banking sector. The second largest assets holder was shareholding commercial banks, whose assets were 8,368 trillion RMB. The third largest assets holder was policy banks, holding 5,265 trillion RMB in 2008[3)].

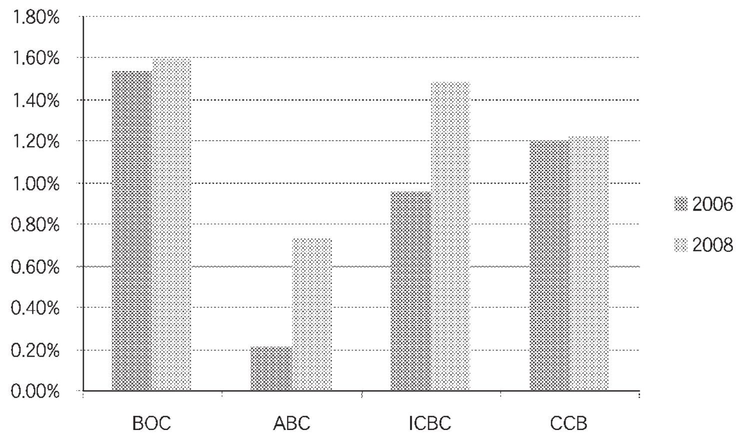
Due to the unclear property rights between state-owned banks and state-owned enterprises (SOEs), for a long time, the SOEs suffered from losing national assets and SOBs had a large amount of Non-performing loans (NPLs). In the early 1990s, the Big Four SOBs accounted for more than 90% of the total amount of formal bank credit and still dominated the credit market in 2007 where they control some 60% of lending[4)]. This creates a situation of credit rationing and funneling of credit to inefficient state-owned enterprises that are the main beneficiaries of lending by state-owned banks. In the 1990s, an estimated 80% of bank credit went to the state sector even though it accounted for less than half of GDP as compared with the contribution of the non-state sector which accounted for a greater portion of GDP but received less than 20% of formal bank credit[5)].

A resultant effect is the accumulation of non-performing loans in the state-owned banks, which has been estimated to be a significant 40% of GDP by the early 2000s[6)]. Allen, Qian and Qian (2007) compare China's NPLs to the U.S. and other major Asian economies during 1998-2006 based on official figures. They find that China's NPLs (measured as fraction of GDPs) are the highest from 2000 to 2006, and as high as 22.5% of GDP in 2001. Since a large fraction of the NPLs among state-owned banks, and in particular, the Big Four banks, resulted from poor lending decisions made for SOEs, some of which were due to political or other non-economic reasons. Taking the Big Four banks as an example, figure 3 shows their return on assets in 2006 and 2008. Among these Big Four banks, ABC, which does not yet complete the reform of stockholding system, has the lowest level of profitability. While this may be related to the bank's service localization and the target client, but from other perspective, the measures that enforcing stockholding system, listing and corporate governance are very necessary for pre-state-owned commercial banks in China. In 2008, the business income of ABC increased from only 87.5 trillion RMB in 2006 to 211.2 trillion RMB, and its return on assets ratio rose from 0.2% in 2006

3) Data is from *Almanac of China's Finance and Banking* 2009.
4) See Bai, Li, Qian, and Wang, (1999).
5) See Garnaut et al., (2001).
6) See Fan (2003).

to 0.74% in 2008. According to 'Top 1000 World Banks 2009' (The Banker, 2009 July), in 2008 the average bank's profit ratio (pre-tax profit to assets) was 1.05%[7]. For China's Big Four banks, except ABC, pre-tax profit ratios of other three banks were higher than the world average level.

Figure 3 Pre-tax Profit Ratio of State-owned Banks



Source: Author's calculation based on *Almanac of China's Finance and Banking* (2008, 2009)

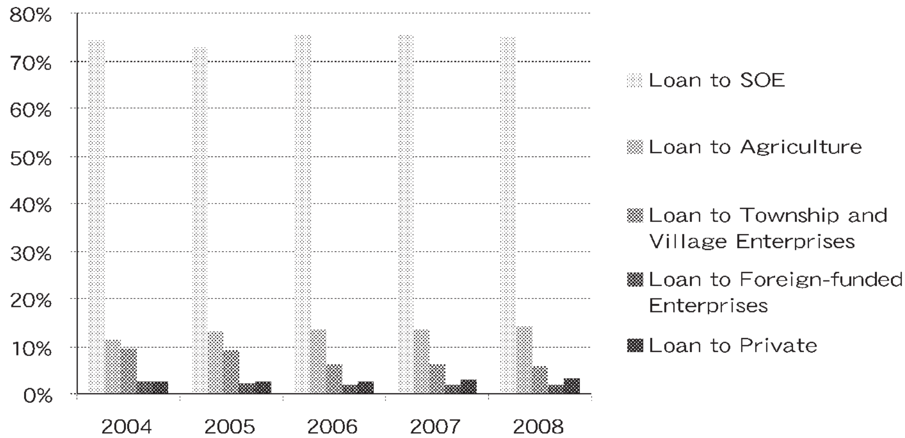
3.1.3 Non-integrated Financial Market

An effective and integrated capital market should gradually eliminate the privileges that the protected enterprises using their monopoly position to access to financial resources at a lower cost.

Taking the short-term loans market for example, figure 4 summarizes the proportions of loans that different types of the enterprises obtained from financial institutions. It is obvious that SOEs always obtain the highest proportion of the loans, which are above 70% from 2004 to 2008. Besides SOEs, the proportion of the agricultural loans is the second largest, and it reaches the highest value (only 14.1%) in 2008. The loans that non-SOEs could obtain from the banks are negligible. In 2008, loans to the private enterprises account for only 3.4% of the total short-term loans, which is an important reason to explain why private sector always lacks funds.

7) See Figure Bank's Profit ratio, *The Banker*, July 2009, p.169.

Figure 4 Structure of Short-term Loans



Source: Author's calculation based on *Almanac of China's Finance and Banking* (2009)

3.2 Structure

3.2.1 Dominant position of Indirect Finance[8)]

Before 1978, under the mono-bank system, China's financing structure was almost only indirect finance. Since the reform and opening up, especially during recent 10 years, with the using of various financing tools, the proportion of direct financing is increasing, while indirect financing still occupies most of the shares. Until 2007, the proportion of indirect financing was still as high as 82%, and direct financing was only 12%. In 2005, total RMB loans increased to 2,354 billion, including short-term loans and bill financing increased to 1,122 billion, which accounted for 47.7%. Bill financing increased significantly in 2005, the total amount raised by bill financing was 471 billion RMB, accounting for 20% of the new loans and 11.1% higher than the same period of the previous year.

3.2.2 Financial Structure of Non-financial corporations

Firstly, external financing is preferred. A firm could finance itself using both external and internal financing. External financing is to obtain fundsfrom outside of the firm. It is contrasted to internal financing which consists mainly of profits retained by the firm for investment. In China, most of the enterprises rely heavily on external financing and ignore internal financing. It led to a high debt ratio.

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8) Indirect finance is where borrowers borrow funds from the financial marketthrough indirect means, such as through a financial intermediary This is different from direct financing where there is a direct connection to the financial marketsas indicated by the borrower issuing securities directly on the market.

Secondly, inside the external financing, indirect finance is preferred. Table 2 shows that from 2003 to 2007 non-financial institutions mainly use loans to finance; all these years loan takes more than 60% of the total external funds. The second important channel is absorbing foreign investment, which accounts nearly 20% of the external funds. For issuing equity and corporate bonds, it is even less than 10%, and it increases to 18% in 2007. Therefore, the operation of China's enterprises is mainly supported by bank loans. When the driving force of economic growth mainly comes from bank loans, then the credit risk will be highly concentrated in the banking sector, which makes the risk of inflation or deflation inevitable.

Table 2 Financing Structure of Non-financial Corporations

(Unit: RMB 100 million)

	Loan	(%)	Bond	(%)	Equity	(%)	FDI	(%)
2003	23,725	80.7	358	1.2	1,438	4.9	3,897	13.2
2004	17,707	73.0	327	1.4	1,687	7.0	4,547	18.7
2005	19,166	66.7	2,010	7.0	1,075	3.7	6,482	22.6
2006	26,403	70.0	2,266	6.0	2,814	7.5	6,226	16.5
2007	26,471	60.9	2,177	5.0	5,583	12.8	9,248	21.3

Source: Author's calculation based on various issues of *Almanac of China's Finance and Banking*

Thirdly, inside the direct financing, equity financing is preferred to bond financing. Figure 5 shows that in recent years China's equity financing is over 50% and as high as 80% in 2003 and 2004. Only in 2005, corporate bond financing reaches 65%, which is the first time that bond financing exceeds equity financing. Later in 2006 and 2007, equity financing returns to its leading position. This financial structure increases the financial risk for the enterprises, and not conducive to diversify financial risk.

3.2.3 The role of State Budget to the Society's Fixed Assets Investment

Total Investment in Fixed Assets of the whole country refers to the volume of activities in construction and purchases of fixed assets of the whole country and related fees, expressed in monetary terms during the reference period. It is a comprehensive indicator which shows the size, structure and growth of the investment in fixed assets, providing a basis for observing the progress of construction projects and evaluating results of investment. The four most important financing sources for all economic units in China, in terms of fixed asset investments, are: domestic bank loans, self-fundraising[9], the state budget and FDI.

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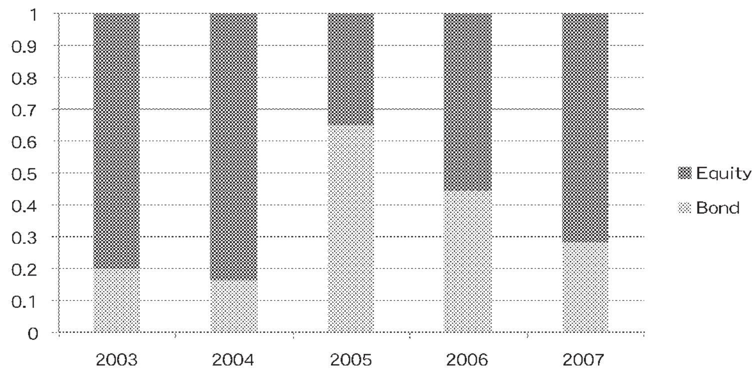
9) Self-fundraising includes capital raised from local governments (beyond the state budget), communities and other investors, internal financing channels such as retained earnings and all other funds raised domestically by the firms.

Figure 5 Financing Structure between Enterprises Bond and Equity



Source: Author's calculation based on various issues of *Almanac of China's Finance and Banking*

Figure 6 shows the sources of total investment in fixed assets of the whole country in China. Since we have no data on what proportion of this investment is conducted by private sector, public non-financial and general government, figure 6 does not show the sources for the investment by private enterprise. We could see from figure 6 that since 1980, the internal financing (self-raising and others) always takes up more than 60% of the total financing and its proportion keeps increasing, and it reaches 78% of the total amount in 2009. It also suggests that the external financing for fixed assets investment is limited. Meanwhile, China used to rely on a central-planned system to allocate the state budget to most of the companies in the country. But the state budget now only contributes 5.1% of total fixed assets funding in 2009, which is 26.7% in 1981. This evidence confirms that China has evolved from a central-planned economy toward a market-oriented economy.

4. Capital Market

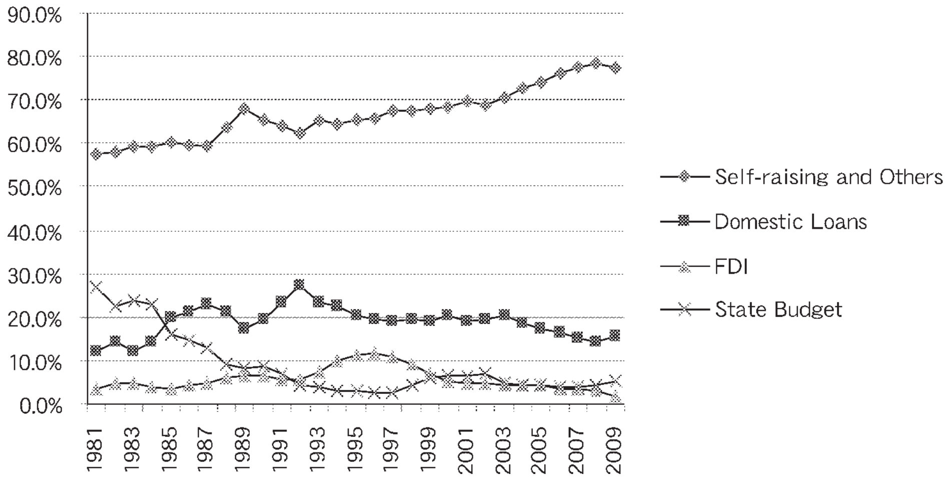
After nearly 20 years' development, China's capital market plays more and more important role in supporting economic growth. Recently, non-tradable share reform and other market reforms have improved China's capital market system. However, we should recognize that China's capital markets are emerging markets in a transitional economy, so the overall development level is still in its infancy.

4.1 Stock Market

4.1.1 Limited Amount of Floating Shares in Equity Market

Figure 7 shows that since 1994 the scale of China's stock market is expanding quickly, especially in 2007 the total Market Capitalization reaches 32.7 trillion RMB, which represented

Figure 6　Proportions of Sources of Fixed Assets Investment



Sources: Author's calculation based on various issues of *China Statistical Yearbook*.

132% of the country's 2007 GDP.　Affected by the financial crisis in 2008, the market capitalization of stock market shrank sharply to 12.1 trillion RMB, which was only 37% of the year 2007's. Although it upturned in 2009, the total scale was still less than the year 2007's.　While the scale of total market capitalization of stock market is large, the scale of Negotiable Market Capitalization of the floating shares[10] is relatively small.　The ratios of negotiable Market Capitalization to total Market Capitalization are always around 30%.　In 2006, after the implement of non-tradable share reform, most of these problems were resolved.　Due to the time lag effects, until 2009, the ratio of negotiable Market Capitalization to total Market Capitalization raised to 62%, which suggests an increased amount of the floating shares in equity market.

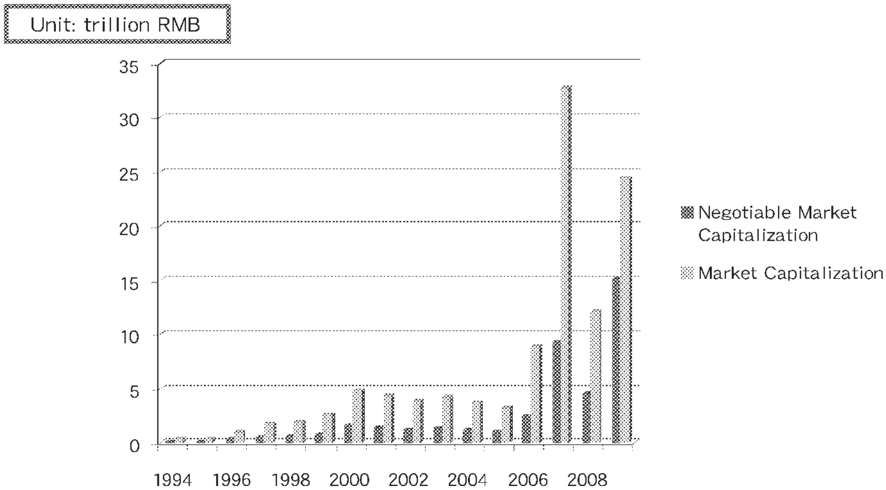
4.1.2　Multilayered Market Structure Still Emerging

International experiences have shown that a healthy Growth Enterprise Market is conducive to meet the direct financing needs from small and medium-sized enterprises, especially high-tech companies.　However, China's Growth Enterprise Market was set up so late.　On 30th October, 2009 Growth Enterprise Market was set up in Shen Zhen Stock Exchange, and the number of the first listed companies was 28.　This event indicated that multi-layered capital market structure in China started to form.

Small and Medium-sized Enterprise Board (SME Board) is still at an early development stage

10) Floating shares refer to the shares of listed companies which can be freely traded on the secondary market and not subject to lock-up restrictions.

Figure 7 Market Capitalization of China's Stock Market



Sources: China Securities Regulatory Commission

with limited scale and industry coverage. By the end of 2009, 327 companies were listed on the SME Board, with a total market capitalization of RMB 1687 billion. Compared to the main board in the same period, the total number of listed companies was 1718, with the total market capitalization of RMB 24,394 billion (nearly 14 times larger than the SMEs).

Table 3 shows the ratio of domestic raised capital in stock market to the amount of loan of bank. Although the amount of capital raised in domestic stock market keeps increasing, compared with the amount from the bank loans, it is still very small. The ratios are even less than 10%, only reaches its highest record of 21% in 2007. We could deduce that SMEs in China face the biggest difficulty which is how to get the external financing. In the banking sector, loans of the bank will give priority to the SOEs. While in the stock market, the amount of capital raised in stock market is only equivalent to less than 10% of the bank loans. Even these limited capital resources, most of them are flowed to the listed companies on the main board. The raised capital for SMEs in the stock market is so limited. What's more, over-the-counter (OTC) market is not yet founded in China. It indicates that there are very limited means for a large number of non-listed corporations' shares to be transferred efficiently. Therefore, the role of investment and financing of China's stock market needs to be further developed.

4.2 Bond Market

4.2.1 Small Scale and Suboptimal Structure

The development of China's bond market was started from the Treasury bond market.

Table 3 Ratio of Domestic Raised Capital in Stock Market to Loan of Bank

Unit: RMB billion yuan

Year	Domestic Raised Capital	Amount of Loan of Bank	%
1995	11.8	934.0	1.3%
1997	93.4	1,071.2	8.7%
1999	89.7	1,084.6	8.3%
2001	118.2	1,243.9	9.5%
2003	82.3	2,770.2	3.0%
2005	33.8	1,649.3	2.0%
2006	246.4	3,059.5	8.1%
2007	772.3	3,640.6	21.2%
2008	353.5	4,170.4	8.5%
2009	505.2	9,594.0	5.3%

Sources: *China Securities and Futures Statistical Yearbook* (2010)

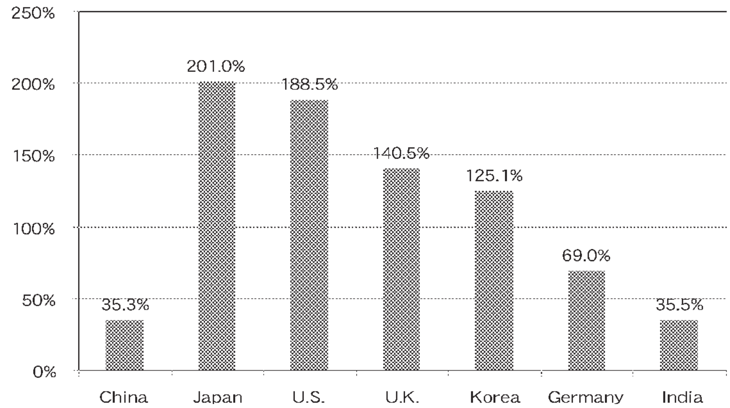
Treasury bond issuance resumed in 1981 and a secondary market for treasury bond was established in 1987. Since then, China's bond market has been growing rapidly. Nowadays, bond products have expanded from treasury bond to a variety of fixed income instruments, including central bank bonds, short-term commercial papers, financial bonds, enterprise bonds, convertible bonds and asset-backed securities.

By the end of 2007, the total outstanding value of the bond market was USD 1.2 trillion, accounting for only 35.3% of the year's GDP. This amount is far below that of overseas mature markets (see figure 8). Therefore, the scale of China's bond market is too small relative to its economy size.

Figure 9 shows the structure of bond market. Central Bank notes, Government bonds, Policy Bank debentures are the three biggest components, and account for 77% of the total bond market in 2009[11]. At the same time, short-term commercial papers, medium-term notes, joint bonds and foreign bonds continue to play a minor role and accounted for only 16% of the total bonds market. Meanwhile, the corporate bonds only accounts for 5% (RMB 425 billion). Corporate bonds market is far from mature.

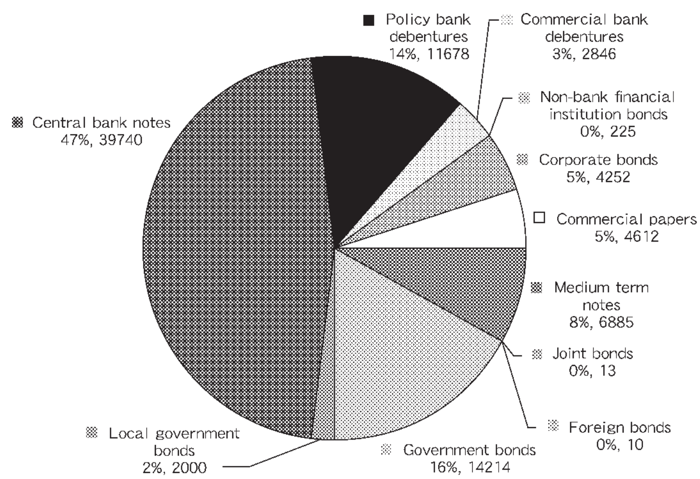
11) Central bank notes are actually the central bank bonds, which are issued by central bank to adjust the excess reserves of commercial banks. It is a kind of short-term debt certificate.
Joint bonds are guaranteed by two or more obligors (guarantors), one of them being the issuer The assets of all the guarantors can be called upon to pay the bond holders if a default occurs.

Figure 8 Comparison of Selected Countries Bond Market Sizes in relation to their GDP



Note: China's data is as of the end of 2007, and the data for other countries is as of the end of 2006.
Source: Figure 3.8 p.245, 'China Capital Markets Development Report', CSRC publication.

Figure 9 Bonds Issued by Category in 2009 (%, RMB 100 million)



Source: www.chinabond.com.cn

4.2.2 OTC Market is not developed

China's bond market comprises an inter-bank market, an exchange-traded market and commercial bank OTC market. At the end of 2008, the outstanding balance of China's bond market reached RMB 15.1 trillion[12], 22.6% higher than 2007. Tradable bonds on the inter-bank market, exchange-traded market and commercial bank OTC market were worth RMB 13.9 trillion, RMB

12) Source: CSRC Annual Report 2008.

300 billion and RMB 100 billion, respectively, accounting for 91.99%, 1.99% and 0.66% of all bonds outstanding. For the total turnover value of China's bond market in 2008, the turnover value of the inter-bank, exchange-traded and OTC market accounted for 97.05%, 2.95% and 0.003% of the total respectively. Investor types are few and commercial banks are the dominant players holding 90% of all bonds outstanding.

5. Conclusions

China's financial system experienced a long time development ever since the foundation of People's Republic of China in 1949, but the real and effective development was after 1978 commencing the reform and opening up policy.

On the one hand, the achievements of China's financial development could not be ignored: monetary ratio keeps increasing; the scale of financial institutions is expanding; the structure of the financial system continuously ameliorates; a variety of financial tools enrich the multi-layered capital market structure.

On the other hand, China's financial system still faces many challenges: the scale of financial institution has largely expanded, but its efficiency needs to improve; indirect financing always occupies the dominant role in the whole financial system; and for the financial structure of the non-financial institutions, external financing is preferred to internal financing, especially the indirect way of external financing is widely used by enterprises; China's capital market is still in its infancy; neither the stock market nor the bond market effectively solves SMEs financing difficulty.

In the future, facing these challenges, the financial system of China should be improved in the following aspects: in the banking sector, maintain a balance between government and markets, gradually weaken the administrative interference and strengthen legal and regulatory framework; create a fully multi-layered capital market to meet diverse investment needs.

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