CHINA'S PUSH FOR MORE MARKET-BASED FINANCING

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Executive Summary

1. China's financial system has traditionally been bank dominated. Though its capital markets have been growing rapidly, they still make up a small share of total financing. With the clampdown on shadow banking and internet finance, banks have further strengthened their dominance. Currently, capital market financing forms less than 15% of all external financing for Chinese firms.

2. China's changing development objectives would be well served with a more diversified financial sector. The authorities have emphasised the bigger role of direct financing through stock and bond markets in its 14th Five-Year Plan. The opening of a new stock exchange to mobilise funds for small and medium enterprises (SMEs), particularly those focused on technology, was also recently announced.

3. While this is a welcome development, expectations should be modest. Only some 4,000 companies in China are listed on any stock exchange. Stock and bond markets remain dominated by state enterprises and SMEs rarely have access to equity markets during the start-up stage. Even access to banks remains a challenge, though fintech development has made credit selection and origination far cheaper and faster.

4. For financing technology-focused enterprises, China has in place a large venture capital industry, in part state-financed through government guided funds. For these companies the option to list on a stock exchange is important as an "exit" mechanism for early investors, hence attracting more investors.

5. China has de facto taken a "financial services" view of its financial sector, with both banks and capital markets playing a useful role. The focus is on creating an environment for intermediaries and markets to provide sound financial services and more direct financing for firms within the context of a large state-owned banking system.

6. China's recent regulatory reforms, in both equity and bond markets, opening up of its capital markets to foreign investors, integrating more into global financial

markets, and internationalising the RMB are all critical steps in the right direction. China could also consider addressing capital market investors' needs for transparent bankruptcy procedures and predictable legal and regulatory processes.

7. While relatively larger firms and better credit risks are likely to benefit most from greater capital market financing, these larger firms may eventually exit the portfolios of commercial banks, leaving banks with relatively poorer credit risks and weaker firms and impacting banks' portfolios. This is an aspect that may need close monitoring.

8. Establishing well-functioning capital markets is a complex, difficult and time-consuming process. Besides the stock exchanges and bond-trading venues, a whole ecosystem of independent judicial institutions, enforceable creditor rights, sound accounting standards, prudent industry regulation, clear reporting requirements and independent rating agencies is essential for the success of these markets.

9. China is making good progress in several of these areas, and the clearest indication of this is the rapid growth of both equity and bond markets in China. As these steps continue and further accelerate, the government's ambitious objectives of mobilising more direct financing could be met.