This paper constitutes an extremely thorough review of the Chinese financial system, jam-packed with rich detail on both the formal and informal sectors. While it is hard to comment on all of the specifics in the paper, especially the extensive empirical detail on each sub-sector, the authors do draw four key conclusions from their review:

(i) China’s financial system is dominated by a large but undeveloped banking system, and given the large number of non-performing loans (NPLs) on the books of the “big-four” banks, improving the efficiency of this sector is critical in the short-run.

(ii) China’s two domestic stock markets are small in scale, and have been ineffective in terms of resource allocation due to “excessive” speculation and insider trading. Several measures are suggested for increasing the size, scope and efficiency of this part of the financial sector, including, improved regulation, greater involvement of institutional investors, and development of more products/markets, e.g., corporate bonds, derivatives and expansion of insurance products.

(iii) Alternative financial channels such as informal financial intermediaries, internal financing and trade credits, as well as “coalitions” of firms, investors, and local governments have encouraged growth of a “hybrid” sector of non-state, non-listed firms with a variety of ownership structures. The authors believe this financial channel should be further encouraged.

(iv) A key challenge to China’s financial system is avoidance of financial crises, including those affecting the banking sector due to accumulation of NPLs, and speculative bubbles in the housing and stock markets. In addition, the authors argue that the risk of a banking and currency crisis has increased with the inflow of speculative “hot” money in anticipation of appreciation of the RMB, i.e., depending on how the central bank (PBOC) handles the partial currency peg, a banking crisis could be triggered if there are large withdrawals from the Chinese banking sector.

In light of these conclusions, I want to raise a few questions concerning NPLs, and the connection between the central bank and the commercial banking system:

(a) Given the latest forecasts of a slowdown in China’s GDP growth and recent commitments by the Chinese government to a large fiscal stimulus, is it still reasonable to believe NPLs can be treated as a fiscal problem?

(b) How confident are the authors that securitization and “tranching” are appropriate methods for liquidating NPLs on the balance sheets of the big-four banks?

(c) Given extensive criticism of ratings agencies, how reliable are the ratings of initial public offerings (IPOs) by the state-owned banks?
(d) How credible is the claim that the injection of capital into the banking system is a one-time commitment, i.e., is there really no moral hazard problem here?

(e) The authors express concern about the possibility of a twin crisis in the financial and currency market – do they agree with arguments put forward Prasad and others that independent monetary policy as opposed to a fixed exchange rate regime is a necessary condition for effective reform of China’s financial sector?