Selected Papers from the 2\textsuperscript{nd} World Forum on China Studies

(abstracts)

Panel 9

The Prospect of Reform and Development of China’s Financial System

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The Prospect of Reform and Development of

China’s Financial System

1) Efficiency Analysis on China's Monetary Policy
------- By Xuebin Chen (China)

Abstracts:
During early 1990s, controlling the scale of credit was taken as the main method for China's monetary policy. Then, after that time, a framework of monetary policy with reserve against deposit policy, rediscount policy and open market operation its main methods, base money its operational goal, gradually came into being. In this framework, the money supply was regarded the intermediary goal, while controlling inflation rate and economic growth rate, its ultimate goal. In this regard, we look on it as goal-targeted policy. Since the exchange rate reconstruction of China in 1994, to maintain the stability of RMB rate was, actually, suggesting USD peg, which, thus, implied two nominal anchors, namely money supply and exchange rate. Meanwhile, goals of anti-inflation changed as well. Before mid-1990s, the inflation featured high rate, together with big fluctuation margin. While after mid 1990s, it featured low inflation rate and small fluctuation margin. In accordance, our Goal of economic growth also witnessed changes. The national economy had a high growth rate, which fluctuated wildly before mid 1990s, while mildly after mid 1990s. The macroeconomic control, as a whole, with "Stabilizing currency value, and to promote economic growth" its target, achieved our wishes after mid 1990s. In general, the framework of the monetary policy ran efficiently, while was plagued by problems at the same time. In detail, the contradiction between blurred ultimate objective and multiple objectives; the decreasing correlativity between intermediary objective, i.e. money supply and ultimate objective becomes unstable; the central bank does not have a good control over overall monetary supply. Considering the difficulty troubling our current monetary policy and the comparison of policies among countries, we suggest an Inflation Targeted policy (IT), to replace the existing money-and-exchange-rate targeted policy. It should not be rigid, but flexible. That is, the IT should be anti-inflation aimed, when keeping eyes on other goals. It should be focusing on continuous inflation of the long run, rather than temporary inflation in the short-run. What's more, further effort should be made for a more independent monetary policy in terms of both enaction and implementation, which, in accordance, might lead to a more transparent monetary policy and a more rational public expectation. A more advanced economic analysis and forecast set foundation for the more effective monetary policy in the future.
2) Time-Variation in Diversification Benefits of Commodity, REITs, and TIPS

----- By Jingzhi Huang (United States)

Abstracts:
Diversification benefits of three "hot" asset classes, Commodity, Real Estate Investment Trusts (REITs), and Treasury Inflation-Protected Securities (TIPS), are well studied on an individual basis and in a static setting. In this paper, we document that the three asset classes are in general not substitutes for each other and that all ought to be included in investors' portfolios, based on a sample of daily return data from January 1999 through December 2005. We also find that diversification benefits of the three hot assets change substantially over time. For instance, benefits of TIPS were significant before 2001 but have been decreasing gradually since then. On the other hand, diversification benefits from Commodity and REITs fluctuate significantly over the entire sample period. We show that this observed time-variation in diversification benefit can be captured by incorporating time-varying return correlations. To see the implications of this finding for asset allocation in practice, we examine the out-of-sample performance of portfolio strategies constructed based on a variety of correlation structures. We find that Engle's (2002) Dynamic Conditional Correlation model outperforms other correlation structures such as rolling, historical, and average correlations. Our findings suggest that diversification benefits of the three hot asset classes do vary substantially over time and that investors need to use appropriate correlation estimates in their asset allocation decision to adjust for such time variation.

3) Regretting is Taking Risk: An Experimental Study of Investors’ Satisfaction

----- By Hiroshi Izawa (Japan)

Abstracts:
Investors may sometimes regret to have bought stocks, when they cause loss, ex post. However, if they are "rational," it seems no reason and no use to regret on the decision making in the past, because it has been already sunk. In this note, we report experimental results of stock trading to examine how regretting or rejoicing affects on the investors’ satisfaction of stock trading, and we discuss of its theoretical implications to financial decision making. We conducted several experiments of trading of stocks actually listed in the Tokyo Stock Exchange, to elicit ex post satisfaction of investors, and the effects of decision making ex ante on it. Our experimental results show that perceived risk ex ante significantly affects on the ex post satisfaction positively, even after controlled by related variables, such as realized returns. This may cause some time inconsistency in financial decision making,
because perceived risk should decrease the utility of an investor. Further we discuss the theoretical implications of such regretting effects on portfolio selection, and we show that they cause behavioral bias to prefer more risky portfolios than the orthodox financial theory predicts. In the literature, many experimental results of high-risk bias in portfolio selections have been reported, and it has been considered as a puzzle. Our results give a new explanation to this anomaly. In addition, we will refer to the international comparison between China and Japan.

----- By Zhihao Wang (China)

Abstracts:
This paper examines the current state of monetary policy in China: its institutions, effectiveness and limits. It explains the reasons why the transmission mechanisms of monetary policy do not yet work effectively in China and some of the broad policies that are required in order to meet this challenge. The problem is primarily explained by excess liquidity in the banking system and a lack of investible debt instruments. The paper also assesses and measures the PBoC’s three-pronged efforts to sterilize FX inflows (bill issuance, reserve requirement increases and window guidance), estimating that the authorities managed to sterilize some 47% of inflows in 2004 and 50+% in 2005. However, the domestic costs of sterilisation are rising and FX inflows are undermining China monetary policy independence, causing money market rates to fall, undermining bank profitability as well as causing other micro-economic problems.

5) Bank Reform in China
----- By Junyang Xi (China)

Abstracts:
Since the late 1980s China has begun to reform her banking system. A great number of steps have been taken. Banks are no longer an official sector but profitable business organizations. Bank business and interest rates are gradually liberalized. Government intervention in the banking system is reduced. Regulation on banks is greatly improved to urge the banks to do business according to the international norms. State owned banks raised capital by huge government injection and issuance of bonds to meet the capital requirement of the international community. The volume of non-performing loans is dramatically reduced by the write-off, sale-out and severe credit risk management. Bank management is also improved by the introduction of western style corporate governance. The earning ability of the banks is strengthened
remarkably. Significant achievements in such short time have implied that the bank reform is highly successful. Great improvement takes place over a short period and we are beginning to see real commitment to improved practices at one bank after another. However, the relict of somewhat weak governance, poor management, lack of innovation and outmoded technology continue to hinder China’s commercial banks. The earning ability of Chinese banks is still low as indicated by low ROA and ROE by international standards. The banking system in rural areas is even worse. The top banks managers are still appointed by the government and seem to serve a government function as well as acting as the chairman of the board of directors. On one hand it seems that they have unlimited power and are often placed at institutions without a process of consultation with the board of directors and therefore may not become sensitive to the full range of shareholder issues. They will better understand all shareholders goals if they take part in a bona fide selection process. On the other hand those top managers have only limited decision-making power for they have no independence from the the government. In this regard the SOCBs are not fully market-oriented yet and generally lack an effective incentive mechanism. No bank officials will abdicate power without external pressure, which has prolonged the reform of China’s banks. The history of market-oriented banks and the related reforms in China is no more than 20 years. The Chinese bank industry is still an infant industry. But Chinese banks on the whole already possess preliminary international competitiveness. Full openness to foreign banks after 2006 will not lead to the collapse of domestic banks. Increased competition between the domestic banks and foreign banks will help provide stimulus for the former to improve their management still further. Chinese banks have already established a framework similar to foreign banks. However it is not easy to learn the way of thinking and the culture from foreign banks. Achieving sustainable performance will depend on meaningful structural overhauls and the emergence of a credit culture, both of which are longer-term propositions. Bank reform is far from finished. Bold and fast steps, for example further privatization, are needed to improve corporate governance and to reduce government control in the banking system. It is almost certain that Chinese banks will make continuous progress over time along with the further reform although it is surely a long journey.