Global Institute for Sustainable Prosperity

Policy Note No. 107
August 2015

One Belt One Road and the Roadmap to Financial Reform

Sara Hsu

Research Scholar, Global Institute for Sustainable Prosperity

Assistant Professor of Economics, SUNY New Paltz

In this policy note, we examine the sufficiency of China's planned financial reforms for its One Belt One Road (OBOR) initiative. Will the ambitious aims of OBOR and financial reform coincide? Are there deeper reforms to consider beyond the financial reforms laid out by the CPC Central Committee?

One Belt One Road and Domestic Financial Reforms

China's One Belt One Road initiative is becoming increasingly better financed, expanding China's reach into Europe, Asia and Africa. The $50 billion Silk Road Fund and the $100 billion Asian Infrastructure Investment Bank are to back the program, while the China Development Bank will invest over $890 billion into over 900 projects in 60 countries.

The projects will build up infrastructure, increase trade and finance, and boost connectivity across Europe, Asia and Africa. Details of the One Belt One Road plan were released on March 28, 2015 by the National Development and Reform Commission (NDRC) and the Ministries of Foreign Affairs and Commerce. The Silk Road Economic Belt is to extend through several corridors over Asia and Europe, while the Maritime Silk Road will include infrastructure projects that lie in South Asia, East Africa, and the northern Mediterranean Sea.

According to the NDRC Silk Road Vision Plan set forth on March 28, 2015, financial policies will:

a. Deepen financial cooperation
b. Build a credit information, investment, and financing system as well as a currency stability system in Asia
c. Expand the scope and scale of bilateral currency swap and settlement with other countries along the Belt and Road
d. Open and develop the bond market in Asia
e. Carry out multilateral financial cooperation in the form of syndicated loans and bank credit
f. Encourage foreign government and companies' issuance of Renminbi bonds in China

g. Encourage qualified Chinese financial institutions and companies to issue bonds in both Renminbi and foreign currencies outside China, and use the funds collected in countries along the Belt and Road
h. Strengthen financial regulation cooperation, encourage the signing of MOUs
i. Create bilateral financial regulation, and improve the system of risk response and crisis management by building a regional, financial risk early-warning system that creates an exchange and cooperation mechanism of addressing cross-border risks and crisis.
j. Increase cross-border exchange and cooperation between credit investigation regulators, credit investigation institutions and credit rating institutions
k. Encourage the creation of sovereign wealth funds in countries along the OBOR region
l. Encourage commercial equity investment funds and private funds to participate in the construction of key projects of the Initiative

In order to accomplish these goals, China must overcome obstacles in expanding its financial reach along One Belt One Road. Challenges include the fact that China's banking interest rates are still not fully market-based; that China's credit scoring institutions must be implemented; that the banking industry is constrained; and that the bond market is underdeveloped.

As previously stated, China's banking interest rates are not fully-market-based. Even if deposit interest rate ceilings are lifted, the persistence of lending to larger and state-owned firms creates a bias against lending based on risk and reward, or market-based lending.

China's credit rating and scoring institutions must be improved before China attempts to implement credit rating institutions in other countries. China is to implement a social credit system in 2017, which will rate individuals and institutions based on past credit transactions and other data, such as legal records. Still, this system will have to be tested so that it functions properly. Since China's bank funds are already limited, bank loans to foreign institutions will be a challenge in a credit-constrained market with insufficient credit risk information.

China's own bond market is underdeveloped—especially the corporate bond market, as the financial sector has mainly emphasized bank loans and equity finance. How can China address expansion of the bond market along OBOR if its domestic bond market is shallow?

Will China's planned financial reforms address these barriers to financial targets for One Belt One Road? Some of the planned reforms may fit the OBOR financial targets, while other necessary reforms are lacking. China's Financial Reform Roadmap from the CPC Central Committee's Decisions on Major Issues Concerning Comprehensively Deepening Reforms are to:

a. Further open up the financial sector by allowing small, privately owned banks to participate in the market
b. Promote equity issuance registration systems, equity finance, development of regulated bond markets, and increased direct finance

c. Improve insurance’s compensation mechanism, develop disaster insurance
d. Develop inclusive finance
e. Encourage financial innovation trough diversified financial products
f. Financial Reform Roadmap (cont.)
g. Improve exchange rate mechanism by accelerating interest rate liberalization
h. Open up capital markets, liberalize cross-border financial transactions
i. Regulate debt and capital flows in a macro prudential framework that accelerates RMB capital account liberalization
j. Implement financial regulatory reforms and clarify regulation responsibilities between central and local governments
k. Develop a deposit insurance scheme by improving financial institutions’ market exit mechanism

Sufficiency of financial reforms for OBOR

Are these reforms sufficient for meeting the financial targets of One Belt One Road?

First, is opening the financial sector sufficient for OBOR? Allowing small privately owned banks will ensure that China’s domestic economy is better served. Five pilot private banks currently focus on serving SMEs. While small private banks will not be able to address all needs for private funding, encouraging private banks will certainly increase available funding in the financial market.

Reforming policy financial institutions will also help improve China’s domestic economy. Two Chinese policy banks are undergoing reorientation toward sustainable development. This reform may help to make financial policy more environmentally and socially friendly and set precedent for lending and investment on OBOR. Most importantly, the domestic economy must be served in conjunction with OBOR, as China is an important engine of growth in the region.

Second, is developing inclusive finance sufficient for OBOR? In conjunction with the first reform, developing inclusive finance will help SMEs and poor individuals obtain finance within China to ensure that the domestic economy is served. This will help to encourage financial and real growth in China and ensure support for OBOR. OBOR should not act as a drain on China’s own financial resources.

OBOR must not transfer resources away from China. This pattern of development would be similar to the phenomenon that occurred for many years, in which funds were transferred from China’s rural to urban sectors as rural savings were used for higher-return urban projects, while rural projects were starved of funds. This should not be repeated on an international scale. Therefore, the domestic economy has to be served through new types of finance.

Third, is expanding the equity and bond market sufficient for OBOR? Promoting equity finance and developing bond markets will help increase financial resources available for OBOR.

However, these reforms have some way to go. In the bond market, government bonds are issued by the MOF and local governments and Central bank notes and Policy Bank bonds are most actively traded. However, state owned banks are supposed to purchase government bonds, rendering the yield curve pointless.

China's corporate bond market is underdeveloped and associated with insufficient market control: issuance of corporate bonds requires excessive administrative procedures, while bonds are subject to insufficient scrutiny by ratings agencies. Non-state owned corporate bonds may face potential default. These issues must be corrected in China's planned financial reform.

Fourth, is encouraging financial innovation sufficient for OBOR? Financial innovation is an important part of OBOR. This can help raise private capital for OBOR projects and also ensure that the domestic economy is properly served through inclusive finance. This is already happening, as newer versions of internet finance cater to underserved populations.

Innovation can also help contribute to financial deepening, which will free up more capital for use in OBOR. However, it does not come without risks. Financial innovation brought about the shadow banking sector. Innovation caused maturity mismatches and generated liquidity risk in wealth management products. Also, the credit risk associated with underlying loans and assets that were securitized and sold as trust products later led to threatened and actual defaults. This also happens to be what caused the financial crisis in the United States.

Fifth, is exchange and interest rate liberalization sufficient for OBOR? Exchange rate liberalization should be embarked upon carefully. Building a body of RMB outside China may increase pressure on China's exchange rate.

Liberalization of the deposit interest rate ceilings is an important step toward interest rate marketization. This is hoped to better reflect supply and demand conditions in the market for loanable funds. However, this is a necessary, but inadequate step in the right direction. Additionally, government bodies should exit the banking sector. If government bodies direct some of the lending, the banking sector will not become fully marketized, reflecting true risk and returns. Strong preference for lending to larger firms also prevents interest rate marketization. If interest rates do not reflect risk and reward internally, how can they reflect this externally?

Sixth, is cross-border financial liberalization sufficient for OBOR? Financial liberalization will be a positive development, but only if risks are properly controlled for. As more investors hold RMB outside of China, and as capital controls are loosened, the potential for large capital inflows or outflows increases. Recall the Asian Financial Crisis where surges in capital flows led to collapsed economies. Safeguards must be put in place to reduce capital flight where necessary. A market-based RMB exchange rate outside of China may deviate more strongly from the loosely pegged exchange rate within China, building pressures for exchange rate appreciation or depreciation.

Seventh, is accelerating financial regulation sufficient for OBOR? Better financial regulations and enforcement must be put in place to prevent fraud and excessive risk. China does not have a strong accounting and auditing system for firms that can guard against fraud. Fraud is a big problem among many Chinese firms. If this is already a domestic problem, how can one ensure that fraud is not extended to OBOR projects?

Information may reduce risk. China is just in the process of creating its Social Credit System, which is set to launch in 2017. This will provide credit ratings for individuals and institutions. This system is, as of yet, untested and includes several different standards. One looming problem is that if institutions provide fraudulent data, their credit ratings will not reflect actual risk.

Eighth, is developing an exit mechanism for financial institutions sufficient for OBOR? Financial institutions experiencing higher levels of NPLs or other distress require a sound exit mechanism. Currently, the bankruptcy mechanism for any type of firm is weak. Applications for bankruptcy can be rejected by Chinese courts, which generally have more power in bankruptcy proceedings than U.S courts.

This must be changed to avoid a "too big to fail" situation—firms in financial distress also need to be considered for winding down or reorganization. Currently, there is little recourse for distressed firms.
The PBOC implemented deposit insurance in May 2015 in order to ensure that once deposit interest rate ceilings are lifted, depositors are protected from risky competitive behavior engaged in by banks.

Furthermore, the lack of underlying institutions presents a barrier to both financial reform and to realizing the financial goals of OBOR. The lack of enforced property and legal rights may undermine the reform process, since it reduces ability to reinforce collateralized loans and debt contracts in general.
Creditors may not seize collateral unless allowed by the court, and there are thin markets for collateral. Creditors' and debtor's rights need to be clearly protected. If borrowers do not have sufficient property rights, they cannot use assets as collateral in the first place: will lending abroad further constrain lending to smaller borrowers?

Summing Up

Creating OBOR will require the harnessing of China's financial sector, which is undergoing constant change. OBOR will complement financial liberalization in China but safeguards must be put in place to control a multitude of risks, including credit, currency, interest rate, liquidity, and solvency risks.

Financial returns for many OBOR projects are expected. This is dependent on proper pricing of risk and reward through loans, equity, or bond financing. Financial investment is expected to increase along OBOR-financial expertise, and proper financial controls are essential.

Policy should emphasize that the rapid development of risk-control and stability mechanisms is essential both for financial reform and for the financing of OBOR projects. Building legal mechanisms, information transparency, and property rights is also an important precursor for any financial reform.

The more that China's own equity, bond, and direct financial markets are built up, the better it can use these means to serve OBOR. Where necessary, domestic needs should be prioritized over OBOR needs. Without a strong domestic financial and real economy, OBOR projects will lack a stable foundation.

In summary, OBOR is an ambitious undertaking that will require financial mobilization. Some of the financial reforms will be sufficient, but additional financial infrastructure is necessary. A continued gradual approach to reform and investment in OBOR is necessary to ensure stability.