

# Research on Finance Liberalization and Regulation Based on the Experience of China's Liberalization Transformation

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## ABSTRACT

Financial liberalization has been widespread since the 1970s. A series of financial crises, such as the Crisis in Southeast Asia, occurred when countries transitioned to financial liberalization. As a result, people believed that financial regulation and liberalization were a prisoner's dilemma. By studying financial regulation and liberalization in China, this paper finds that financial regulation and financial liberalization are not opposites, and it is desirable to transition to financial liberalization under financial regulation. Moreover, financial liberalization should be gradual, not overnight. Finally, we get a series of suggestions on financial reform: Firstly, the reform should pay attention to the order of financial marketization, and on this basis, we should build a market-oriented micro-system and improve the function positioning of government regulatory agencies.

**Keywords:** Financial Liberalization, Regulation, Transformation

## 1. INTRODUCTION

### 1.1. Background

With the continuous development of the world economy, the dual impact of finance on the national economy is becoming increasingly evident. On the one hand, economic development cannot be without finance, and financial modernization cannot separate from economic modernization. On the other hand, the globalization of financial risk directly threatens the financial security of one country and even the whole world.

International trade liberalization has increased the requirements for the development level of the financial industry in various countries, so various countries have paid the level of financial liberalization more and more attention. Financial liberalization is not only strengthened the competition, improve the efficiency of the financial system, promote the globalization of the world, and between the financial markets in the formation of a high degree of dependence, increase the risk of international financial markets, and the widespread application of derivative instruments makes the instability of international financial, deepened the vulnerability of the financial system.

### 1.2. Related research

Based on the findings of McKinnon's 1973 study on the short-term influencing factors of financial development, Elkhuzien et al. studied the importance of social capital as a prerequisite for effective economic liberalization policies. Elkhuzien et al. also concluded that financial liberalization promotes financial growth. Success depends on the general level of social capital. In addition, Elkhuzien et al. pointed out that the influence of this type of relationship is powerful in countries with weak institutional environments [1]. Philip explored the relationship between financial liberalization and the crisis. Through the Southeast Asian crisis and the 2008 international financial crisis. Philip concluded that the financial system needs to be supervised and gave suggestions worthy of reference: financial stability focusing on appropriate control of the financial sector and coordination with monetary and fiscal policies [2].

Lanau and Wieladek studied the impact of financial regulation on current account adjustments by establishing an existing account intertemporal model. Lanau and Wieladek came to the following conclusion: a flexible exchange rate system has nothing to do with recent account adjustments, and financial supervision is independent of exchange rates. The size and dynamics of

the current account balance of the system have a significant impact [3]. Settle analyzes the economic impact of financial liberalization on Pakistan by interpreting the balance sheet at the microeconomic level. Draw the following conclusion: Pakistan's banking industry is facing foreign exchange and interest rate risks after experiencing rapid financialization, which has caused Pakistan's inflation to rise rapidly. Furthermore, Settle The financial threat among ordinary people has increased since the Pakistan government deregulation of the critical economic sector [4]. Starting with a microeconomic model, Pandit analyzes how financial control and regulation in financial markets can best accelerate economic growth and make it more inclusive, concluding: State-owned economy and government control over financial institutions can stimulate national economic growth. On the other hand, government-controlled financial institutions can also protect vulnerable sectors of the economy through the economic policy of preferential sector loans. In addition, reserve banks' prudential supervision of the financial sector has helped maintain financial stability [5].

Cubillas and González analyzed the banks of 83 countries to study the impact of financial liberalization on bank risk-taking and came to the following conclusions: First, for developed countries, economic liberalization has promoted more intense banking competition and increased banks. Therefore, it is necessary to adopt more stringent capital supervision; Second, for developing countries, banks' liquidity risk has been increased by expanding risk-taking opportunities. The supervisory agency needs to improve the supervisory system continuously [6]. By studying the problems faced by emerging Asian economies in the process of financial liberalization, Wang made the following conclusions: First, each country should maintain some regulatory space, safeguard its financial decision-making power independently, and carry out capital account liberalization reform in an orderly and gradual manner. Second, Regulators should protect domestic financial institutions until they develop policies that suit national conditions [7]. Vitta and the World Bank analyzed a series of crises caused by the lack of supervision of financial institutions after the global financial liberalization in the 1980s and put forward the following suggestions for regulators: Regulators should possibly separate banks from their subsidiaries to reduce the possibility of banks conducting internal transactions. At the same time, relevant non-bank businesses will be transferred to subsidiaries to maintain the bank's low leverage ratio and reduce the possibility of bank runs [8]. Jürgen and Zhang examine the common problems faced by small open economies: whether financial liberalization will improve economic productivity, who will benefit, and whether financial liberalization should be gradual. The following conclusions are drawn: the improvement of production efficiency by relaxing the

regulation of a particular sector depends on the financial regulation of other sectors. Moreover, domestic borrowers are likely to be the ultimate beneficiaries, as they can benefit from greater access to productive domestic assets and financial liberalization. Finally, if financial liberalization is carried out too fast, it will likely cause inflation and further asset outflow. Therefore, financial liberalization is gradually implemented to adapt [9].

By evaluating the relationship between the financial crisis and financial regulation, Hlaing and Kakinaka study how financial crisis affects financial policy reform. Hlaing and Kakinaka draw the following conclusions: First, Hlaing and Kakinaka agree that 'reforms tend to occur after the crisis'. Meanwhile, further research finds that reforms after the financial crisis become incomplete due to the lack of reforms on prudential regulation, thus failing to reduce the vulnerability to the next financial crisis [10]. Kishi examines the causes of moral hazard caused by financial liberalization policies in Northeast Asia in the 1970s and 1980s and then discusses the need for new financial regulations to avoid these obstacles on the road to complete financial liberalization. Kishi concludes that further financial liberalization requires a different kind of support system from the old one, accommodating the operation of competitive markets while detecting excessive speculation. In addition, Kishi emphasizes the importance of cooperation between government and private sectors [11]. Hong et al. examine the likely outcome of China's liberalization and whether a gradual approach to financial reform can indeed avoid a sharp fluctuation in average interest rates. The following conclusions are drawn: the average interest rate did experience a structural fracture during the study period, but Hong et al. emphasize that this was caused by macro factors and had nothing to do with economic liberalization. Average interest rates did not change significantly after government reduce the government power in a particular industry such as energy industry, transportation industry. In addition, Hong et al. find that gradual reforms can help benefit from a market-based interest rate environment while also reducing the damage to the domestic economy [12].

### ***1.3. Objective***

Based on the above series of explorations, the research objective of this paper is to study the relationship between financial liberalization and financial regulation. Considering China's recent transformation as a scenario, this paper studies how a developing country transforms from financial regulation to financial liberalization, thus concluding a series of characteristics and implementing similar countries to help their transformation safety and stability.

## **2 . DEFINITION AND RISK OF FINANCIAL LIBERALIZATION**

### **2.1. Definition**

Financial liberalization or financial deregulation refers to the relaxation or lifting of financial regulation and the formulation of reasonable game rules. Financial liberalization must be structured around respect for market mechanisms, where official governments remove undue restrictions or controls and reduce unnecessary intervention, creating a level playing field and enhancing the efficiency of market resources [8]. Many critics think that financial liberalization will increase the risk of the financial crisis and disrupt the stability of financial markets but does not mean that the government financial liberalization of financial policy and financial supervision, it is through the government official's positive participation, further improve the existing financial regulation, with emphasis on financial discipline [5]. On the other hand, financial disturbance or crisis will not be derived out of order in the process of financial liberalization. This is proven by studying the common problems faced by small open economies, it is found that financial liberalization is carried out too quickly in financial crises, which leads to the rapid entry of external capital into local markets, resulting in inflation and further asset outflow [10]. Furthermore, Through the financial reform in Northeast Asia, it is found that although the average interest rate and inflation rose rapidly during the reform process, this was caused by macro factors and did not cause economic turbulence [13]. Regulators can reduce the probability of financial crises by detecting excessive speculation in markets and intervening early [12]. To be specific, financial deregulation should include the following aspects:

#### **2.1.1. Financial price liberalization**

Financial price liberalization including foreign exchange liberalization and interest rate liberalization. Foreign exchange liberalization means that foreign exchange is held by the private sector, which is not restricted by physical borders and can be freely remitted out and in. As for a country's exchange rate, supply and demand also determine its price. Foreign exchange liberalization is mostly a constraint on the final liberalization, mainly because its implementation will increase the risk of financial institutions participating in international financial and foreign exchange transactions. As a result, governments tend to take a cautious approach to foreign exchange liberalization. Interest rate liberalization refers to the reduction or removal of interest rate control, the level of interest rate determined by market supply and demand, and the improvement of operating efficiency of financial institutions through interest rate competition.

#### **2.1.2. Administrative liberalization**

Financial administrative liberalization means that the government relaxes the establishment of financial institutions, branches, and foreign banks, expands the business area of financial institutions, and improves the financial system, etc. Administrative liberalization mainly inject competition and creativity into the financial industry, which not only strengthens competition within the industry, but also administrative liberalization strives for more reasonable interests for consumers.

#### **2.1.3. Business liberalization**

Financial business liberalization refers to the relaxation of financial business restrictions, allowing and encouraging the creation of new financial products to diversify and "departmentalize" financial business to meet the diverse needs of today's society. In addition, financial institutions are required to control the risks of assets and liabilities by formulating safe and sound operating principles. The financial inspection and risk rate or deposit insurance system are strictly implemented to maintain credit order.

## **2.2. Risk of financial liberalization**

In recent years, the emergence of international financial risk events has proved the urgency and importance of regulating the global financial market. Global liberalization in financial markets that gathered energy in the 1980s led to a jump in financial volatility and risk. The complexity and high cost of instruments sought to diversify those risks, with the result that the 1990s were marked by a series of financial disasters of varying degrees. Financial crises in many countries resulted from inadequate regulation of large private short-term capital flows. In addition to these significant events, the opening of domestic capital markets in the face of international competition has led to financial crises in many countries. IMF studies estimate that the damage from these crises is between 3% and 25% of GDP [8]. Experts argue that public intervention is counterproductive, that the market should be left to its own devices, and that self-regulation by participants is the only solution [2]. The risks can be defined as follows:

#### **2.2.1. Liquidity risk**

The liquidity risk refers to the financial institutions must hold higher cash positions or variable linear assets or external funds to meet the capital needs that may occur at any time, which is the liquidity capacity and debt capacity of financial institutions. Therefore, the so-called liquidity risk refers to the financial institution's capital source and use of improper control or maturity imbalance, or because of sudden, seasonal capital outflow created by the risk of illiquidity. Improper liquidity management is

either due to high liquidity and idle capital to reduce profitability or insufficient liquidity resulting in payment failure.

### 2.2.2. Operational risk

This risk is more likely to occur in newly established financial institutions because the operating income is unstable. The expansion of domestic and foreign branch units leads to increased costs and losses.

### 2.2.3. Credit risk

Such risk means the risk arising from the failure of the customer. As a result of the fierce competition caused by financial liberalization, the financial industry, in pursuit of business volume growth to relax the necessary audit, resulting in the sacrifice of asset quality and endangering the business foundation.

### 2.2.4. Concentration risk

Due to the combination of general industry consortiums and the financial industry, the financial industry focuses on granting credit to a specific industry or related enterprise, thus increasing the risk of granting credit.

## 3. FINANCIAL SUPERVISION

The Journal of World Trade defined that financial supervision refers to the various supervisions of a country's government agencies on financial institutions and a series of related legislation and law enforcement systems and processes [7]. Furthermore, risks exist with the development of the financial industry, and this requires scientific and adequate financial industry supervision to effectively prevent financial risks and protect the interests of investors [11].

### 3.1. To ensure the stability of financial market

The world financial crisis of 2008 tells people: If a financial institution goes bankrupt due to operating difficulties, it will have a knock-on effect on other financial institutions. At the same time, if the financial order is disrupted, the entire society will have to bear substantial social costs. In China, with the infrastructure construction stimulus plan since 2008, many funds have been poured into the real estate industry as a reservoir of funds to stimulate the economy. As shown in Figure 1, by 2021, credit has accounted for 287% of GDP. In addition, household debt increased to 61.3%. The expansion of the real estate industry driven by debt has brought China potential debt crises and business risks.

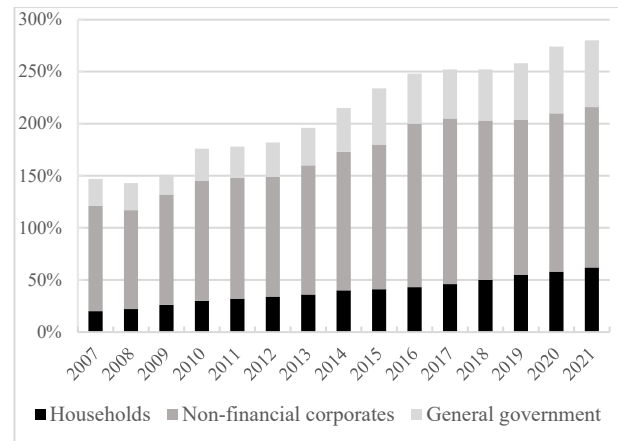


Figure 1 Composition of Debt in China (% of GDP) [13].

To curb leverage and speculation in the real estate industry, regulators further tightened financing policies on the one hand: First, China Banking and Insurance Regulatory Commission (CBIRC) introduced deleveraging policies to limit the debt/asset ratio and net debt ratio of real estate developers. Second, CBIRC tightened the restrictions on cross-border loans and allowed banks to set a ceiling on loans to the real estate industry, thereby controlling the risks to banks and further reducing the impact of debt default on the financial system. On the other hand, through prudent supervision of the financial market to reduce the debt default rate, minimize the credit and concentration risks caused by debt default.

With constant by example, Evergrande currently has 300 billion dollar debt, if default, liquidity risk may lead to mass unemployment-related personnel. Moreover, other pass crisis to its affiliated institutions, credit risk caused by heavy selling high yield bonds, ultimately affect bank risk system of real estate industry and disrupt the stability of the financial system. To prevent the spillover effect caused by Evergrande's default, the People's Bank of China, on the one hand, released the news to the society that Evergrande's debt was controllable and isolated to stabilize market confidence. On the other hand, the intervention in Evergrande's debt restructuring and assisting if necessary to ensure the stability of the financial market.

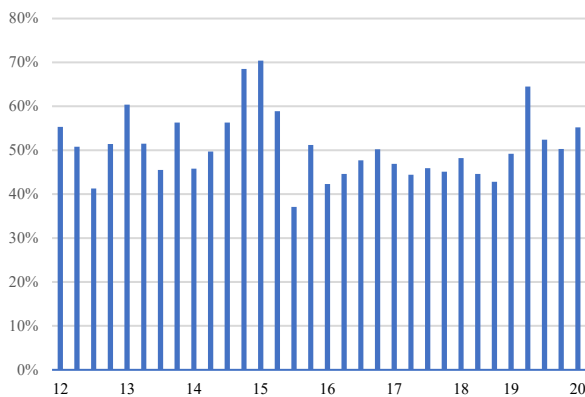
### 3.2. Protecting the interests of investors

Due to the information asymmetry in the financial market, investors cannot obtain enough information to judge the level of market risk. In addition, listed companies refuse to disclose information and have insider trading, and most investors cannot assess the company's strengths and weaknesses. In China, due to establishing a stock exchange and related departments in the 1990s, there were a series of loopholes in securities supervision, which led to subsequent market scandals.

In 2011, Xu Xiang conspired with the executives of 13 listed companies to raise the stock price and help him cash out at a high level, earning hundreds of millions of yuan within a month. On November 1, 2015, Xu Xiang was sentenced to five years and six months in prison for operating the securities market and insider trading crimes and was fined 11 billion yuan and confiscated about 9.337 billion yuan of illegal income.

In December 2018, Kangmei Pharmaceutical was filed for investigation by the China Securities Regulatory Commission's (CSRC) due to suspected violations of information disclosure. Under the investigation of the CSRC, Kangmei Pharmaceutical's 2016 annual report inflated currency funds by 22.58 billion yuan; 2017 inflated by 29.94 billion yuan; 2018, 36.19 billion yuan were inflated. On August 16, 2019, the spokesperson of the CSRC stated that Kangmei Pharmaceutical had planned and organized long-term systematic financial fraud to deceive investors maliciously. On May 14, 2020, CSRC announced that it would impose administrative penalties and market bans on Kangmei Pharmaceutical's violations of laws and regulations under the law.

A series of market scandals have severely hit the interests of market investors. As shown in Figure 2, investors' confidence in the Chinese stock market has plummeted to the historical low point in July 2017 and dropped again after July 2019.



**Figure 2** China investors' confidence index [14].

In response to this, on the one hand, the Securities Amendment passed in 2019 (SA 2019) allows CSRC to, after making the administrative penalty decision, the relevant responsible units and personnel will also face investor civil litigation claims to rebuild investors' confidence. On the other hand, CSRC has also passed regular reviews, and random investigations will punish violations in the market. In addition, SA 2019 strengthens investors' rights and effectively enforces the law, regulates market entities, and protects investors by strengthening regulatory agencies' powers, such as freezing and seizing illegal funds and compulsory delisting companies.

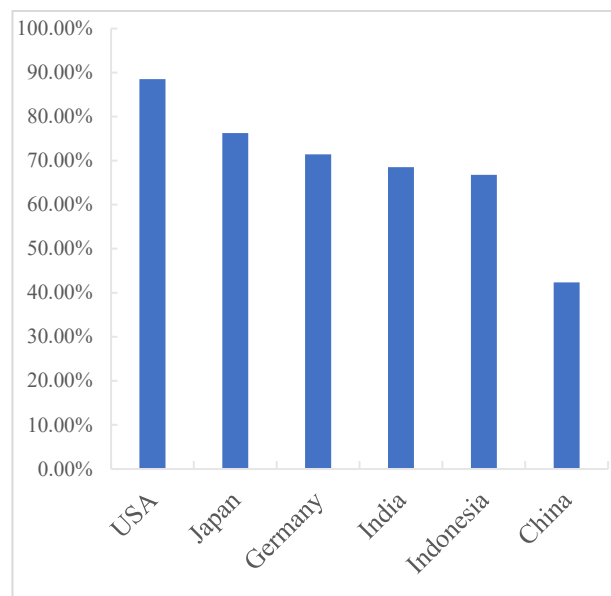
Therefore, the unmaturation of the Chinese financial market determines the necessity of financial supervision. The characteristics of economies of scale of financial institutions make the free competition of financial institutions eventually develop into a high degree of centralized monopoly, whose prices must be higher than the equilibrium level of competition, resulting in the loss of the efficiency of resource allocation in the financial industry and the loss of consumer welfare. Therefore, as a restrictive and monitoring force for market monopoly, the government will help maintain the stability of the financial market and protect the interests of investors.

#### 4. FINANCIAL LIBERATION

Although financial liberalization will bring about a series of financial risks in the short term, in the long run, interest rates determined by market forces can, on the one hand, stimulate investors to invest in more productive activities, thus improving overall productivity. On the other hand, improving the quantity and quality of financial intermediation can increase the vitality of the domestic economy and make it develop healthily. Since the essence of the financial system is to raise and channel funds to productive investment, the transition to economic liberalization is necessary.

##### 4.1. Share markets

Figure 3 shows that before the financial reform, China's share of direct financing was much lower than that of developed economies, even other emerging markets. As a result, most of the funds were controlled by banks, which was not conducive to improving the efficiency of capital use and could not flow to industries in real need of capital.



**Figure 3** Direct financing share of total financing in 2014 [15].

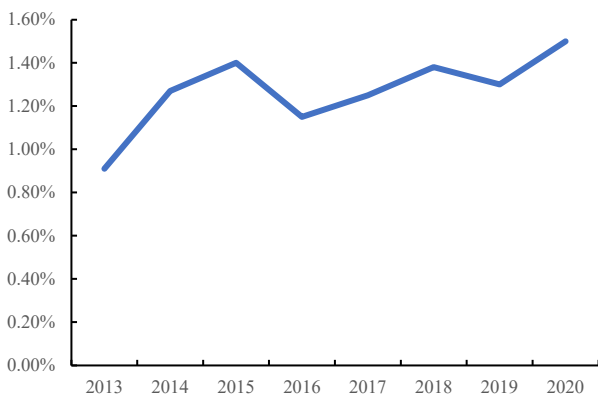
Therefore, a series of financial reforms in recent years have focused on expanding and developing the capital market. CSRC aims to improve financing channels for small and medium-sized enterprises by establishing a registered stock offering system and increasing the proportion of direct financing. For example:

On the one hand, the establishment of the Beijing Stock Exchange will screen high-quality enterprises, and the low investment threshold (¥ 50 million for investors) will help improve the liquidity of market funds. On the other hand, relatively relaxed listing conditions can also solve the financing difficulties of small and medium-sized enterprises and help cultivate a batch of small start-up enterprises with huge transaction space.

Thus, indirectly expanding the proportion of direct financing in the market, promoting scientific and technological innovation, and activating the development of the real economy.

**4.2. Easing of capital restrictions**

Despite China's strict restrictions on outbound investment, the CSRC has also been reducing and simplifying approvals for new foreign direct investment in recent years amid financial reforms to allow institutional investors to invest in cross-border securities. The Shanghai-Hong Kong Stock Connect (ShHKSC) plan in 2014 and the Shenzhen-Hong Kong Stock Connect (SzHKSC) plan in 2016 will further open the mainland stock market to overseas investors. Promote the transformation of China from indirect financing dominated by banks to direct financing dominated by investors and improve the rate of capital flow.



**Figure 4** Bank of China offshore RMB index [16].

Figure 4 illustrates that with the implementation of ShHKSC and SzHKSC, as both use RMB for settlement, the overseas utilization rate of RMB is increasing year by year, which helps promote the internationalization of RMB and is expected to reduce the exchange rate impact on the onshore RMB market and onshore foreign exchange reserves.

**4.3. Improve company ownership**

The Chinese government proposed to promote the development of a mixed-ownership economy, allowing state-owned enterprises to attract private capital. For example, in July 2014, the existing mixed ownership structure of the Bank of Communications was reformed. In September, the bank's managers began using their funds to buy shares to increase employee ownership and reduce the number of shares held by the Treasury. Individual holdings now account for 26% of the total.

In addition, CSRC lifted foreign equity caps on brokerages in April. On February 17, Nomura Orient International securities set up a securities business department in Shanghai. On March 6, JP Morgan Securities (China) set up a securities business office in Shanghai.

On the one hand, the change of ownership is conducive to the enthusiasm of employees and the improvement of the company's competitiveness. On the other hand, it also forces the reform of the industry and optimizes the allocation of market resources by intensifying the competition in the industry.

Therefore, Financial liberalization should be based on the marketization of the real economy. The sequencing of reforms is also crucial because of the particular importance of finance in the real economy. China's financial reform is gradual [5], starting with corporate ownership reform, followed by a shift to direct financing by introducing foreign capital and easing cross-border investment.

**5. FINANCIAL LIBERALIZATION AND RATIONAL ORIENTATION OF FINANCIAL SUPERVISION**

**5.1. The order of financial marketization**

For those countries that want to transition from financial regulation to financial liberalization, the order of liberalization and marketization is essential. The first step of reform should be to improve trade and finance by lifting controls on the productive sector on the premise that domestic prices of goods and services are basically in line with international prices and the fiscal deficit is under control [1]. The second step is to gradually open the domestic capital market to determine the domestic interest rate. Third, deregulate the current account of the balance of payments. Fourth, abolish capital account controls on the balance of payments. In essence, finance is only the intermediary of the real economy, so financial marketization should be based on the marketization of the real economy. At the same time, reform is an irreversible process. Given the particular importance of finance in the real economy, the sequencing of reforms is also essential. From the perspective of China's financial market, it

followed a gradual reform path, gradually accumulated experience, constantly reflected and made progress, and successfully resisted the impact of the Southeast Asian financial crisis. Therefore, the order of financial marketization should follow two basic principles: first, it must coordinate with the whole economic reform; second, it must adhere to the combination of micro reform and macro reform, especially the micro reform.

### **5.2. Market micro system**

The market economy needs to make policy-based banks gradually closer to policy-based financial institutions in the real sense. The financial regulation should gradually transform commercial banks into all-directional and diversified commercial banks and establish capital operation mechanisms, risk management mechanisms, financial restraint mechanisms, comprehensive assessment and evaluation systems, and the internal incentive mechanisms of commercial banks. Strive to create a self-management, self-risk, self-progress of the micro-market subject. The merger and reorganization promote the securities to the fundamental investment bank transformation, standard trust business. In a word, we should build a micro financial organization system full of strength and pioneering ability with distinct levels and orderly competition.

### **5.3. The establishment and function orientation of government supervisory organization**

To meet the needs of modern scientific and technological progress and financial innovation, some countries have reformed the original separate regulatory system into a single regulatory agency [7]. However, China's situation is precisely the opposite, from the original single regulatory system to the banking, insurance, securities, and other sectors of the regulatory system. Since China's accession to the WTO, the financial industry is also facing the situation of intensified competition, merger and reorganization, the diversified development of financial business, and the risks: the ambiguity of financial business, the supervision of financial innovation, so China's financial supervision system may return to its original position. No matter what kind of financial regulatory system is protected and supported by law. In this situation, neither objective economic conditions nor government officials will affect or control the supervision of the financial field. To adapt to the regulatory model of the free market, the current simple prevention should be upgraded to both prevention and efficiency. Create a level playing field where different financial institutions coexist. Adopt international standards to build market infrastructure, increase market openness, emphasize financial market and regulatory disclosure, and reform the current accounting system. It is necessary to consider both market access mechanisms and market withdrawal

systems so that the government supervision departments can perfect, promote, and supplement the market.

## **6. CONCLUSION**

In this paper, from two aspects of China's regulatory and liberalization to the process of China's financial reform found that financial regulation and freedom can be both, at the same time, financial liberalization reform should be under the open domestic market, easing restrictions on capital, eventually ownership reform to achieve capital liberalization, to stimulate economic activity. In addition, the government should constantly monitor the domestic market during the reform process and make a series of amendments to the existing laws to ensure the stability of the capital market and protect the interests of investors to the greatest extent. Finally, this paper believes that China's financial reform has specific reference value and that other developing countries should take China as a reference for their financial reform and carry out financial liberalization transformation step by step in combination with their characteristics, to reduce a series of financial risks caused by the reform.

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