China may be about to repeat the financial mistakes of Japan in the 1980s

China's financial system is developing rapidly, swelling the country's bank assets to become the largest in the world, and there are worrying similarities with the global dominance of Japan's banks in the late 1980s.

Japan's experience ended in tears with the bursting of a domestic and international financial and real asset bubble, heralding the economy's descent into on-and-off recessions for the next 3 decades and stubborn deflation.

Research done for the Asian Development Bank Institute found that, despite the rapid development of capital markets since the 1990s, China's financial system continues to be dominated by bank lending.

Large commercial banks continue to pump credit into the system, and capital-based constraints and administrative measures are not very effective.

Large state-owned banks have become important players in bond and equity markets, as well as important providers of liquidity for smaller commercial banks and a range of non-bank financial institutions through a combination of inter-bank funding activities, wealth management products, and shadow-banking capital market activities.

The importance of non-bank financial institutions has continued to grow.

From 2007 onward, foreign banks have been allowed to transform their mainland branches into locally incorporated banks.

By 2015, some 37 solely funded foreign banks had done so, but stringent capital requirements and the treatment of capital injections as foreign direct investments increased the complexity of the approval process, and the presence of foreign banks remains low at just 1.3% of assets in 2015.

While foreign banks have had a relatively low domestic presence, China's banks have been expanding their international activities, becoming an increasingly important source of international credit.

By the end of 2015, their cross-border assets accounted for more than $700 billion, making them the tenth-largest creditor in the international banking system and a significant supplier of dollar credit.

But, unlike other larger international creditors like the UK, Japan, and Germany, China is a net debtor in the international financial system.

This is partly to do with the unique role of Hong Kong, China, where China's banks have listed subsidiaries on the Hong Kong Stock Exchange and operate the market in renminbi deposit accounts and bonds.

The emergence of Shanghai and Shenzhen as China's main on-shore financial centers can be traced to the establishment in 1990 of stock exchanges in both cities.

Recently, both cities benefited from national policies promoting pilot free trade zones and Stock Connect schemes that allow approved overseas investors to purchase domestic shares via Hong Kong, which serves as China's off-shore financial market.

Shanghai was the first to benefit from this in 2014, and the scheme was extended to Shenzhen in 2016.

While foreign holdings of domestic financial assets such as equities, bonds, and loans have remained low, China created a large pool of off-shore renminbi, known as "CNH," and helped by the creation of the so-called "dim sum" bond market, which was launched in Hong Kong.

China's "big four" banks—ICBC, CCB, ABC, BOC—are now the 4 largest banks in the world by assets, while another 14 are in the top 100 largest banks, and China's bond market is the third largest after the US and Japan.

China is also the world's leading nation in financial technology, with the biggest market for digital payment and online lending.

Beijing's efforts to promote the renminbi as an international currency have already resulted in its inclusion in the International Monetary Fund's Special Drawing Rights basket, where it joined the dollar, the euro, the yen, and the British pound in 2016.

While this reflects the incredible growth and development success China has achieved over the past 4 decades, caution is warranted.

In the late 1980s and early 1990s, Japanese investors and consumers were buying assets and consuming conspicuously around the world.

Boutiques on the famous French fashion street Rue du Faubourg Saint-Honoré were filled with Japanese-speaking shop assistants as Japan's financial firms purchased global assets at record-high prices.

The rise of China's banks is reminiscent of the rise of Japan's banking institutions, which in 1989 dominated the list of the 10 largest banks in the world.

For Japan, the rapid expansion and internationalization of its financial system proved challenging and costly.

China's leadership is dealing with these challenges and is committed to establishing Shanghai as a global financial center and developing the renminbi into a truly global currency, but it has become increasingly conscious of the dilemmas posed by an open capital account.

And efforts to internationalize the renminbi slowed recently with the reinforcement of stricter capital controls, much to the chagrin of mainlanders wanting to invest overseas.

China faces major challenges in maintaining financial stability because of its huge debt and enormous shadow financial system.

Weak governance significantly limits restructuring.

In the absence of further reform, equity markets also appear poorly placed to absorb large amounts of debt.

Another major challenge, which has received growing attention from China's financial authorities, is the alignment of the financial system with sustainable development and the impact of industrial activity—particularly pollution—on the economy.

These risks are among the greatest systemic medium- and long-term challenges facing the economy, and the financial sector ought to lead in mitigating them.

China is facing the challenge of aligning the interests of society and the financial sector.

And with Paris boutiques now filled with Mandarin-speaking shop assistants to meet the demand of wealthy mainland tourists, the risks of history repeating are clear.

This episode was based on research done for the Asian Development Bank Institute by Damian Tobin, a lecturer on Chinese business and management at the School of Finance and Management, SOAS University of London, and Ulrich Volz, head of the Department of Economics at the same institution.

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