Four Key Directions for Building a Digital Financial Powerhouse[1]

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Abstract: *To build China as a digital financial powerhouse, we need to focus on four main areas. First, we must promote the digital transformation and upgrade of financial institutions, effectively carrying out supply-side reforms in the financial sector. Second, we should vigorously develop industrial digital finance and cross-border digital finance to better support the real economy and achieve a dual circulation of finance both domestically and internationally. Third, the emphasis should be placed on the driving effect of artificial intelligence on digital finance, pushing digital finance companies into a new stage driven by technological innovation. Fourth, we need to establish mechanisms that encourage financial innovation, providing institutional support for continuous innovation by financial institutions.*

1. Promoting Digital Transformation and Upgrades in Financial Institutions

First, true strength comes when all are strong: promoting the digital transformation and upgrade of financial institutions.

Starting from 2003, the development of digital finance has spanned over 20 years. During these two decades, digital finance has become the most significant innovation within China's financial system. The development stages of digital finance in China can be divided into two halves: 2003 to 2018 as the first half, and the period after 2019 as the second half. This division is based on the People's Bank of China issuing the "Financial Technology Development Plan (2019-2021)" in 2019, followed by the "Financial Technology Development Plan (2022-2025)" in 2022.

In the first half of digital finance innovation, large digital finance platforms, especially mobile payment platforms and fintech companies, played a leading role. This propelled China to a global leadership position in mobile payments, online investment and wealth management, big tech lending, and contextualized financial services. Meanwhile, the development of digital finance introduced strong competitive effects to licensed financial institutions, represented by commercial banks, as well as collaborative and empowering effects.

Entering the second half, various financial institutions, including banks, brokerages, insurance companies, and funds, whether traditional or licensed, are vigorously pushing forward with digital and intelligent transformation and upgrades. I refer to this transformation as the supply-side reform of the financial sector. In China's financial system, licensed financial institutions remain the main service providers to the real economy. Only through the digital transformation and upgrade of these institutions can China ensure its status as a powerhouse in digital finance.

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2. Vigorously Developing Industrial Digital Finance and Cross-Border Digital Finance

Second, supporting the real economy is what truly defines strength: vigorously developing industrial digital finance and cross-border digital finance.

From the National Financial Work Conference in 2017 to the Central Financial Work Conference in 2023, the General Secretary has consistently emphasized that the essence of finance is to support the real economy. In recent years, digital finance has played an important role in supporting the real economy, for example, by lowering the barriers and costs of financial services and solving the problem of information asymmetry. However, prior innovations in digital finance were mainly consumer-oriented, focusing on solving the financial needs of consumers in activities such as payments, wealth management, e-commerce retail, social networking, and food delivery, significantly improving retail financial services. It's important to recognize that another crucial element in China's economic development is the supply side. Currently, China's economic development model has undergone profound changes, transitioning from rapid growth to high-quality development, with the digital economy accounting for more than 50% of China's economy and being the most innovative part. The 20th CPC National Congress report specifically proposed accelerating the development of the digital economy, focusing on promoting the deep integration of the digital economy with the real economy in the future. To support the real economy, the next direction for digital finance might be to shift from the demand side to the supply side, supporting the development of the industrial sector.

Specifically, this involves vigorously developing industrial digital finance, utilizing digital technology and the ecosystem of the industrial chain and the industrial internet to reduce information asymmetry and provide better financial services to enterprises in the industrial sector. It also involves leveraging the new dual-circulation development pattern to address challenges in cross-border financial needs with digital finance, encouraging Chinese digital finance enterprises to go global, enhance international influence, and integrate into the global economic circulation. Additionally, attracting overseas digital finance institutions to China is crucial, both competing abroad and welcoming foreign competition at home. Digital technology should be used to solve difficulties for foreign individuals and companies using digital finance in China, attracting foreign digital finance institutions to participate in market competition and services. The Singaporean case shows that establishing a clear and transparent regulatory framework is very important. Improving communication between regulation and the market and reducing policy uncertainty is crucial for attracting overseas digital finance institutions to develop in China.

3. Driving Digital Finance with Artificial Intelligence

Third, embracing cutting-edge technology is the key to sustained strength: AI-driven digital finance.

According to text analysis of annual reports from Chinese commercial banks, between 2018-2021, the focus of commercial banks' digital transformation was on fintech and digitalization, with intelligence becoming the focal point in 2022. With the emergence of ChatGPT, the application of AI has reached a new milestone, and companies both domestically and internationally have begun to actively embrace large AI models. Large AI models are not only adept at human-computer interaction experiences but can also generate content automatically. These two features enable them to assist humans in many tasks within the financial services sector, empowering financial practitioners to reduce costs increase efficiency, and even partially replace human labor. Additionally, AI technology can also be used to solve challenges in personal investment and financial management.

AI can help lead China's fintech and digital finance innovation from an application-driven stage to a technology innovation-driven stage. In the first half of China's digital finance development, many innovations were merely combining two existing technologies or innovating in business models. While these innovations had a significant impact, they were not necessarily technologically advanced. Entering the second half, the low-hanging fruits of digital finance innovation have been mostly picked, and digital finance companies now need to enter a stage driven by technological innovation.

4. Establishing Mechanisms to Encourage Financial Innovation

Fourth, continuous innovation is the key to enduring strength: establishing mechanisms to encourage financial innovation.

The goal of financial regulation is always to balance risk with innovation. An important reason for the rapid development of digital finance in China in the early days was the relatively pragmatic and inclusive attitude of Chinese regulatory authorities towards mobile payments and online investment and wealth management services.

Today, with a strong emphasis on licensed financial operations in China, establishing mechanisms that allow for controlled risks and permit innovation is crucial. Two mechanisms to consider are regulatory sandboxes and regional pilot mechanisms. Regulatory sandboxes involve conducting pilots in a controlled environment, and projects entering the sandbox should specify which aspects do not comply with current regulations. Fully compliant projects should not enter the sandbox, as this would negate the purpose of a trial-and-error mechanism and turn the regulatory sandbox into an advertising platform. The operational effects and risks of projects entering the sandbox should be assessed and disclosed thoroughly. The pilot mechanism involves establishing financial innovation pilot zones for broader-scale opening or experimentation, a mechanism that has been repeatedly tested and proven effective since the reform and opening-up. Additionally, attracting foreign financial institutions to China is crucial, and treating enterprises of different ownerships equally, clarifying rules, and establishing a negative list is important.

During my trip to Singapore, I strongly felt that enhancing communication between regulatory authorities and the market is particularly important. The Singapore Fintech Association has a close relationship with enterprises, representing them in communications with regulatory authorities. In China, many industry associations are more like an extension of government departments, some even managed at certain administrative levels, resulting in relatively weak communication with the market. In addition to industry associations, China should also utilize industry alliances, research institutions, think tanks and other communication platforms to improve communication between regulation and the market.