

SUMMARY. China's securities markets have fared reasonably well through the Asian financial crisis due to: (1) their comparatively high level of insulation from regional and global factors, (2) resilient macro economic fundamentals – such as fundamental currency strength, export performance, growth, among others, (3) several progressive reform initiatives aimed at recapitalizing the financial sector – such as attempts at reform of trusts and investment corporations, the introduction of foreign banks and insurance companies, the setting up of Asset Management Corporations, among others, and (4) the containment of specific events - preventing systemic shocks.

However, given that China's relatively high level of insulation will inevitably decline - either through intentional reform efforts or unintended developments - ongoing stability remains subject to: (1) the successful implementation of loan recapitalization initiatives (2) the success of institutional financial market reforms, (3) the successful implementation of a new currency regime over the long term, and (4) the ability of the People's Bank of China to prevent event risks (such as the growing number of corporate defaults) from triggering a systemic crisis, (5) the ability of the Ministry of Finance to efficiently manage the development of fixed income markets necessary to recapitalize the state-owned sector and to deal with pending fiscal constraints, and (6) the ability of the China Securities and Regulatory Commission to implement the December 1998 Security Market reform initiative.

The sequential timing for these preceding issues remains China's single largest risk. China's financial markets can cope with more corporate defaults and absorb the fiscal cost of more bailouts. However, if for example these occur during a tenuous currency regime transition, coincide with a significant reversal in macro economic fundamentals (i.e. a dramatic fall in foreign direct investment or export growth, etc), or occur alongside a major political crisis the combination could prove fatal for China's securities markets.

Market Segmentation. It is important to look at how China's various markets performed – see charts. Domestically insulated markets remained relatively immune while global debt and equity markets with China risk suffered considerably. Market intervention and/or the manipulation of bond yields and stock prices allowed domestic investors to remain sheltered. However, as the securities markets increasingly open to global participation, administrative controls – such as the closure of informal currency swap market in 1998 – become less feasible, and total securities volume increases through new issuance and debt for equity swaps the market will be increasingly subject to real changes in Chinese and global risk valuations. As a result, we should expect to see the manifestation of market segmentation to continue to diminish considerably in the medium to long term.

Corporate Defaults. Starting with the bankruptcy of Guandong International Trust and Investment Corporation (GITIC) in late 1998, China has experienced a spate of corporate defaults. GITIC was one of China's premier institutions for accessing international investments and its default triggered a shock wave throughout the China investment community due to the high proportion of foreign creditors involved and the

corporation's perceived backing by government entities. GITIC missed an interest payment in October 1998 and was officially declared bankrupt in January with a then estimated 38.77 billion yuan in liabilities against a mere 20.94 billion yuan in assets. Recently in October 1999 a creditor committee's report has indicated total liabilities are an estimated at 24.33 billion yuan and that 7.7 billion yuan of (or 36.7 percent) of booked assets are recoverable. However, actual recovery promises to be a long and difficult process and revisions are likely given the unclear cross claims throughout the corporate group.

Guangdong Enterprises Holdings (GDE) – the flagship conglomerate affiliated with the Guangdong government, Guangzhou International Trust and Investment Corporation (Gzitic), and several other firms and ITICs have also gone into default in the last year.

Systemic risk. While the Chinese financial sector has been able to absorb these corporate defaults, the risk lies in their ability to trigger a systemic shock throughout the system. Although, ITICs make up less than 5 percent of total financial assets in the Chinese economy, their lending activity represents the forefront of China's financial market innovation. Many ITICs were believed to have a crucial role in allocating capital to parts of the economy not covered by state banks and thus the breakdown of this financing system could prove very problematic and indicative of other problems to come.

There are two potential avenues for a systemic shock to transpire which have been ignored by the market: (1) the insurance sector and (2) the interbank market. The former is critically underfunded – the recent move to allow insurance companies to buy mutual funds is an attempt to allow these firms to diversify their balance sheets. The latter has developed a major asset-liability mismatch which looks very similar to the situation in Thailand prior to the crisis. Banks are funding long term fixed asset projects through short term interbank borrowings, there has been net loan creation in this market, and the potential for cross defaults in the market could be the institution that facilitates a systemic crisis.

While the lack of transparent financial reporting makes it hard to determine the domino effect of ITIC bankruptcies, the reported effect on the Bank of China can provide some indication and allow us to extrapolate the effects to an aggregate level. For example, in the first half of 1999 bad-loan provision for the Bank of China's local operations in Mainland China caused a 47% drop in pre-tax profit for the 1H99 according to company press releases. This was largely due to GDE and Mainland ITIC exposure, raising the question that given these are only the tip of the iceberg in terms of corporate insolvency "how many more event defaults can the system withhold"?

While the government can transfer major corporate and banking defaults into a fiscal burden – the government will reach a fiscal threshold when debt to GDP ratios become dangerously high over the medium term as all these bailouts add up.

Securitization. In an effort to recapitalize the state sector and draw funds into the banking sector, the China Securities Regulatory Commission has endorsed an

aggressive stock issuance plan. Plans have recently been made to extend the issuance of equity for banks beyond the current listing of Shenzhen Development Bank to other banking institutions. The success of this plan will rely on whether stock issuance corresponds to a change in the real ownership structures of banks versus simply providing a capital injection. Without the changes to corporate governance that should accompany share issuance, the effect will be marginalized. Plans of massive issuance have recently led to higher levels of stock market volatility giving some indication of the markets unwillingness to expand significantly at present without progress on reform. Some progress has been made in the issuance of corporate debt, with the successful debt issuance of China Telecom (Hong Kong) for US\$600 million marking the return of Chinese corporate debt issuance for the first time since the Asian crisis (priced at a spread of 190 bps over US treasuries and trading to a spread of around 175 bps). Ongoing securities issuance will be crucial for China to diversify the finance structure of its corporations and as a means to funnel in much needed capital.

Debt equity swaps are also being advocated throughout China, but again these face the same challenges as straight share issuance with regards to their effect on corporate governance. Furthermore, these swaps are being met with limited investors interest given the dire state of the existing corporate entities in bankruptcy. The granting of permission to Hainan International Trust and Investment Corp to merge operations with Hainan Provincial Trust and Investment Corp and Haikou Trust and Investment Corp with foreign creditors taking an equity position in the new venture is one example of such corporate restructurings and debt-equity swaps.

Market Regulations and Manipulation. While the reforms proposed in late 1998 by the China Securities Regulatory Commission to upgrade trading, reporting, and brokerage operators to a higher standard are clearly in the right direction – few to none of these reforms have been implemented. Market rumors of government manipulation of the stock market prior to the October 50th anniversary were rampant and insider trading appears to persist. The rise of institutional investor bases should help increase market scrutiny as more diverse private agents have vested interests in proper trading behavior.

The lack of a standardized government debt market and the forced issuance of special government bonds to state owned banks merely perpetrates triangle debt problems, although it does formally securitize bad loans which can be perceived as a first step. Manipulations of interest rate controls are still relied upon to make government debt attractive.

Foreign Banks. The mandate granting foreign banks the right to enter the local currency markets – albeit on a very limited scope – signifies a crucial reform step. Allowing foreign banks to enter the market - along with insurance companies and money managers – will both transfer much needed financial risk management skills to the domestic financial sector as well as provide much needed market signals through their pricing of various products. For example, in October 1999 Hong Kong Shanghai Banking Corporation secured 3 billion yuan in loans from state owned banks - thus

financing their lending activity in the yuan market. Prior to this, yuan liabilities were only obtained through short term borrowing on the interbank market.

Non Performing Loans. Finally, the securities markets will closely evaluate the ability of the various Asset Management Corporations (AMCs) to sell non-performing loans to non-state entities. On the one hand the creation of AMCs is a first step to structurally organizing and dispensing with the massive stock of accumulated bad loans in the state sector. On the other hand, the incredibly sloppy and ineffective handling of the GITIC, GDE, Gzitic, and other defaults and restructurings puts into question the ability of a national level initiative to sort out and restructure non performing loans.

If these AMCs rely on government directed/forced purchases of these assets and if the management in charge of these non-performing portfolios are not held accountable little is accomplished beyond another accounting scheme to reclassify bad debt -except perhaps by allowing the central bank to partially inflate away the problem through its funding of debt buybacks. The failure of AMCs would seriously impact China risk valuations.