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Challenges for China's financial reform

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Introduction

Since the onset of the financial crisis in East Asia in 1997, China has caught the attention of the world not only for its critical foreign exchange policy but also for the uncertainties surrounding its own future. China has so far averted a currency crisis and maintained relatively sound economic performance.¹ The frequently discussed contributing factors include inconvertible Chinese currency under the capital account, current account surpluses in most of the 1990s, the dominance of foreign direct investment and long term debt in total capital inflows, and world's second largest foreign exchange reserves (Song Ligang 1998; Lardy 1998).

The Chinese economy, however, is not totally immune from the crisis. Growth of both exports and foreign direct investment slowed significantly in 1998. Doubts have been cast on the effectiveness of the government's control over capital movement (Institute of Economics 1998). Already, about half of Hong Kong's currency, which is equivalent to one-fifth of China's circulated currency, is used in southern China. Similarly, in Hong Kong, more than 10 billion yuan Chinese currency are in circulation (CCER 1998).² It is argued that parallel use of foreign currency in a country, without tax, could produce similar outcomes as free flow of capital (McKinnon 1993).

Economists are often puzzled by the coexistence of excess domestic saving and massive capital inflows in China. In the 1990s, only the United States takes in more capital than China. Domestic saving was, on average, 5 per cent greater than domestic investment. The 'missing money' was partly wasted in the domestic financial system and partly moved out of the country through informal channels. By examining carefully the accounts for international transactions, Li Yang (1998) estimated China's total informal outflow of capital at \$US87.5 billion in the period 1992–96, which was about 43 per cent of the capital inflow during the same period.³ It was speculated that the large amount of informal capital outflow, given the official control of the capital account, was mainly driven by domestic financial repression and lack of confidence in the exchange rate policy, the banking sector and the legal system.

The absence of capital account convertibility reduces the possibility of large volume speculations on Chinese currency and hopefully removes one external trigger. If things go wrong in the domestic economy, however, the control could only delay but not stop capital flight. Risks in the domestic financial sector are greater. The Chinese economy shows a remarkable resemblance to those of Thailand, Indonesia, Korea and Malaysia before crisis, especially the 'asset bubbles', high reliance on banking intermediation and fragility of the financial system.

China's financial system has experienced significant change since reform began. To develop a modern financial system, new policies were introduced, first from 1983 and then from 1993, (1) to re-establish the People's Bank of China as the central bank responsible for the country's monetary policy; (2) to relinquish fund allocation responsibilities from the State Planning Commission and the Department of Finance to the banking sector; (3) to transform the state-owned specialised banks into commercial banks;⁴ (4) to set up three policy banks to take over policy-oriented loans;⁵ (5) to develop a whole range of other commercial banks and non-bank financial institutions; and (6) to nurture the growth of debt and equity markets.

The policy changes brought some new features to China's financial system. One is the high degree of monetarisation. Between 1978 and 1996, China's GDP growth averaged 9.7 per cent, the average inflation rate was 7.5 per cent and the annual growth rate of broad money (M2) was 25 per cent. The ratio of broad money to GNP increased from 0.32 in 1978 to 1.3 in 1997 as a result of the dramatic financial deepening (Yi Gang 1996).⁶

Another feature relates to the structure of China's financial assets. Deposits and loans of banks and financial institutions accounted for 93 per cent of the country's total financial assets in 1978. This proportion declined in the following years but was still 81 per cent in 1997.⁷ Of households' total financial assets, about 85 per cent was in the form of bank deposits in the 1990s. High concentration of financial assets often increases financial risk because of lack of both diversification and competition.

A final feature was that China's banks rely heavily on saving deposits of the households but lend almost exclusively to the state-owned enterprises. Households' share in total domestic saving increased from 24 per cent in 1979 to above 70 per cent in 1997. And the state-owned enterprises, while producing only one-third of the country's industrial output, take nearly 80 per cent of the bank loans. In essence, the state enterprises borrow money from the households, through the banks.

Financial vulnerabilities

China's financial system, especially its banking sector, suffers from serious vulnerabilities. First, the nonperforming loans have increased to alarming levels. In 1997, the proportion

of nonperforming loans was 24 per cent for the four state-owned commercial banks, including 6 per cent bad debts and 18 per cent overdue loans (Dai 1998; CCER 1998). It was more serious than that in pre-crisis Thailand (15 per cent), South Korea (16 per cent), Indonesia (12 per cent) and Malaysia (7 per cent). The total outstanding loans of the state commercial banks were 6,610 billion yuan in the mid-1997. This implied a total of 400 billion yuan bad debts in China's banking sector, which was greater than the banks' net assets, 317 billion yuan. The state-owned commercial banks are, therefore, technically insolvent. It must also be noted, however, that about 30 per cent of the banks' total deposits were held by government organisations (5 per cent) and enterprises (25 per cent), mainly state-owned enterprises. At the end of 1996, the non-bank financial institutions had total assets of 2,000 billion yuan, 50 per cent of which was estimated as non-performing assets (Li Xinxin 1998).

Second, all the state banks are significantly under-capitalised, which illustrates the banks' fragility in safe operation and dealing with asset losing. The average rate of capital replenishment for the four state-owned commercial banks was 4.4 per cent in 1996, lower than the 8 per cent that is required by China's 'Commercial Bank Law' (Table 1).

Third, banks are operated inefficiently. The annual circulation rate of bank loans was very low and fell consistently in the 1990s, from 1.32 in 1993 to 1.07 in 1996 for the four state-owned commercial banks in 1996 (Table 1). This was significantly lower than that was achieved in many Southeast Asian economies before the crisis (around 3). Total profits of the four state-owned commercial banks also dropped consistently, from 34.3 billion yuan in 1992 to 19.6 billion yuan in 1996. The average profit-to-net asset ratio was 5.6 per cent in 1996. This net profit rate could be turned to a net loss if the uncollected interest payments were not counted as revenues. In 1996, the four banks only collected about 60 per cent of the due interest payments.

Table 1 Performance of China's state-owned commercial banks, 1996

	Capital replenishment rate	Profit- net assets rate	Loan circulation rate
State Commercial Banks	4.37	5.55	1.07
Industrial and Commercial Bank	4.35	6.17	1.30
Agricultural Bank	3.49	1.44	1.30
Bank of China	4.84	10.29	1.01
Construction Bank	4.81	5.7	0.68

Source: Data compiled from PBOC, *Almanac of Finance and Banking in China*, various years; Li Xinxin, 1998. 'Looking at China's potential financial risks from the East Asian financial crisis: Analyses of the assets operation of the state-owned commercial banks', *Reform [Gauge]*, 3(March):31-9 and 86; RGCFSR, 1997. 'A tracking study of the Chinese financial system reform', *Reform [Gauge]*, 3: 64-75, and 4: 83-98.

And, finally, there is a rising trend in the gaps between bank deposits and loans. In 1995, the total gap was 291 billion yuan for all state commercial banks, this was increased to 744 billion yuan in 1996 and 810 billion yuan in the first half of 1998. It was argued that this might be (1) because of weakening economy and rising real interest rates (Li Xinxin 1998), (2) partly because of the reluctance to make lending on the bank side in the fear of rising bad debts (CCER 1998), or (3) because of tightening of monetary policy through credit control. A more fundamental cause, however, was the likely inefficiency of the banking sector. Between 1992 and 1996, there were two years, 1994 and 1995, when domestic financial sector's increased debt was greater than its increased assets (in shortage of funds) (Table 2). New deposits were thus wasted either to support those nonperforming loans that would never be repaid or to cover the increasing costs of bank operation. Such a banking system is not sustainable.

Table 2 **Net financial positions**

	1992	1993	1994	1995	1996
Domestic financial system	10.92	34.95	-10.52	-20.17	219.60
Domestic non-financial sector	24.39	-100.77	76.73	33.85	-158.41
Households	494.11	524.21	763.48	893.99	1123.49
Non-financial firms	-404.25	-602.24	-681.83	-851.30	-1241.52
Government	-65.47	-27.73	-4.93	-8.85	-40.38

Source: Li Yang, 'Capital flows of the Chinese economy in the process of opening up', *Economic Research Journal [Jingji Yanjiu]*, 2(February 1998): 14-24.

In 1995, the state banks were graded as E by Moody, the lowest grading, because of their incompatible practices with the international convention and their high proportion of nonperforming loans.

The causes

The creation and development of these financial problems in China were closely associated with an evolving triangular relationship between public finance, the banking sector and the state-owned enterprises during the reform period. In the pre-reform period, fund allocation was almost exclusively handled by the state plans. The People's Bank of China, a subordinate body of the Department of Finance at that time, was only auxiliary in providing supplementary working capital to the state-owned enterprises. Reforms introduced attempted to distinguish budget and banking financing of investment in a bid to improve the efficiency of capital utilisation (Qian 1994). While the policy-oriented items would continue to be covered by government funding, other capital requirements, including that by the state-owned enterprises, would be met through the banking sector on a commercial basis.⁸ In 1978, only 24 per cent of the total provision of funds (for both fixed assets and working capital) was supplied through the state banking sector. This proportion rose to 88 per cent in 1997. These changes, are yet to achieve their final goals but have contributed directly to the weakening of the financial system. First, even though the reform policies introduced intended to establish a truly independent central bank and purely commercial state-owned banks, this has never been achieved. Since the branch managers of the state-owned commercial banks are appointed by the local governments, banks' lending decisions can hardly avoid administrative intervention.

At the same time, the government's fiscal capacity declined relatively during the reform period. The share of budget revenues in GDP fell from 31.2 per cent in 1978 to 22.4 per cent in 1985 and 10.8 per cent in 1996. The government thus frequently sought resources from the state-owned commercial banks to support the projects and activities that

otherwise should be covered by the state budget. This was often described in China as the implicit transfer of budget deficits. The main categories of policy-oriented lending include (1) loans for investment in fixed assets of basic industry and infrastructure; (2) loans for working capital for purchase of agricultural products and import/export activities; and (3) loans for agricultural production, poverty alleviation, regional development and research and development activities (Institute of Economics 1998). Even after the creation of three policy banks in 1994, the state-owned commercial banks continued to be burdened with policy loans. In the 1990s, these policy-oriented loans accounted for about 35 per cent of total loans made by the state banks (Table 3). The repayment rates of the policy loans were often extremely low due to poor management and purposeful abuse. If losses of policy loans were counted, China's budget deficit would be about 9 per cent of GDP, instead of the 2 per cent that is officially reported.

Second, the 'loan for grant' reform implied that state-owned enterprises rely heavily on bank loans for capital inputs, as 90 per cent of enterprise borrowings were from the state banks (Li Xinxin 1998). In fact, many new state-owned enterprises were built using exclusively bank loans.⁹ The debt-to-equity ratio rose quickly from 19 per cent in 1980 to 79 per cent in 1994. This caused great difficulties for enterprise operation. In 1997, for instance, the total real interest income from the bank loans was 361.4 billion yuan, about eight times the total profits of the state-owned industrial enterprises. Financial performance of the state sector worsened during the reform period. In 1996, about half of the state-owned enterprises became money-losers and the state sector as a whole made a net loss of 38 billion yuan.

Table 3 **Policy loans in China**

Policy loans	1991	1992	1993	1994	1995	1996
Investment in fixed asset	1906.5	1959.0	2735.9	3896.0	5382.1	6631.2
Purchase of agricultural products	1874.2	1857.4	2272.1	3144.5	3589.7	3695.6
Purchase of products for export	1791.5	2145.8	2594.4	2890.6	3266.3	3745.5
State bank agricultural loans	1209.5	1448.7	1720.2	1554.1	1921.6	2367.8
Policy loans total	6781.7	7410.9	9322.6	11485.2	14159.7	16440.1
Total loans by state banks	18044.1	21615.5	26461.1	32441.3	39393.6	47434.7
Proportion of policy loans (%)	37.6	34.3	35.2	35.4	35.9	34.7

Source: Chinese Institute of Economics, 1998. 'Aggregate trend, financial risk and external shocks: Analyses of the current Chinese macroeconomic situation', *Economic Research Journal [Jingji Yanjiu]*, 3(March):3-14.

On the part of the enterprises, reforms were not yet successful in eliminating the 'soft-budget' problems. Managers and employees of the state-owned enterprises not only lacked

incentive to run the firms efficiently but also have felt no pressure to repay the bank loans as 'both banks and enterprises are owned by the state'. The state banks became the victims of this money-losing behaviour. The government, on the other hand, does not want to see closure of state-owned enterprises for stability reasons. The banks, therefore, not only failed to recover the old loans but were also forced to extend new loans. This created a moral hazard problem and further weakened the state banking sector.

Third, the state-owned banks have exactly the same institutional problems as the state-owned enterprises. Property rights are vaguely defined and monitoring of the bank operation by the state was poor, which is further complicated by policy loans. Bank managers and employees do not take long-term interest in bank development. Undoubtedly, state banks are one of the most corrupted economic sectors in China. Chinese banks are also slow in adapting to international bank practices. There was no proper risk management process in lending decisions and there was no competition from other major financial institutions.

Policy responses

From late 1993, further measures were taken to ensure that People's Bank of China becomes a real central bank whose objective is to 'maintain stability of currency so as to promote economic growth'.¹⁰ Lending from the People's Bank of China to the budget and non-financial institutions was suspended after 1993 (Song Ligang 1998). The dual-track foreign exchange rates were unified in 1994. Conditional convertibility was realised under the current account and a unified national foreign exchange market was also established. In order to facilitate state-owned commercial banks becoming purely commercial banks, organisational restructuring was introduced to the banks and three new policy banks were created to take over policy-oriented transactions (RGCFSR 1997).

After the East Asian financial crisis began in 1997, the risks of delaying major reforms were seen more clearly. In early 1998, Premier Zhu Ronji announced an ambitious reform program, including completion of reforms of the banks and the state-owned enterprises within three years. Small and medium enterprises are to be liberalised through bankruptcy, leasing, selling, merging and share-holding, the government will focus on restructuring and efficiency improvement of only 1000 large enterprises in key industries.

In the banking sector, first, commercial banks are required to run transactions on purely commercial basis. Regional headquarters of the People's Bank of China are to be established replacing the provincial branches to ensure minimum disturbance from local officials. At the same time, the central bank also tightened supervision and regulation of banks and other financial institutions (Lardy 1998). A number of financial institutions were closed, including the Hainan Development Bank and Venturetech, for their insolvency and illegal transactions.

Second, controls over credit quotas are to be abolished. Total loans of commercial banks are determined according to an asset-to-liability ratio management system. But the guidance credit quota will remain in place. Commercial banks will also be given more room in setting their own interest rates. The financial authorities are set to achieve the objective of 'commercialization of banks and marketization of interest rate' (Lin Yifu 1998).

Third, the central bank has lowered the interest rates on the central bank loans six times since the early 1996. This gave the state-owned enterprises a total annual saving on interest payment of 190 billion yuan.

Fourth, measures were taken to improve the financial position of the state banks. The government plans to raise 270 billion yuan through issuance of treasury bonds to increase the capital replenishment rate to 8 per cent for state commercial banks before the end of 1998.

Fifth, the central government also committed substantial funds to finance write-offs of enterprises' bad debts. The amount of funds was increased from 20 billion yuan in 1996 to 30 billion yuan in 1997 and 40 billion yuan 1998. It is expected to rise further in 1999 and 2000. This will hopefully reduce the size of nonperforming loans held by the state banks.

And, six, international practices have been introduced to the banking sector, including the accounting method and bank assessment system. A new scheme for classifying five types of nonperforming loans, which is consistent with the international standards, is expected to be in place at the end of 1998.

Key to success

The current financial crisis in East Asia not only demonstrates the urgency for change but also brings further difficulties to financial reforms in China. The Chinese economy is losing growth momentum both because of external shock from neighbouring countries and from internal austerity programs introduced in the earlier years (CCER 1998; Song 1998). To maintain a relatively high growth rate, the government seeks stimulation from fiscal and monetary measures through dramatic increases in investment. This encourages the overruling of commercial considerations by administrative instructions, in order to lift the growth rate of GDP and exports, and thus undermines the reform efforts in the financial sector. If economic growth slides, the triangular debts between state-owned enterprises, and thus nonperforming loans of the banks, would accumulate quickly. An economy with slow growth also has limited ability to offer new jobs. This creates further difficulties for restructuring both the enterprises and the bureaucratic system.

Given all the vulnerabilities and weakness of China's financial and banking system, what has kept it going? Apart from the favourable macroeconomic conditions and continued rapid GDP growth, the main engine keeping the inefficient banks running is the ever growing household deposits. Between 1990 and 1996, household deposits grew at 33 per cent per annum. This unusual growth was made possible by three factors. First, the Chinese economy experienced extraordinary growth during the reform period and Chinese people saved a very high proportion of their income (nearly 40 per cent). Second, as the markets for equity and debts are underdeveloped, bank deposit was the only major option left for households. And, third, the ordinary Chinese are still relatively confident about the safety of the state banks. This last point was also reflected in the lack of a risk assessment process in household banking behaviour.

The growth of household deposits has already started to slow down (only about 20 per cent in 1997), and this trend is likely to continue. China's GDP growth and thus household income growth will fall somewhat given the adverse external shock. Observing the closure of banks and other financial institutions and introduction of non-state banks, the public may increasingly recognise the importance of risk assessment. The markets for equity and debt will develop rapidly in China and more options will be available for savings and investment.

The Chinese financial system will not collapse for the time being. If the current high proportion of nonperforming loans, low circulation rate and high deposit-loan gap remain, a significant slow down in growth of the deposits may well trigger a domestic financial crisis. To avert such a crisis, financial reform needs to be pushed forward more briskly. The eventual successfulness of China's financial reform depends on masterful address of three questions: (1) how to improve the financial institutions financial position? (2) how to stop the creation of new inefficiency? (3) how to transform the state-owned banks into independent commercial banks?

The outcome of the financial reforms will, therefore, be largely dependent on changes in other sectors, especially reform of the state-owned enterprises and the public finance system. Otherwise non-performing loans will not stop accumulating. Nonperforming loans should be transferred or written off in a proper way to avoid the 'moral hazard' problem. Further development of non-bank financial institutions, especially markets for debt and equity, is not only useful for diversifying financial risks but also helpful in offering competition to the inefficient state banking sector.

The property right issue of the state banks also needs to be examined carefully. It is doubtful if the government or the central bank is able to provide sufficient funds to the commercial banks in the face of slowing deposit growth. Printing new money is not only no longer easy but can also bring unbearably high inflation. The state budget is even more difficult. The central government has failed to lift the relative strength of the budget revenues since the beginning of the 1990s. More importantly, as the policy banks are set up, the need for solely state-owned commercial banks can be questioned.

Endnotes

¹ The GDP growth rate in 1998 and the following years may be lower than that was achieved in the previous years, but it will still be at relatively high levels according to international standard (Song Ligang 1998).

² In this paper, yuan is the unit of the Chinese currency while \$ refers to the United States dollar.

³ Li Yang (1998) applied the following formula in estimation: total capital outflow = international capital transaction + errors and invisibles + others - international reserve assets - reserve currency. This is a slightly modified version of the method used by the World Bank and the IMF.

⁴ The four large state-owned commercial banks include the Industrial and Commercial Bank of China, the Bank of China, the Construction Bank of China and the Agricultural Bank of China. Bonin (1998)

pointed that these banks are not commercial banks in strict sense as they do not have universal licenses. They can take deposits and make loans, but are barred from making direct investment. Later, a number of share-holding commercial banks were also set up, such as the CITIC Bank, Everbright Bank, Bank of Communication and the non-state Minsheng Bank.

⁵ The three policy banks are the State Development Bank of China, the Agricultural Development Bank of China and the Import and Export Bank of China. These banks extend loans following the policy guidelines of the government. They raise fund through loans from the central bank and issuance of financial bond but do not directly take deposit.

⁶ China *M2/GNP* ratio in 1997 was higher than most other countries of the world, including Indonesia (0.46), Britain (1.04), Japan (1.14), Singapore (0.89) and USA (0.59).

⁷ The dominance of banking financial assets is also revealed by the declining ratio of narrow to broad money. The faster increase of (*M2-M1*), 34 per cent per annum between 1978 and 1997, suggests that households' financial assets take the main form of term deposits.

⁸ This was implemented through the 'loan for grant' reform in 1983 and 1984.

⁹ Questions were raised, when the property rights of these firms were to be reformed in the 1990, whether these enterprises were really state-owned since the state did not invest a cent in them except to help them to obtain loans from the state-owned banks.

¹⁰ In December 1993, the government issued "The Decree on Financial System Reform by the State Council" which outlined a blueprint of reform. In 1995, the National People's Congress officially passed 'The People's Bank of China Law' and 'The Commercial Bank Law of China' (RGCF SR 1997).

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