

China's Banking Reform: A Single Step in A Thousand-mile Journey

Joanne Li^a and Jot Yau^b

^a *Sellinger School of Business and Management, Loyola College in Maryland*

^b *Alberts School of Business and Economics, Seattle University*

ABSTRACT

We present an analytical framework to comprehend the ramifications of recent banking, state-owned banks (SOBs) as well as state-owned enterprises (SOEs) reforms. We update, review and discuss the most recent banking reform efforts of China within the framework presented for the period from 1998 to August 2000. We then discuss the continued challenges of the efforts given current economic and political conditions surrounding China. Specifically, we argue the major challenge to China's banking reform is to maintain a balance between the sustainability of continued growth of the economy and the opening up the economy to the world. Economic reforms in China are unfinished until free market mechanisms truly pervade in all businesses including both banking and non-banking sectors, even though the non-performing loan problems in the SOBs are resolved and the balance sheets of SOEs are cleaned up.

JEL: G28, P21, O53

Keywords: Chinese banking reforms; State-owned enterprises; Chinese economy

I. INTRODUCTION

With the transformation from a central-planned economy into a market-based economy mandated by Deng Xiaoping in 1978, China has since grown into a major economic power in the world. China has then further confirmed its reputation as a major “economic power player” among the G7 countries after it had steered its economy tactfully through the turbulent 1997 Asian currency crisis and played an instrumental role in stabilizing the neighboring economies. The phenomenal economic growth and recognition as a world economic leader, however, do not come without a price. Voluminous research has surfaced to explain how China managed to become an economic miracle, while many other emerging markets failed miserably. The early research focuses on the management and operational aspects of different types of enterprises that thrived under the market-based economy. Accolades seemed stop coming when state-owned enterprises (SOEs) started to show financial weakness. When non-performing loans (NPLs) kept piling up at the state-owned banks (SOBs) and posed serious threat to the financial system, the government started a series of reforms on both SOEs and SOBs to curb the deterioration of their financial conditions. After the Asian currency crisis and the resulting turmoil in the financial sectors of the East Asian countries, these problems are under close scrutiny by the Chinese government as well as international banks and investors.

This paper presents an analytical framework to comprehend the ramifications of recent banking as well as SOEs reforms. We also update, review and discuss the most recent banking reform efforts of China within the framework presented for the period from 1998 to August 2000. Furthermore, we discuss the continued challenges of the efforts given current economic and political conditions surrounding China. Previous research suggests that major challenges to banking reform include SOEs reforms, NPLs workout, recapitalization of banks, fiscal sustainability of bank reform program, and corporate governance. We believe, however, the major challenge to China’s banking reform is to maintain a balance between the sustainability of continued growth of the economy and the opening up the economy to the world. Economic reforms in China are unfinished until free market mechanisms truly pervade in all businesses including both banking and non-banking sectors, even though the NPLs problems are resolved and the balance sheets of the SOEs are cleaned up.

First, we present an analytical framework in the next section, which helps us understand the origin and nature of the problems associated with the SOEs and the banking sector. This section also puts the nexus of the problems in perspective in the grand scheme of China’s transformation into a market-based economy since 1978.

We then briefly review the NPLs problem and those measures that have taken in the capital markets to deal with it. An update of the most recent banking reform measures (1998 to August 2000) is also provided.

Thereafter, we discuss some of the major challenges to recent banking reform measures. In this section, we discuss the impact of China's entry into the World Trade Organization (WTO) on its banking reform effort.

We believe all wholehearted efforts that China has been embarking on diligently make gradual improvement over the problems that it faces. And the key to China's economic reform success lies with a strong monetary system. Unfortunately, China has not done much about its monetary system, specifically the opening up of the capital accounts and full convertibility of RMB. Until then, success on banking reforms is limited. Given the importance of the Chinese economy in the world economy and particularly to the neighboring countries in Asia, accelerating the process towards full convertibility of RMB is a decision worthy of consideration but should be made cautiously without haste. Nevertheless, we look forward to seeing China make that great leap towards a free economy. Just as optimistic as the Chinese saying "A thousand-mile journey starts with a single step," piecemeal reforms mark a good beginning.

II. ANALYTICAL FRAMEWORK

In order to understand the ramifications of the current problems facing SOEs and SOBs, we must realize that the root of the problem stems from the entangled bureaucratic relationships among various government agencies and officials under the centrally planned economy in credit and lending allocation. Provincial governments used to maintain authority over bank personnel with their localities. Hence, governments directly and indirectly influenced the decision pertaining to lending and credit allocation. This obvious conflict of interest led to a common practice of SOBs lending generously to support ambitious projects of local governments and SOEs, regardless of the commercial consideration of profitability and prospect of getting the loans back. This also lends to explain why many SOEs had been unprofitable for many years but they could still keep producing. Xu (1998), using the housing sector, illustrates that the structural breakdown in the credit/investment allocation in the system that led to the problem of coexisting unsatisfied demand and excess supply. They borrowed from the SOBs that were asked to dole out "policy loans". These policy loans kept not only SOEs from closing down, but also thousands of workers on the payroll. This bureaucratic practice, unfortunately, also led to inefficiency in the system and overproduction in the manufacturing sector, pushing prices down to almost nothing. Moreover, interest rates charged on these policy loans were often below market's prevailing rates, further worsening the insolvency of SOBs.

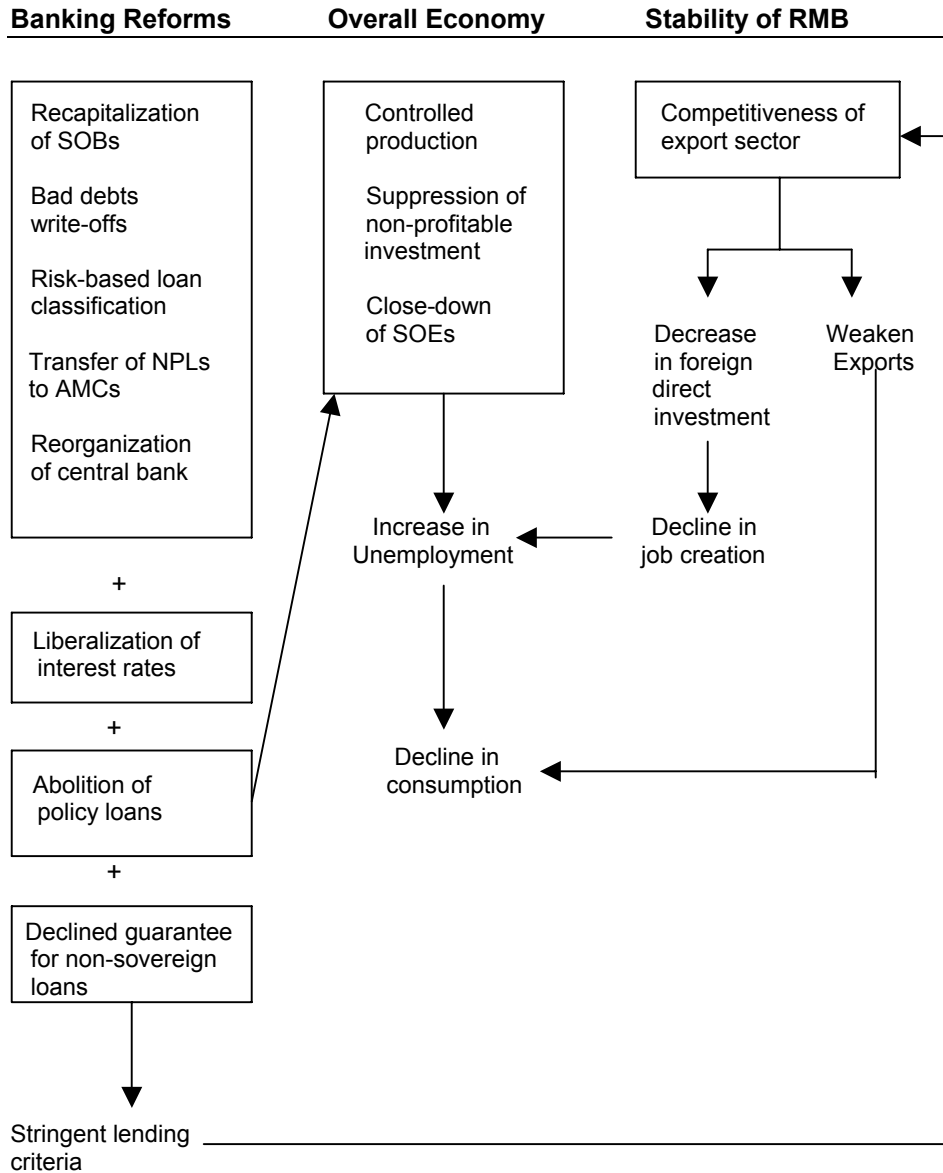
Thus, the dilemma facing the central government right now is that if policy loans are discontinued, massive layoffs and furloughs are expected. Thus, to avoid massive unemployment and possible social unrest, government

continues to lend, policy loans continue to grow, and NPLs continue to increase. The conventional view contends that it is the inefficiency of the SOEs that has created the NPLs problem at the SOBs. For instance, Li and Zhu (1999) argue that SOEs do not cause bad loan problems in the banking sector. It is the lack of autonomy and incentives for banks to make sound lending decisions. They believe that if SOEs cannot get easy loans, they will either have to strive for efficiency in order to survive or simply go bankrupt. Thus, the inefficiency of China's financial system has sustained the SOE's chronic losses.

We concur with Li and Zhu (1999) from a theoretical perspective based on the economics of the free market. However, from a practical perspective, the underlying cause of the NPLs problem is not as important as to how to fix the inefficiency problem of the SOEs and SOBs, which needs to be solved simultaneously. With both the SOEs and SOBs in financial distress, the government chose to proceed with the SOEs reforms first. It is plausible that SOEs reforms have taken priority because their shutting down will lead to increase in unemployment, slowing down consumption, and sluggish growth in the economy.

Previous research has, therefore, focused first on SOEs and then the banking sector, especially SOBs. Almost all researchers believe the problems concerning the two sectors are unequivocally related. Ironically, reforms aimed at solving the looming problem of NPLs also are the causes of fragility in the Chinese banking sector. As efficient financial intermediation is a prerequisite for economic efficiency for the whole country, the solvency and financial health of the banking sector hold the key to the success of the economic reform, which started two decades ago. Mo (1999) points out that bank restructuring without deflation is a challenge to bank reforms. As seen in Asia, Japan and elsewhere, high-level NPLs invariably hold back economic growth and when bank-restructuring proceeds, lending behavior turns cautious and losses get recognized and absorbed. Bank restructuring at a time when growth is slowing down is even more deflationary. Therefore, it is highly plausible that if Chinese banks ease the lending criteria to finance investment projects so as to sustain growth, banking reform would suffer a major setback.

Figure 1
 Triangular relationship among the banking reforms, the stability of RMB, and the overall economy



Despite extensive efforts have been done to explicate the existing economic problems facing China, little or none has been offered to explain the triangular relationship among the banking reforms, the stability of RMB, and the economy as a whole. We provide Figure 1 to illustrate this relationship. This figure shows that the three aspects that affect the economic growth of China interact contemporaneously and dynamically. The interrelationship and interdependence of the two major reforms and the stability of RMB suggest that reform success in any aspect hinges on the success in the other two aspects. Therefore, solving one without tackling the others simultaneously will only lead to inevitable failure sooner or later. In this section, we expound and emphasize the importance of the stability of RMB in the context of stabilizing the overall economy while gradually supporting the banking reform.

The ultimate goal of China's economic reform is to maximize the economic growth that can be attainable under the market-based economy. As such, the first attempt of economic reforms is the SOE reform under which SOEs are encouraged to operate and compete under a free-market environment. However, SOEs fail miserably to make profits and worse yet, the operating losses are so huge that SOBs have to finance their losses with "policy loans." As the NPLs of SOBs increase, it becomes more and more difficult for the government to shut down SOEs and SOBs because their ramifications on unemployment can have significant socio-political impact on the nation. As we indicate in Figure 1, the recent policy changes (i.e., abolition of policy loans, liberalization of interest rates, and declined guarantee for non-sovereign loans) in addition to other reform measures (recapitalization of SOBs, bad debt write-offs, risk-based loan classification system, transfer of NPLs to AMCs, and reorganization of the central bank) can lead to higher unemployment, and lower consumption and economic growth.

In section III, we argue that a permanent solution to the SOBs' NPLs problem is possible only if the SOEs can be made viable so that new policy loans are no longer necessary. Otherwise, the NPLs will emerge as a recurring problem. Reforms of the SOEs are, thus, essential to the long-term success of the banking reforms. It can be seen in Figure 1 that the ultimate goal of a growing Chinese economy is to reduce the reliance on the SOEs. A growing GDP and a robust non-state-owned sector facilitate the reforms of the SOEs, and consequently resolving the NPLs problem of SOBs. This is why China is concerned about the GDP growth; without the growth in the GDP, growth in the private sector will not be sustainable.

Absent from most prior research are the analysis and discussion of the importance of the stability of RMB to the banking and SOEs reforms and the overall economy. As indicated in Figure 1, a stable RMB is favorable in attracting foreign direct investment and promote exports. An unstable RMB, on the contrary, will decrease foreign direct investment and weaken exports, which in turn will cause unemployment to increase and consumption to reduce. Hence, the stability of RMB has been the top priority of the government in its macroeconomic policy. Indirectly, there is also a ripple effect on the

competitiveness of the export sector resulting from various bank reform measures. Under more stringent borrowing requirements, SOEs as well as smaller private enterprises will find bank financing more costly, hence losing competitiveness in export prices. For these reasons, China has not opened up its capital accounts and allowed full convertibility of RMB. The agenda for a complete free-market economy is scheduled to progress gradually under a 5-year plan. The plan of having a stable RMB without any adverse effect on the economic growth represents a major challenge to the economic reforms.

To sum up, this intricate, triangular relationship explains the reluctance on the part of the central government to (1) close down all non-viable SOEs; (2) shut down all ailing SOBs; and more importantly, (3) allow full convertibility of RMB. This also makes it clear why the government did not try to fix up the SOEs and SOBs at the same time while allowing full convertibility of RMB. Instead, it has been taking a gradual approach to reforms. Arguably, we may say that the stability of RMB is the last bastion of saving all reforms efforts that have been launched thus far.

We discuss in the next section that Chinese banks are not prepared to do their job well in a market-based environment after years of operation under the central-planned economy. Ever-increasing NPLs become the major concern of the central government since 1993. Based on the extant research on Chinese banking sector, we focus on the bank reform measures initiated after 1998 and discuss their implications on the country economy.

III. RECENT EFFORTS OF BANKING REFORM

Banks play several functions in an economy. Besides being a payment and settlement system, the banking sector also performs a financial intermediation function. In the U.S., the latter function of financial intermediation of banks has become less important as non-bank financial institutions started to encroach the nearly monopolistic position under the protection of the 1933 Glass-Steagall Act. Not surprisingly, because of the advent of telecommunication technology and globalization of financial markets, the roles of the banking sector in a developing market economy like China have also changed. A recent *Business Week* (2/14/2000) article attests to the rapidly changing scene of the Chinese banking sector. Specifically, banks are again being ushered into changing economic scenes and are expected to perform well in the changing environment, despite how ill prepared they are. This is the crux of the problems facing the Chinese banks. The first time that banks failed to answer the call for duty is when they were asked to clean up the bad loans problem not too long ago. This is the primary reason for the banking sector reforms.

A. Non-performing Loans of the SOBs

As mentioned in section II, the origin of NPLs is deeply embedded in the bureaucracy of a central-planned economy. Since the majority of the policy loans is made to SOEs for making up the operating losses, operating inefficiency of the SOEs is then transferred to the SOBs. This risk-shifting phenomenon is well documented in the literature.

Putting NPLs of the SOBs in perspective, we summarize their uniqueness:

1. NPLs are almost exclusively owed by state-owned enterprises to the SOBs. This is because until very recently, only SOEs had access to credit from the formal banking sector in China. According to Moody's (2000), at year-end 1999, about 89% of all bank loans went to state companies, while only 11% or so were lent to the non-state sector, comprising township and village enterprises (7%), foreign-invested companies (3%), and private companies (1%).
2. As pointed by Lau (1999), and for those who are familiar with the Chinese business practices, the NPLs are lent out as "policy loans", meaning that the loans are made because of the policy that keeps SOEs alive in order to avoid social unrest and massive unemployment. In fact, policy loans are made and not expected to be paid back. As long as this policy exists, NPLs is a recurrent (or flow) problem.
3. The interest rates charged on the policy loans are not market rates, but still SOEs are not able to service them.
4. Some of the loans lent by SOBs went to finance the real property bubble and excess capacity across a broad range of industries.

The amount of bad loans in the Chinese banking system is widely cited to be 20-25% of the total loans, although no official data is released for confidence reasons. According to Fitch IBCA (1998a), the total is made up of bad loans to SOEs, which accounts for 10-15%, and the property bubble of the early 1990s for another 10%, giving a total of 20-25%. *Business Week* estimates that the total amount is about US\$250 billion, which is 25% of all outstanding loans. Bonin and Huang (2000) estimate of the proportion of the NPLs is at least 30%, which is on the high side as compared to other estimates. They figure that the costs of completely restructuring the banking sector are about 20% of the GDP. Lau (1999) and Mo (1999) estimates are lower than the more recent estimates.

Not only the banking sector but also the non-bank financial institutions, including trust and investment companies, credit cooperatives, finance companies, and leasing companies, lose money. The total amount of bad loans in the non-bank financial institutions is also large. In this paper, we focus on the NPLs of the SOBs.

B. Banking Reform Measures

As soon as the NPLs problem became apparent, the government responded with a series of bank reforms. Measures initiated since 1998 to deal with the NPLs and improve the soundness of the Chinese financial system are summarized below.

1. Recapitalizing the four state-owned banks starting with RMB 270 million (US\$32.5 billion) in August 1998.
2. Requiring banks to adopt a risk-based system of classifying bank loans. The NPLs loans are classified into four categories in accordance with international standards if loans are overdue for three months: special mention, substandard, doubtful, and loss. Implementing a risk-based loan classification system to replace the one based on the overdue period is an advance in capital risk management.
3. Requiring banks make loans on a commercial basis as stipulated in the Commercial Bank Law passed in May 1995, which requires the SOBs to assume exclusive financial responsibility. Also, effective from January 1, 1998, the People's Bank of China (the central bank) replaced the credit plan system (which used to allocate credit for working capital loans and fixed investment loans to loss-making SOEs) with an indicative, non-binding target as a reference for commercial banks to plan their business.
Lardy (2000), however, is not so optimistic about the development of a commercial credit culture. He uses some institutional and empirical evidence to suggest that it is still at an early stage. For one, the continued rapid growth of lending relative to gross domestic output, suggests that a commercial credit culture has yet to emerge. For another, allocation of a disproportionately large share of loans to state and collectively-owned companies continued. This pattern of lending is also true to non-bank financial institutions.
4. Reorganizing the central bank and thus banning local governments from influencing the lending decisions of the banks.

China has adopted a regional bank supervision system similar to the Federal Reserve system of the U.S. Nine regional banks are combined from the 31 provincial offices of the PBC to oversee several provinces. Presidents of the regional branches of the People's Bank of China now outrank provincial governors and first party secretaries and should be more able to rebuff requests for political loans that are directed to banks that they supervise.

5. Transferring the NPLs of the four large SOBs to the four newly established asset management companies (AMCs) – Cinda, Huarong, Changchong, and Dongfang.

AMCs were established to deal with the NPLs of the four SOBs, financed by issuing government backed bonds. They purchased NPLs at face value from the banks in exchange for equity positions in the borrowing firms. The primary objective of the AMCs is to recover as much as possible through a combination of liquidation, auction, securitization, sale of equity, mergers and acquisitions, and private placements of the assets they acquire. Thus, AMCs operate more like asset holding companies, loan workout agencies and as much as venture capitalists.

Lardy (1998b) believes that the AMCs can only recover more through sale of equity via initial public offerings (IPOs) rather than relying on auction and liquidation, as in the case of the Resolution Trust Company in the U.S. He attributes the difficulty in liquidation to the antiquated bankruptcy laws in China under which recovery of loans through auction is usually low, around 10 to 15 percent. As such, AMCs would recover very little and thus it is expected that they would most likely take other alternatives instead.

More interestingly, Lardy (2000) suggests that the lack of corporate governance in corporate China may also lead to the above conclusion that relatively low rates of recovery on the investment by AMCs is expected. He cites the case of Cinda in which the AMC, after becoming the majority owners of the borrowing firms, could hardly exercise its rights. The lack of corporate governance and such a concept in China is now a major area of concern for international investors whose investments are highly sought after by China. In section IV, we update and review the recent research findings regarding corporate governance in China and discuss what should be done to instill such culture in China. The implication of the lack of corporate governance is a lower stock price for these firms when they are listed on a stock exchange.

Lardy (2000) also recognizes that the stage of development of the capital markets in China can significantly affect the outcome of the NPLs workout scheme. For instance, the absence of large institutional investors, such as pension funds, mutual funds and insurance companies in the U.S. that could invest in equities on behalf of millions of households and policy holders, could lead to a low recovery rate by either securitization of the loans or IPOs. Likewise, the lack of efficient secondary markets for the NPLs makes securitization of NPLs difficult. Hence, Bonin and Huang (2000) believe that deep discount on NPLs in the secondary markets will lead to low recovery. Furthermore, there is a shortage of skilled personnel who have experience in all these capital market activities, e.g., loan recovery, venture capital activities, and investment banking.

The recently announced merger of the two stock exchanges, the Shanghai and Shenzhen, is another step toward a more efficient market. It is hoped that the combined stock market will reduce trading costs, improve market oversight (all trading will be regulated by one agency – the China Securities Regulatory Commission), and most importantly, allow hundreds of cash-strapped state enterprises to raise money in preparation for China's entry into the WTO. The size of the combined market has over 1,000 class-A stocks listed, with a total capitalization of more than US\$500 billion, already rank among Asia's largest. In addition, class-B shares traded have a capitalization of about 5% of that of class-A shares. Once the exchanges are merged, there is a plan to launch a NASDAQ-style market for high-tech companies and other start-ups, including both state-owned and private firms.

On the debt financing side, the undeveloped domestic government bond market does not help much in solving the NPLs problem. The market is huge given the size of the country's economy, with over RMB 1 trillion (US\$120 billion) of outstanding issues at the end of 1999 (Table 1). There will be a steady flow of new issues sold in 2000 as the government maintains its policy of infrastructure spending. Moreover, as the interest rates remain low and corporate credits remain weak, the banks will have little alternative but to buy the government and policy bank bonds. Corporate issuance is not expected to increase in a major way relative to the government market.

Lardy (2000) estimates that the present bond market is too small to absorb all the costs involved which he puts it as about 30% or more of GDP, or twice as much as the current treasury debt issued to date, in the debt-equity swaps of the AMCs as well as patching up the balance sheets of non-bank financial institutions. He also questions whether the depth and liquidity of the bond market would be adequate to facilitate the issuance of bonds that are necessary to finance the recapitalization of the financial system.

China's bond market cannot be evaluated in the same fashion as in other developed markets in terms of depth since most bonds are bought and held to maturity by banks. Depth and liquidity are important for markets where investors do not hold bonds for long-term purposes. As long as foreigners are not permitted to participate in the bond markets, these issues are not pressing. It is interesting to note that trading in the secondary bond market was even less in 1999 when demand for long-term bond holdings was great because of low interest rates and few credit alternatives available for bank investments. However, as Lardy (2000) points out, a highly liquid secondary market is a necessary condition prior to attracting investors who would invest in the new issuances of bonds for recapitalizing the SOBs. Thus, further development in the debt market is necessary to attract foreign investors.

More importantly, the opening up of the capital accounts and full convertibility of RMB are prerequisites for attracting foreign investments.

Table 1
Maturity of instruments outstanding (RMB billion)

		1Yr	2Yr	3Yr	4Yr	5Yr	6-10yr	10Yr+	Total
Government	1999	155.29	171.48	83.27	128.67	30	249.35	96	914.06
	1998	114.45	115.29	155.48	28.27	128.67	89.95	100	772.11
Corporates	1999	3.20	7.70	4.78	3.50	3.18	3.85	2.40	28.61
	1998		3.20	1.50	7.70	3.50			15.90

Source: *Guide to Asian Currency Bond Markets 2000*, Finance Asia, March 2000

6. Letting non-bank financial institutions such as the Guangdong International Trust and Investment Company (GITIC), the Guangzhou International Trust and Investment Company (GZITIC) and Guangdong Enterprises to bankrupt in October 1998. This unexpected change of government stance towards non-sovereign loans conveys a clear message to the market that the government is not responsible for all the foreign debt, only those registered with the approved authorities, and thus lenders beware. This helps reduce the moral hazard problem in the future.

7. Liberalizing interest rate regime

The latest banking reform measure is the uplift of controls on foreign currency lending and some deposit rates in September 2000, a major step toward liberalizing its rigid interest rate regime (see Table 2). However, this is not expected to have much impact on the banking business, deposits and the economy. But, it is a small step toward a liberalization of China's currency regime.

Lastly, according to *Business Week*, several measures, inter alia, are under consideration by China:

- a) Let more banks to list on exchanges, such as Shanghai Pudong Development Bank in November 1999 in the Shanghai Stock Exchange;
- b) Raise foreign banks' tax rates to bring them more in line with local banks (foreign banks pay half of the 33% profit taxes paid by local banks); and
- c) Lend more to profitable, private sector companies.

Table 2
The latest update on the banking reform

1. Transfer of NPLs is nearly completed.

As of end-August, a total of about RMB 1.3 trillion (US\$157 billion) of problem loans have been transferred from the four state banks to their respective AMCs. It accounted for about 20% of the banks' combined loan portfolios at end-1999.

2. Liberalizing interest rate regime.

Starting September 21, 2000, financial institutions begin setting their own hard-currency lending rates. Benchmark rates on hard-currency deposits in excess of \$3 million, are set by the China Banking Association. And rates for deposits below \$3 million are still set by the central bank. However, lending and deposits rates for RMB are still fixed by the central bank.

Source: *Moody's Banking System Outlook*, August 2000; *The Wall Street Journal*, September 6, 2000.

IV. CHALLENGES TO RECENT BANKING REFORM EFFORTS

Following the report of the recent banking reform progress, we discuss some of the major challenges to banking reforms. There are several issues that beg for solutions:

1. The probability of success of the current bank recapitalization program, especially the efficacy of the asset management companies in dealing with the NPLs;

Mo (1999) questions the adequacy of capital injection. He suggests to stop the flow problem, i.e. the flow of NPLs, instead of keep injecting capital, which is doomed to fail with precedents in eastern and central European economies.

As discussed in sections II and III, the NPLs problem and the associated bank recapitalization program are closely related to the interdependence between the credit allocation decision-making process of the SOEs, SOBs, and state officials. Li and Zhu (1999) suggest that current reform measures that focus on recapitalization and recentralization of the banking sector fall far short of addressing these two problems. The first problem is the interference by the government agencies with the bank business. The second problem is the fact that state controls leads to a non-market oriented mechanism for selecting and rewarding bank management. They contend that in order to solve the bad loan problems, banks must either collect them from the borrowers or increase their

own revenue to offset the losses. The first alternative is difficult given the interdependence of SOEs and SOBs and the state and the need to lend heavily to fund massive infrastructure spending to reflate the economy. The second alternative depends on the management of the banks of their new lending. Lending to profitable companies in fast-growing private sectors seems promising.

Bonin and Huang (2000) propose the following to manage the bad loans problem in addition to current practices:

- a) terminating policy loans;
- b) introducing private and foreign strategic investors in the NPLs market;
- c) redefining the relationships between the parent banks and the AMCs; and
- d) transferring problem enterprises' deposits as well as NPLs from parent banks to AMCs.

As discussed above, problems involving NPLs are quite complex. Solutions suggested by previous studies are either too specific to the issues that they analyzed or too general if they are policy-oriented. Nevertheless, China has been very receptive to these recommendations.

2. Legal foundations for the success of the equity and debt markets

There is no doubt that China lacks the legal infrastructure that includes supervisory, regulatory and accounting standards. For example, the lack of modern bankruptcy laws prohibits the full recovery of NPLs as discussed in the previous section. But, to build the legal and regulatory infrastructure from the ground up takes time and talents. Progress has been made. For example, the decision to merge the two stock exchanges besides economic reasons was based on the consideration of improved regulation. In addition, the China Securities Regulatory Commission has been re-modeled after those of the western countries.

3. Fiscal sustainability of the bank reform program

Lardy (2000) argues that even if the institutional obstacles that hinder the progress of bank reforms could be overcome and AMCs work smoothly, bank recapitalization and related reforms will pose a considerable fiscal challenge for China's central government. He shows that net issuance of treasury debt as a percent of central government expenditures, the latter inclusive of interest expenditure, increased from 19 percent in 1993 to 46 percent in 1998. Consequently, the interest burden of treasury debt also grew 10 folds in five years in 1998 or grew from 3.8% in 1993 to 15.5% of the central government outlays in 1998.

Lardy (2000) shows concern about the fiscal challenge of bank restructuring. He argues that because the ratio of domestic treasury debt to GDP in China is low, leaving considerable headroom for additional government bond issuance to finance the write-off of NPLs in the state-owned banking system. He argues that the conventional wisdom fails to consider adequately both the limited fiscal capacity of the central government and the rapid growth in recent years of government debt, both treasury debt and other debt obligations of the central government. His analysis suggests that a successful program of financial sector restructuring depends critically on both further fiscal reform and the rapid development of a commercial culture in the financial system.

In contrast, Lau (1999) concludes that the Chinese economy is not in imminent danger of financial collapse, despite the existence of a significant stock of NPLs. Moreover, while the existence of the NPLs and their continual increase over time are not desirable, they do not yet pose a serious threat to the solvency of either the banking system or the central government. He believes the system is sustainable for at least another decade or longer. He believes that this is not the right time to radically reform SOEs since the economy is weak and slowing. The fiscal situation can certainly support a couple of years of deficit running without significant adverse effects, especially given the low rate of growth of non-government aggregate demand and the low, indeed, negative, rate of inflation currently prevailing in the economy.

This may be one of the areas regarding bank reforms that economists disagree most. The fiscal sustainability of the bank reform program determines the pace of gradual transition from the state of financial fragility to financial strength. The collapse of any sector of the state enterprise, either SOEs or SOBs, could throw the country into socio-economic and political turmoil. In order to proceed slowly and prepare for eventual opening up of the economy, including full convertibility of RMB, fiscal support for these two sectors must be sufficient and correctly estimated. The stronger the fiscal support, the sooner China can afford opening up of its economy completely, i.e. capital accounts and full convertibility of RMB. This is definitely one of the areas that current research is lacking.

4. Competitiveness of the Chinese financial institutions with China's entry into WTO

China's entry into WTO serves as a rude awakening to both the SOEs and SOBs. Since the discussion of China's entry into WTOs, they have started to realize that their monopoly power bestowed to them by the state would eventually dissipate. SOBs eventually have to face competition by foreign banks, although complete opening up of the financial sector is not expected to take place soon. The question is by introducing competition, will the Chinese banks be able to handle the competition and improve efficiency? If not, what would be the costs paid by the whole nation?

As Li and Zhu (1999) point out correctly, simply by introducing foreign competition would not be sufficient to improve efficiency. If the Chinese banks are not allowed to operate in an environment such as the foreign banks in terms of making business decision, they are doomed to fail. Thus, fundamental changes in the structure of ownership and incentives would be the necessary changes in complement to competition.

It is, nevertheless, time for them to modernize and operate on the basis of free and fair competition. While Moody's (2000) is positive about the introduction of foreign competition to the domestic banking sector, it is cautious about the severe problems, which it may bring. Domestic banks, as well as foreign alike, are preparing for keen competition. Some Chinese banks have started to diversify their loan portfolios into different sectors that will increase their return on their capital. Instead of lending to the traditional commercial real estate development, banks have started to lend actively to high-tech and housing industries. Some banks are busily seeking for public listing to obtain fresh capital, while some are looking for strategic partners with other domestic or foreign banks. Many foreign banks plan to expand their local operations once China joins WTO. Meanwhile to pave the way for the eventual opening up of the banking sector to foreign banks, the central bank is liberalizing interest rates (see section III, Table 2), which government officials hope will force state banks to overhaul their business practices.

The 5-year agenda for opening up the domestic banking sector to foreign banks is as follows:

- a) Foreign banks will be allowed to handle all foreign currency transactions in China for foreign customers immediately after its entry to the WTO;
- b) Foreign banks will be authorized to carry out foreign currency transactions for mainland customers one year after entry;
- c) Two years after entry, foreign banks will be permitted to conduct local currency business in RMB with Chinese enterprises, and
- d) Five years after joining the WTO, foreign banks will be allowed to take local currency deposits from Chinese individuals from anywhere in the country.

As Moody's November 1999 report points out, the 5-year timetable that China has given itself is too ambitious by any standard, particularly in light of the weak state of financial system. However, analysts and academics all agree that China's entry into WTO will pose no immediate threat to the Chinese banking sector. This is simply because the market penetration and business activities carried out by foreign banks are very limited, primarily because they do not have sufficient sources of local currency funding. However, the number of foreign banks and their representative offices are growing and branching into different major cities. Once foreign banks are allowed to take RMB deposits, their capacity to do RMB business will be significant. Meanwhile, China's entry

into WTO will speed up the commercialization and restructuring processes of the banking sector. It serves as a good catalyst for further reforms that eventually will bring China to a true market economy. The long-term benefits of increased foreign competition are clear.

5. Weak or absence of corporate governance

Along with the restructuring measures in the SOBs and SOEs, the Chinese government must recognize the importance of improvement from within. With the closing of the 15th Communist Party Congress, an identified strategy of “grasp the large, release the small” has been spelled out among both state-owned and private-owned enterprises. China is in high hope of competing in the global market. Policymakers are hungered for China’s best state enterprises ultimately to resemble South Korea’s business groups, known as chaebols. However, chaebols are also to be blamed for bringing Korean economy into crisis. Top officials in Beijing are cautious to recognize all precautions to prevent a similar lesson from Korean conglomerates. Among all, corporate governance is one of the immediate issues to be acknowledged.

The success of any economic reforms lies on both exogenous and endogenous control mechanisms. Exogenous control mechanisms emphasize on an effective takeover market. Endogenous control mechanisms concern efficient internal corporate governance. The interaction of an effective takeover market and an efficient internal governance system helps provide a fluent market and establish a proper culture for corporate control. Similar to Lardy (2000), Li (2000) argues the terminology of corporate governance is acknowledged but the concept is non-existing. Li contends that Chinese enterprises must look into models established in other developed countries, such as the U.S. and the U.K. Many practitioners also share her concern.

To resolve problems in the SOBs and SOEs, China must develop a sophisticated capital market. Yet, operating an efficient capital market requires culture in proper corporate governance. And the key element in internal corporate governance hinges on an effective and vigilant board of directors. To ensure board of directors working for the best interest of shareholders, a well-designed compensation package must be in place. In the public sector, since the capital market in China is still far from that of her U.S. counterpart, both companies and domestic investors have minimum knowledge on building up a board that can work for them. For instance, Xu and Wang (2000) argue that director information and compensation are misleading even for those listed in the Shenzhen Stock Exchange. Even though the China Securities Regulatory Commission requires publicly traded companies to disclose information, only less than half of those companies provided details in reports. They suggest that most of the directors are compensated much higher than reported. The inaccuracy in report is due to two reasons: companies fear shareholders’ discontentment and directors’ compensation exceeds what is allowed in the law.

In the private sector, the notion of corporate governance is also weak. Since the economic reform began in 1978, many new private firms have been born. Initially, many of them were designated as “collectively-owned” to avoid the label of private ownership. After more than twenty years of economic reforms, China has now developed a sizable and vigorous private sector. Liang and Li (2001) survey members of Shanghai Association of Private Enterprises (SAPE) and find 66% of those 190 responded firms have some kind of board structure. Their finding confirms how underdeveloped the Chinese corporate governance is.

Successful economic reforms must come with the aid of an efficient capital market. In return, to develop an efficient capital market, we believe both state-owned and non-stated owned enterprises must model their company structure and board composition after those of developed economies, such as the U.S. and U.K. Until then, Chinese economic reforms can only be implemented half-heartedly and hindered by the lack of corporate culture and governance.

V. CONCLUSION

From the economic theory, an open financial sector is no doubt the best route to economic growth. However, the pace of opening up the financial sector depends on the particular situation of the country. For China, concerns about the ramifications of closing down the SOEs and SOBs, and opening up the capital accounts, which may cause instability in RMB on the overall economy, are the dominant factors. Despite its eagerness for maintaining a continuous economic growth that began 20 years ago, China is proceeding cautiously with the choice of an inflationary or deflationary economy in achieving its economic goal.

We present an analytical framework for understanding the origin and nature of the problems associated with the SOEs and the banking sector. In this paper, we update, review, and discuss the most recent banking reform efforts of China and their challenges for the period from 1998 to August 2000. Our contribution to existing literature is putting the nexus of the problems in perspective, which may help predict the general trend in the economic reform efforts that China will pursue.

In reviewing the recent banking reform efforts and the NPLs problem in particular, we find that China has demonstrated a strong commitment to banking reforms as well as in the broader financial sector such as the insurance industry, the investment and trust sector, and the domestic stock and bond markets.

Although China has made significant progress in banking reforms since 1998, unresolved issues are still bountiful. For example, struggling SOEs are still burdening the banking system. The success of the bank recapitalization and efficacy of the AMCs in dealing with the NPLs is highly questionable. Likewise, doubts have been cast on whether China has the legal infrastructure

to support a sophisticated capital market, which is a prerequisite for sustaining growth in private enterprises in the future. Despite substantial progress has been made in the last two years, transparency is poor and accounting and regulatory standards are still low relative to international standards. Furthermore, the fiscal sustainability of the bank reform programs has been questioned. Yet, there is no consensus on the issue among economists.

In contrast, most economists agree that China's entry into the WTO provides a strong catalyst for change and it is expected to bring long term benefits to the economy. In the meantime, Chinese banks will face tough competition against foreign banks since they remain undercapitalized, inefficient, and unprofitable. Their disadvantaged position is further hampered by their lack in credit skills and a commercial mindset or culture, although it is believed to be emerging at some banks. Tight government control still undermines governance and incentives at banks and hampers their commercial behavior and decision-making.

Last, but not least, as SOEs, SOBs, and private enterprises start raising capital from the stock and bond markets, corporate governance issues begin to surface. To date, corporate governance terminology has found its way into the companies' boardrooms, private or public, its meaning and concept remains absent from practice.

ACKNOWLEDGEMENTS

The authors are thankful for beneficial discussions with Hung-Gay Fung, the editor, and Gary Shiu. Responsibility for any errors remains with the authors.

NOTES

1. Lau (1999), comparing the size of the Chinese economy and the U.S. in terms of GDP and per capita income, points out that despite spectacular growth of 10% in the last two decades, the Chinese economy is still relatively small.
2. See Fernald and Babson (1999).
3. For example, Woo (1994), McMillan and Naughton (1992), Sachs and Woo (1994), Lo(1997), to name a few.
4. See Huang, Woo, and Duncan (1999).
5. See Lau (1999), Mo (1999), Bonin and Huang (2000), and Lardy (2000).
6. Lau (1999) attributes most of the SOEs losses to factors unrelated to the profitability of the business operations of the enterprises. For example, the overburden of pension and social welfare liabilities such as housing, education and medical care, burden of the interest costs on loans incurred on the establishment of the enterprises in lieu of a founding equity, losses due to improper transfer pricing and other irregular practices, diversion or re-lending of loans for other unauthorized purposes. From the perspective of western financial management, however, profitability of the firm as

measured by the return on equity depends on the return on its assets as well as financial leverage and other factors. Thus, in sharp contrast to centrally planned economy where cost of capital is not considered as part of the costs of operation, we believe the decision to employ financial leverage (versus equity) is an important business decision and it should be recognized by SOEs as the basic guiding light of financial health.

7. Lardy (1998b) suggests that the share of banks' financial intermediation is almost nine-tenths.
8. Lo (1997) points out that China was deliberating between inflation and deflation in dealing with the ailing banks at that time. It might have been inflationary should the government decide to bail out the banks by printing money. It might have been deflationary should the government decide to close down non-viable SOEs and restructure SOBs.
9. See Xu (1998).
10. For discussion and analysis of SOEs reforms, see Lardy (1998a), Huang, Woo and Duncan (1999), and Hu and Yu (1998). For bank restructuring up to 1998, Lardy (1998b) and Fitch IBCA (1998b) are excellent references.
11. Moody's (2000) cites the cases of CITIC and Everbright Group which may, sooner or later, break the Glass-Steagal barrier in China. In addition, conventional economics literature does not recognize the role of commercial banks as ¹ Lardy (2000) reports that non-bank financial institutions were also in financial troubles as early as 1996 when non-performing assets equal to 50% of their total assets. The worse could be the rural credit cooperatives that had been officially declared insolvent by the People's Bank of China at the end of the third quarter in 1999. The stake at risk at the rural credit cooperatives was more than one trillion RMB deposited in savings accounts. China has thus launched a program to close failing rural credit funds, known as foundations.
12. "China's banks prepare for battle," *Business Week*, February 14, 2000.
13. For detailed description of recent banking reform measures, see Mo (1999).
14. See, for example, Lardy (2000), Lau (1999), Mo (1999).
15. See Lardy (2000).
16. "China's banks prepare for battle," *Business Week*, February 14, 2000.
17. Lau (1999) estimates that NPLs is about 2-3% of GDP in terms of annual flows; total amount US\$200 billion; NPLs to 1998 GDP is slightly above 20% (consistent with central bank's estimate). Mo (1999) citing Peoples' Bank of China's end of 1997's NPLs figure: 20-25% of total bank loans or about RMB 1500 billion (US\$ 180 billion). This amount is just under 20% of the GDP. He estimates 6-7% of the total NPLs are irrecoverable or RMB 400 billion (US\$50 billion), and if international accounting norms were applied, the number would even be higher.
18. Lardy (2000) reports that non-bank financial institutions were also in financial troubles as early as 1996 when non-performing assets equal to 50% of their total assets. The worse could be the rural credit cooperatives that had been officially declared insolvent by the Peoples' Bank of China at

the end of the third quarter in 1999. The stake at risk at the rural credit cooperatives was more than one trillion RMB deposited in savings accounts. China has thus launched a program to close failing rural credit funds, known as foundations.

19. The four state-owned banks are the Agricultural Bank of China, Construction Bank of China, Industrial & Commercial Bank of China and Bank of China. Lardy (2000) and Mo (1999) analyze the partial recapitalization of the four state-owned banks.
20. In order to allow the four large state-owned banks to concentrate on commercial lending, three "policy banks" – State Development Bank of China, Agricultural Development bank of China and Export-Import Bank of China - were established in 1994.
21. Details of how AMCs operate can be found in Bonin and Huang (2000).
22. Lo (1997) thinks that the competitiveness of the banking sector is bleak as investors may switch their savings deposits to the capital markets for possibly higher returns.
23. "China will merge its two stock markets," *The Wall Street Journal*, September 2000.
24. Hu and Yu (1998) support this development and stress the importance of such growth in China and in achieving the ultimate goal of building a market-oriented modern economy.
25. *Finance Asia* estimates that they account for 90% of insurance and funds account for the rest. According to Finance Asia (2000), there are about 50 primary dealers and around 319 separate institutions that have accounts with China Government Depository and Trust Company. These institutions include the four largest commercial banks, all the regional commercial banks and many of the rural credit unions and the city commercial banks, as well as insurance companies and securities houses. Lardy (2000), without citing the source, reports that daily transaction in the spot market in September 1999 was about RMB 100 million without citing the source of data.
26. See "The Failure of GITIC", Fitch IBCA, November 1998, for a good description of the background of the trust and investment companies in China, and "Bankruptcy of GITIC", Fitch IBCA, January 11, 1999, for a detail description for the debacle of GITIC.
27. See *The Wall Street Journal*, September 6, 2000.
28. "China's banks prepare for battle," *Business Week*, February 14, 2000.
29. For details of his argument and evidence, please see pp.13-31.
30. Twenty foreign banks licensed to do RMB business in Shanghai and more are expected to be added. An additional 10 or so banks, including the Shanghai branches of Bank of America Corp and ABN Amro Holding, will soon be allowed to borrow from and lend to local banks – a privilege that is now limited to nine banks (Source: *Business Week* 2/14/2000).
31. See Moody's (1999).
32. See Yatsko (1998).

33. See Brickley and James (1987).
34. See Jensen (1993), and Baysinger and Butler (1985).
35. "Bouncing Back: Our Asia Ahead Focus Looks at the region's recovery from crisis", *Far Eastern Economic Review*, July 6, 2000, Vol: 163, No. 27.
36. See Hirshleifer and Thakor (1994).
37. According to official statistics, at the end of 1996, the non-state owned sector (including various foreign-funded, collectively owned, jointly-owned, share holdings, and sole proprietorship) produced 48% of China's GNP. By the end of 1996, the private sector employed over 21 million full-time workers in China.
38. SAPE is a semi-private, semi-government trade association representing over 60,000 private firms in Shanghai

REFERENCES

- "Bankruptcy of GITIC," Fitch IBCA, January 11, 1999.
- Baysinger, Barry D. and Henry D. Butler, "Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition," *Journal of Law, Economics and Organizations* 1, 1985, pp. 650-657.
- "Bouncing Back: Our Asia Ahead Focus Looks at the Region's Recovery from Crisis", *Far Eastern Economic Review* 163, July 6, 2000, No. 27.
- Bonin, J., and Y. Huang, "Dealing with the Bad Loans of the Chinese Banks," Paper presented at the American Economic Association Annual Meeting, Boston, 2000.
- Brickley, James A. and Christopher James, "The Takeover Market, Corporate Board Composition and Ownership Structure: The Case of Banking," *Journal of Law and Economics* 30, 1987, pp. 161-180.
- "China's Banks Prepare for Battle," *Business Week*, February 14, 2000.
- "China's Entry to WTO: Preliminary Assessment of the Impact on the Chinese Banking Industry," Fitch IBCA, November 1999.
- "China Takes Another Step in Easing Currency Rules," *The Wall Street Journal*, September 6, 2000.
- Fernald, J.G., and O.D. Babson, "Why Has China Survived the Asia Crisis So Well? What risks remain?" International Finance Discussion Papers, Board of Governors of the Federal Reserve System, Washington, D.C., 1999.
- Guide to Asian Currency Bond Markets 2000*, Finance Asia, March 2000.
- Hu, Fred and George Yu, "Fire Up China's Growth Engine," *The Asian Wall Street Journal*, November 2, 1998.
- Huang, Y., W.T. Woo, and R. Duncan, "Understanding the Decline of China's State Sector," *MOCT-MOST: Economic Policy in Transitional Economics* 9(1), 1999, pp. 1-15.
- Hirshleifer, David and Anjan V. Thakor, "Managerial Performance, Boards of Directors and Takeover Bidding," *Journal of Corporate Finance*, 1994, pp. 63-90.

- Jensen, Michael, "Presidential Address: the Modern Industrial Revolution, Exit and the Failure of Internal Control Systems," *Journal of Finance* 48, 1993, p. 831-880.
- Lardy, Nicholas, "When Will China's Financial System Meet China's Needs?" The Brookings Institution, Washington, D.C., 2000.
- Lardy, Nicholas, "Banking Restructuring in China," The Brookings Institution, Washington, D.C., 1998b.
- Lardy, Nicholas, *China's Unfinished Economic Revolution*. The Brookings Institution, Washington, D.C., 1998a.
- Lau, Laurence J., "The Macroeconomy and Reform of the Banking Sector in China," in *Strengthening the Banking System in China: Issues and Experiences*, BIS Policy Papers, October 1999, pp. 59-89.
- Li, Joanne, "The External Labor Market for Board of Director – A look at the Chinese Market" in *Corporate Governance: Chinese Practices and American Experiences*, A joint Publication of Chinese Economists Society (CES) and Beijing International MBA Programs at Peking University (BiMBA), 2000.
- Liang, Neng and Joanne Li, "CEO Duality, Board Composition, and Firm Performance: New Evidence from China's Private Firms," Working Paper, Loyola College in Maryland, 2001.
- Li, Shan and Tian Zhu, "An Open Financial Sector Helps China," *The Asian Wall Street Journal*, April 30-May1, 1999.
- Lo, Chi, "China Can Dodge a Financial Crisis," *The Asian Wall Street Journal*, December 27, 1997.
- McMillan, J., and B. Naughton, "How to Reform a Planned Economy: Lessons from China," *Oxford Review of Economic Policy* 8, Spring 1992, pp. 130-43.
- Mo, Y.K., "A Review of Recent Banking Reforms in China" in *Strengthening the Banking System in China: Issues and Experiences*, BIS Policy Papers, 1999, pp. 90-109.
- Moody's Banking System Outlook*, Moody's Investors Services, August 2000.
- Moody's Banking System Outlook*, Moody's Investors Services, November 1999.
- Sachs, J.D. and W.T. Woo, "Structural factors in the Economic Reform of China, Eastern Europe, and the Former Soviet Union," *Economic Policy* 18, April 1994, pp. 102-45.
- "The Failure of GITIC," Fitch IBCA, November 1998b.
- The People's Republic of China Banking System*, Fitch IBCA, March 1998a.
- Woo, W.T., "The Art of Reforming Centrally Planned Economics: Comparing China, Poland, and Russia," *Journal of Comparative Economics* 18, June 1994, pp. 276-308.
- Xu, Shawn, "Reversing China's Structural Downturn," *The Asian Wall Street Journal*, April 7, 1998.
- Xu, Xianian and Yan Wang, "Ownership Structure and Firm Performance: An Empirical Study of China's Listed Companies," in *Corporate Governance: Chinese Practices and American Experiences*, A Joint Publication of

Chinese Economists Society (CES) and Beijing International MBA Programs at Peking University (BiMBA), 2000.

Yatsko, Pamela, "The Bigger, The Better", *Far Eastern Economic Review*, May 21 1998, pp. 10-13.