WikiLeaks Document Release

http://wikileaks.org/wiki/CRS-RL31363
February 2, 2009

Congressional Research Service

Report RL31363

China's Banking Reforms: Background and Issues for Congress

Dick K. Nanto and Radha Sinha, Foreign Affairs, Defense, and Trade Division

Updated May 22, 2002

Abstract. This report concludes that despite serious problems in China's banking system, the risk seems small that, in the near future, a financial crisis will occur that will pose severe problems for the international financial system. An internal financial crisis, however, could occur. Without government support, the economic viability of many of China's banks is questionable. The government and central bank authorities acknowledge the situation and have taken some steps toward reform.

Order Code RL31363

Report for Congress

Received through the CRS Web

China's Banking Reforms: Background and Issues for Congress

May 22, 2002

Dick K. Nanto
Specialist in Industry and Trade

Radha Sinha
Research Associate
Foreign Affairs, Defense, and Trade Division

China’s Banking Reforms: Background and Issues for Congress

Summary

The Peoples Republic of China’s entry into the World Trade Organization (WTO) will require that it open its financial services sector to foreign investment and international competition. In preparation for a more market-based banking system, China has announced reforms intended to strengthen its banks and American investors have been buying portfolios of Chinese non-performing loans. The international community has a stake in Chinese financial reform primarily for three reasons. The first is to prevent contagion – to keep a failure of Chinese banks from touching off global financial turmoil. The second surrounds the likely political unrest in China that could ensue should the Chinese economy fail, and the third is to ensure that foreign firms gain access to Chinese financial markets.

This report concludes that despite serious problems in China’s banking system, the risk seems small that, in the near future, a financial crisis will occur that will pose severe problems for the international financial system. An internal financial crisis, however, could occur. Without government support, the economic viability of many of China’s banks is questionable. The government and central bank authorities acknowledge the situation and have taken some steps toward reform. The most serious threat to the banking system lies in the accumulation of non-performing loans (NPLs) – many of them policy-based loans extended by state-owned banks to money-losing state-owned companies with little expectation that they would be completely repaid. Between 28 and 40 percent of all bank loans in China are estimated to be nonperforming. China has been taking measures to keep the problem from worsening and has created four asset management companies to dispose of NPLs that still have value.

Since the Chinese economic reforms began in 1978, Chinese authorities have made significant progress in modernizing their banking system, although they still have a long way to go and are faced with competing interests. While attempting to introduce more market forces and efficiency into their economy, for political and other reasons, the government continues to subsidize ailing state-owned enterprises. They would like to clear the banks of excess NPLs, but fear the resultant rise in unemployment and social distress that might occur.

China escaped the worst effects of the 1997-99 Asian financial crisis because of factors that still keep its financial and foreign exchange system viable. China’s continued high rate of growth and high savings rate have funneled deposits into the banking system, while a $20 to $30 billion annual trade surplus together with an inflow of foreign direct investment at about $40 billion per year have resulted in an accumulation of foreign exchange reserves exceeding $200 billion. China does not carry an unusually heavy debt burden, either domestic or international, although its short-term borrowing in foreign currencies has been increasing. China, therefore, does not currently face a serious risk of either a domestic or international liquidity crisis – unless, of course, a severe and prolonged world recession occurs that adversely affects Chinese exports as well as the inflow of foreign direct investment.

Contents

List of Figures

List of Tables

China's Banking Reforms: Background and Issues for Congress

The Peoples Republic of China's entry into the World Trade Organization (WTO) will require that it open its financial services sector to foreign investment and international competition. In preparation for a more market-based banking system, China has announced reforms intended to strengthen its banks. American and foreign investors have been buying portfolios of Chinese non-performing loans, and the private investment arm of the World Bank has invested in the Bank of Shanghai.

For the U.S. Congress, China's banking problems and reforms may be of concern because: (1) China's financial sector plays a key role in the development of the Chinese economy; (2) the opening up of China's banking sector could be an indicator of the degree to which Beijing will be able to comply with its commitments for entering the WTO; (3) China's banks face a huge accumulation of nonperforming loans which could threaten their solvency and, in turn, cause financial panic that could spread to other countries; (4) U.S. banks are seeking access to the Chinese market, and (5) China's banking system plays a key role in the conduct of Beijing's monetary and fiscal policy.

Most analysts feel that despite serious problems in China's banking system, the risk seems small that, in the near future, a financial crisis will occur that will pose severe problems for the international financial system.[1] Recently, in a speech at the China Economic Forum, People's Bank of China Governor, Dai Xianglong gave the assurance that in light of economic fundamentals and development of the financial sector, financial risks in China are being contained, reduced and can be resolved.[2] Nevertheless, China's financial system has fundamental weaknesses and is in immediate need of reform. Many state-owned banks are close to being technically insolvent. In its 2001 consultation with China, the International Monetary Fund concluded that progress has continued in addressing the problems in China's financial sector, but much remains to be done to complete the reform agenda. Difficult reforms are yet to be accomplished, and China's entry into the WTO has increased the urgency of these reforms.[3]

---

[1] Lau, Lawrence J, "The Macroeconomy and Reform of the Banking Sector in China," in Bank of International Settlements , *Strengthening the Banking System in China*: *Issues and Experience*, BIS Policy Paper No.7, October 1999, p. 83. See also Fernald, John G., Babson, Oliver D., "Why Has China Survived the Asian Crisis So Well? What Risks Remain" (Unpublished), International Finance Discussion Papers, No. 633, February 1999, Board of Governors the Federal Reserve System [http://www.bog.frb.fed.us].

[2] *People's Daily,* September 20, 2001 reported on [http://www.china.org.cn].

[3] International Monetary Fund. IMF Concludes 2001 Article IV Consultation with the (continued...)

Without government support, the economic viability of many of China's banks is questionable. The government and central bank authorities acknowledge the situation and have taken some steps toward reform. They reorganized the People's Bank of China, the central bank, and have set in motion a supervisory and regulatory structure with emphasis on upgrading the skills of those concerned. with supervision. In 1998, they replenished the capital base of the state-owned banks in order to help them meet the Basle Accord's minimum capital adequacy requirements.

The most immediate threat to the banking system lies in the accumulation of non-performing loans (NPLs) – many of them policy-based loans extended by state-owned banks to money-losing state-owned enterprises with little expectation that they would be completely repaid. In order to keep the problem from worsening, China's policy-banks have taken over policy-based lending, and even the state-owned banks have been made responsible for their profits and losses. Ostensibly, priority is now being given to commercial considerations over political and social factors, and not all financial institutions in difficulty are being rescued. Some international trusts, banks, and rural and urban cooperatives have been closed; others have been consolidated.

Currently, the government guarantees bank deposits, but it is considering a more conventional system of deposit insurance.[4] Foreign banks are increasingly being licensed to operate there, and under China's WTO accession agreement they will be allowed to undertake retail banking and local currency business. Commercial banks – other than those owned by the state – can be owned by private individuals, and even the state-owned banks may, in due course, sell shares on stock exchanges. Many SOEs, which have been the main contributors to the problem of NPLs, are being privatized, consolidated, or closed down. The pace of reform, however, has been slow because reforming the SOEs increases unemployment and, consequently, threatens to create social unrest. China also is strengthening its equity and bond markets to provide alternative sources of finance for investment.

To reduce the accumulation of NPLs, the government has created four asset management companies (AMCs) to help dispose of NPLs that are not completely worthless being held by four state-owned banks. The AMCs have sold some portfolios of NPLs to foreign investors at steep discounts.

The international community has a stake in Chinese financial reform for three primary reasons. The first reason is to prevent contagion – to keep the failure of Chinese banks from touching off global financial turmoil in the same manner that the failure of several finance companies in Thailand ignited the 1997-99 Asian financial crisis. The second reason is associated with the political turmoil that could ensue should the Chinese economy fail. Indonesia and Argentina are two examples of what can happen to society and political order when a country's financial system

---

[3] (...continued)
People's Republic of China. Public Information Notice No. 01/91, August 24, 2001.

[4] Wang Ying, 'Banking on Insurance,' *Beijing China Daily(Business Weekly Supplement)* (Internet version) in English, May 22, 2001. (FBIS transcribed text)

collapses. With a quarter of the world's population living in China, economic and political turmoil, such as occurred during the Great Leap Forward or Cultural Revolution, would have a direct impact upon the rest of the world. The third reason is to ensure that China opens its financial markets in accord with its WTO obligations.

Since the initiation of the economic reforms in 1978, China has acted to implement a number of changes to open the economy and move further away from central planning, even though many have criticized the pace of change as being too slow. Considering their starting point, the Chinese authorities have made significant progress, although they still have a long way to go and are faced with competing interests. While attempting to introduce more market forces and efficiency into their economy, they continue to subsidize ailing state-owned enterprises for political and other reasons. They would like to clear the banks of excess NPLs, but fear the resultant rise in unemployment and social distress that might occur.

The need for China to change its financial system to make it more market and profit-based has been made more urgent by China's entry into the World Trade Organization in December 2001. Under its accession agreement, China has committed itself to the following actions related to banks and other financial institutions:

- for foreign currency business, upon accession, no geographic or client restrictions;

- for local currency business, upon accession, no geographic restrictions in Shanghai, Shenzhen, Tianjin, and Dalian; within one year after accession, no restrictions in Guangzhou, Zhuhai, Qingdao, Nanjing, and Wuhan; within 2 years after accession, Jinan, Fuzhou, Chengdu, and Chongqing; within 3 years after accession, Kumming, Beijing, and Xiamen; within 4 years after accession, Shantou, Ningbo, Shenyang, and Xi'an; and within 5 years after accession, all geographic restrictions to be removed;

- for local currency business, within two years after accession, foreign financial institutions are to be permitted to provide services to Chinese enterprises; within 5 years after accession, foreign financial institutions are to be permitted to provide services to all Chinese clients; those institutions licensed in one region are to be able to service clients in any other region that has been opened for such business;

- within 5 years after accession, all existing non-prudential criteria (economic needs tests, quantitative limits, etc.) for licenses to deal in China's financial services sector are to be eliminated;

- upon accession, motor vehicle financing by non-bank financial institutions is to be unbound (except for some restrictions on the provision and transfer of financial information, data processing, and software).[5]

In essence, within five years, China is to grant foreign banks full market access to conduct local currency business (including taking deposits), with no geographic and customer restrictions. Upon accession, non-bank financial companies are to be able to offer automobile financing.

The Development of China's Banks

Serious problems remain if the Chinese banking system is to efficiently service and help allocate scarce financial resources in the rapidly developing and modernizing economy of China. Yet the country has made considerable progress over the last quarter of the twentieth century in transforming its banks. Before the economic reforms initiated in 1978, China had only one bank, the People's Bank of China (PBC), which had branches located throughout the country. The PBC accepted deposits, offered loans, and handled monetary remittances. All public institutions and state-owned enterprises (SOEs) had to deposit their cash with the PBC. Cash and bank deposits were the only two financial assets available. In effect, the PBC combined the functions of a central bank with those of commercial banks. All lending by the PBC was policy-based – the availability, size, term, and interest rates on loans were administratively determined.[6]

As part of the economic reforms, China changed its banking system from one of strictly centralized control to a diversified and functionally more specialized system. The first step towards specialization came in 1979 with the establishment of three state-owned banks, the Agricultural Bank of China (ABC), the Bank of China (BOC), and the People's Construction Bank of China (PCBC). The ABC was given the responsibility of providing banking services to rural areas and townships and to supervise the activities of the Rural Credit Cooperatives. The ABC gives priority to the development of rural infrastructure, particularly, key sectors such as transportation, telecommunications, public utilities and power. The BOC is much like an urbanized international bank providing a wide range of banking services. When first formed, it primarily funded imports and exports. The China Construction Bank (PCBC) gives priority to financing fixed capital investment projects, construction of infrastructure, and the development of large enterprises. Subsequently, in 1985, Beijing established the Industrial and Commercial Bank of China (ICBC) as the fourth state-owned specialized bank to deal with commercial enterprises and urban credit cooperatives. The ICBC also took over from the central

---

[5] World Trade Organization. *Report of the Working Party on the Accession of China*, WTO Document No. WT/MIN(01)/3, November 10, 2001.

[6] Nasution, Anwar, "Recent Issues in the Management of Macroeconomic Policies: The People's Republic of China," in Asian Development Bank, *Rising Challenges in Asia: A study of Financial Markets – The People's Republic of China* (Manila: Asian Development Bank, 1999), p. 11.

bank the normal commercial banking functions (such as taking deposits and commercial lending).[7]

In 1984, the PRC named the People's Bank of China as its central bank and, as is the case with other central banks, gave it the responsibility for formulating and implementing Chinese monetary policy. In this context, the Bank issues Renminbi, (RMB, also referred to as yuan) the Chinese currency, and regulates its supply.[8] It also manages the country's foreign exchange and gold reserves, regulates the financial market, manages international financial operations, and safeguards the workings of China's payment and clearing system.

The PBC's control over monetary policy, however, remains relatively weak. In the past, under pressure from various public authorities – including the provincial governments and SOEs engaged in aggressive development strategies, the PBC often exceeded its credit targets.[9] In order to reduce the undue influence on the bank by provincial and local politicians, The PBC abolished its 31 provincial branches and established nine regional branches in central cities (Tianjin, Shanghai, Shenyang, Nanjing, Jinan, Wuhan, Guangzhou, Chengdu and Xi'an).[10] This placed the head of each regional bank in a position superior to that of the provincial governors.

In a further effort to streamline the Chinese banking system and to release the four state-owned commercial banks from the responsibility of policy lending, in 1994 China created three 'policy' banks. These include the State Development Bank, the China Export-Import Bank, and the China Agricultural Development Bank. The State Development Bank provides finance for infrastructure projects, with priority on transportation, telecommunications, electric power and power grids, agriculture, forestry and water conservancy, urban development, and environmental protection.[11] The Export-import Bank finances foreign trade transactions, and the Agricultural Development Bank provides capital or loans for projects related to agricultural development projects. It also assists in the reform of the grain marketing system and provides funds for purchasing grain, cotton and oilseeds.[12]

Under the Commercial Banking Law of 1995, the four specialized state-owned banks, the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China (ABC), the Bank of China (BOC) and the People's Construction Bank of

---

[7] For a more information on bank development, see: Lardy, Nicholas R. *China's Unfinished Economic Revolution* (Washington: Brookings Institution Press, 1998), pp. 59-73.

[8] The annual average exchange rate in terms of yuan (RMB) per dollar was: 2.5 in 1970, 1.9 in 1975, 1.5 in 1980, 2.9 in 1985, 4.8 in 1990, 8.6 after devaluation in 1994, and has continued at about 8.3 since 1996. It was 8.2774 yuan per dollar on March 29, 2002.

[9] Cho, Yoon Je, 'The Banking System of the People's Republic of China, in Asian Development Bank, *Rising Challenges in Asia: A Study of Financial Markets -The People's Republic of China* (Manila: Asian Development Bank, 1999), p. 62.

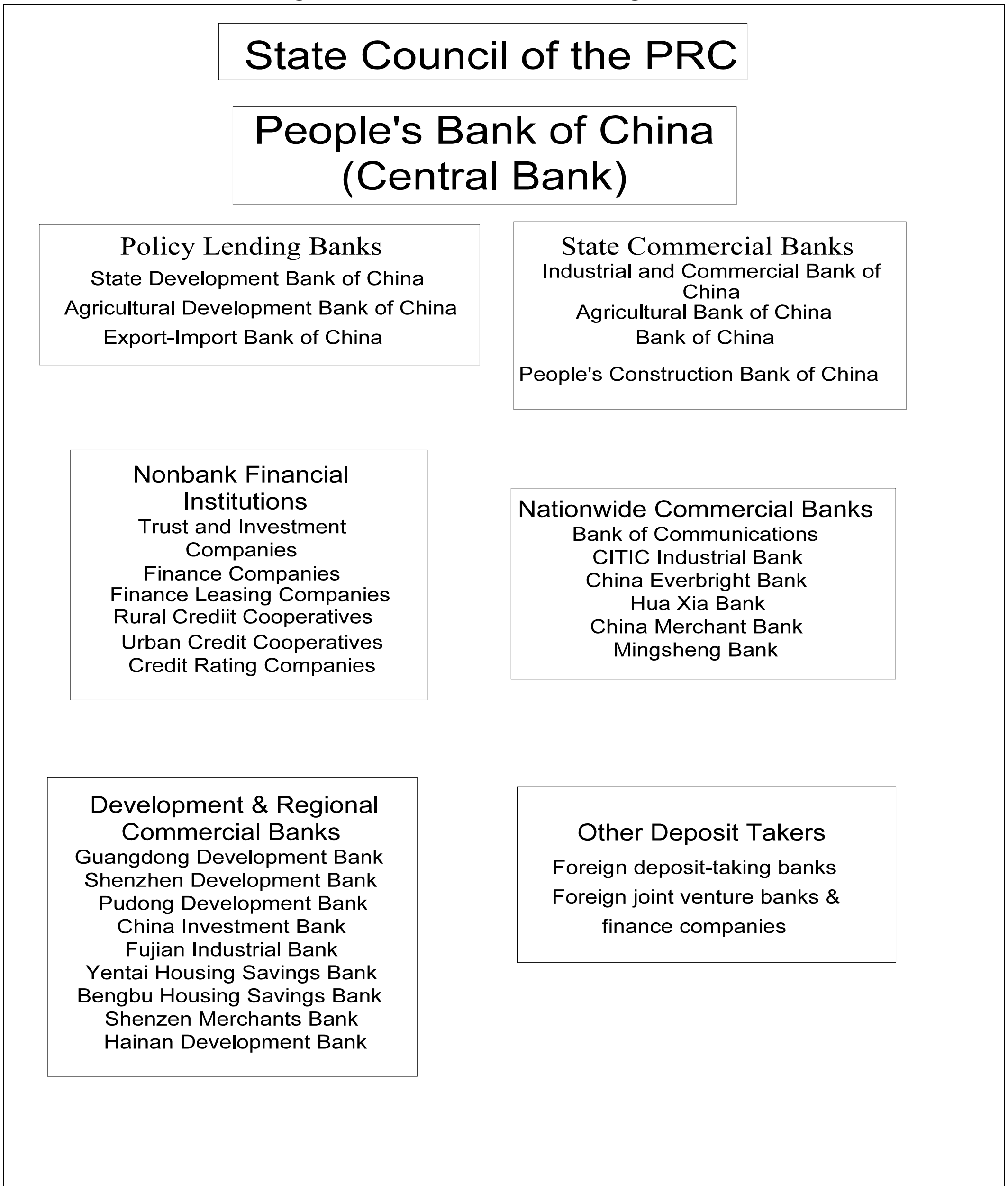
[10] *Almanac of China's Finance and Banking, 1999*, (Beijing: China's financial Publishing House, 1999), p. 31. This report states that 32 provincial branches were closed. (p. 57)

[11] *1999 Banking Almanac*, p.73.

[12] *1999 Banking Almanac*, pp. 81-2.

China (PCBC) began to operate as commercial banks responsible for their profits and losses. Loans were to be made on a commercial, not policy, basis. From 1998, the ICBC began extending consumer credit for purchases of automobiles and telecommunications equipment in addition to its role of providing financial support to enterprises of all sizes and to joint ventures.[13]

Figure 1. China's Banking Sector



During the second half of the 1990s, China also saw the emergence of a new genre of commercial banks with shares owned by public authorities at various levels of government, including local governments and, in some cases, by private

[13] *1999 Banking Almanac,* pp. 86-7.

individuals. This included the Shenzhen Development Bank, Guangdong Development Bank, Everbright Bank, and the Fujian Industrial Bank.

In a further move toward greater specialization, the 9th National People's Congress in December 1998 adopted a Securities Law which transferred the responsibility for examining securities houses from the People's Bank of China to the newly created China Securities Regulatory Commission.[14] Similarly, the supervision and regulation of the insurance industry was transferred from the PBC to a newly created China Insurance Regulatory Commission.[15]

Currently, therefore, the Chinese financial system consists of policy banks, state-owned commercial banks, several other nationwide and regional commercial banks, and some foreign banks, nearly 60,000 rural credit cooperatives, and some 15,000 urban credit cooperatives, as well as trust and investment companies and finance companies. The financial system also includes securities firms, insurance companies, and leasing firms.[16] As Table 1 indicates, somewhat more than three-quarters of the assets of all the financial institutions are held by the PBC and the state-owned commercial banks – the later owning slightly more than half the total assets. Non-banking financial institutions[17] in China are still in their infancy. They own about 6% of the assets. Not counting the assets of the PBC, state-owned commercial banks represent nearly 69% of the total assets of all China's financial institutions. Non-state-owned commercial banks account for only 7% of the total assets.

People's Bank of China and Monetary Policy

As China has transformed its economy from one under the direct control and direction of the central government toward a type of market socialism, it has introduced methods for conducting monetary policy similar to those in other industrialized countries. Still, the bulk of China's available financial resources are allocated by the government through investment, credit, and the cash plans aimed at meeting the investment targets and the credit needs of the state-owned enterprises.[18] The credit and cash plans determine quantitative limits on lending by commercial banks, although since 1995, the credit plans have applied only to four state-owned

[14] *Almanac of China's Finance and Banking 1999, op. cit.*, p. 194.

[15] *Almanac of China's Finance and Banking 1999, op. cit.*, p.157.

[16] Cho (1999)*, op. cit.*, p. 62. The *Almanac of China's Finance and Banking, 2000* mentions that in 1999, there were 39,516 rural credit cooperatives as independent accounting units, and 61,885 rural credit cooperative branches and savings offices without accounting independence.(P.144).

[17] These include trust and investment companies, leasing companies, securities companies, finance and insurance companies. At the end of 1997, China had 16 leasing companies, 13 insurance companies (not including 8 foreign insurance companies), 63 finance companies (not including 5 foreign finance companies), 93 securities houses, and 244 trust insurance companies. See Nasution (1999), *op. cit.,* p. 32.

[18] *Ibid.*, p. 11,

commercial banks and four nationwide commercial banks.[19] This limits the authority of the People's Bank of China to conduct its monetary policy independently of direction by the government.

Table 1. Asset Distribution in China's Financial System, 1999

Institutions	Assets (billion Renminbi)	Percent of Total
Total Assets	16,406.2	100.0
People's Bank of China	3,534.9	21.5
Deposit Money Banks	11,982.6	73.0
State-owned commercial banks*	8,852.8	54.0
Other commercial banks**	1,123.5	6.8
Rural cooperative banks	1,239.2	7.6
Urban cooperative banks	630.0	3.8
Finance companies	137.0	*0.8*
Specific Deposit Institutions***	888.7	*5.4*

Source: *Almanac of China's Finance and Banking, 2000* (Beijing: China's Financial Publishing House, 2000), Tables 4-11, pp. 212-219.

*Includes the Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, Construction Bank of China, and the Agricultural Development Bank of China.
**Includes the Bank of communications, the China ITIC Industrial Bank, the China Everbright Bank, the Hua Xia Bank, the Guangdong Development Bank, the Shenzhen Development Bank, the Pudong Development Bank, the Shenzhen Merchant Bank, the Fujian Industrial Bank, the China Investment Bank, the Yentai Housing Savings Bank , the Bengbu Housing Savings Bank, the Merchant Bank, and the Minsheng Bank.
***Includes financial trusts, investment corporations, and financial leasing companies, the State Development Bank of China, and the Export-Import Bank.

Yet, within constraints, the PBC has introduced conventional monetary policy instruments such as control over interest rates and the money supply through bank reserve requirements and open market operations. The Bank establishes projected targets for money growth and has been working with commercial banks to improve the transmission of monetary policy.[20]

---

[19] *Ibid.*, p. 16.

[20] Dai Xianglong, Continuing the Sound Monetary Policy and Consolidating the Rebound (continued...)

For example, in response to the Asian financial crisis that began in 1997, Beijing decided to pursue expansionary monetary and fiscal policies in order to maintain the high growth rate of the economy. With this objective, in 1998, the PBC reduced its discount rate and the interest rates on deposits and loans of financial institutions three times (following three previous cuts in 1996-97). According to Bank of China estimates, the three interest rate cuts in 1998 saved enterprises over 83 billion yuan ($10 billion) in interest charges during the following year.[21] In 1999, countering deflation remained the main focus of Chinese monetary policy, and the Bank cut interest rates a seventh time in June1999. This reduced the PBC's interest rate on loans to financial institutions from the May 1996 level of 10.98% to 3.24% in June 1999 where it remained through 2001. The lending rate for short- and medium-term loans by banks consequently fell from 12% in April 1996 to 3.24% in June 1999.[22]

Introduced first in 1984, the PBC has vigorously used changes in reserve requirements of financial institutions as an instrument of monetary policy. In 1989 an additional 'excess reserve requirement' made it obligatory for financial institutions to keep in reserve an amount equivalent to 5 to 7 percent of their domestic currency deposits. Furthermore, each branch of a financial institution was required to keep its reserves on deposit in a branch of the PBC at the same administrative level. In order to meet this requirement, bank branches often resorted to borrowing on the interbank loan market which was not always readily available to them. As a result, the bank branches tended to keep high excess reserves. Monitoring of the reserves under this fragmented system proved to be cumbersome and somewhat wasteful. Hence, in 1998, the PBC decided to allow banks to meet the reserve requirement on a consolidated basis.[23]

In 1998, the PBC reduced the required reserve ratio from 13 to 8 percent and again to 6% in November 1999. The Bank required that the liquidity created by the cuts in the reserve ratio in 1998 be used for buying special government bonds. In 1999, however, the Bank allowed the nearly 200 billion yuan ($24 billion) worth of liquidity created by lowering the reserve ratio to be used at the discretion of the financial institutions.[24]

As for open market operations (buying and selling government securities), from 1993, the PBC has used them to regulate the reserve base of the banking system.

---

[20] (...continued)
of the Economy. Speech by the Governor of the People's Bank of China, January 17, 2001.

[21] *Almanac of China's Finance and Banking, 1999, op. cit.*, p. 18.

[22] *Almanac of China's Finance and Banking, 2000, op. cit.*, Table 24, p. 239. Before 1998 discount rates were normally 5-10% lower than the rates charged by financial institutions on loans of the same grade, and the rediscount rate was usually 5-10% lower than the rates on relending rates of the same grade. In 1998, the rediscount rate was made an independent basic rate which could, thenceforth, be determined according to the relending rate. The discount rate was determined by adding points to the relending rate. See: *Almanac of China's Finance and Banking, 1999*, pp. 21-22.

[23] Nasution (1999), *op. cit.,* p. 17.

[24] *Almanac of China's Finance and Banking, 2000, op. cit.*, p. 19.

From 1995, however, it also began to use open market operations for debt management and for government borrowing.

Initially, open market operations were kept to a relatively small scale. The PBC bought and sold its own bank bills to reduce surplus liquidity in some areas and to redistribute the funds to other areas. In 1995, the PBC, in addition to using its own bills, began to use treasury bills with maturity of less than one year and policy-based financial bonds as instruments for its open market operations.[25] During 1998, the PBC carried out 36 open market operations by which it injected 70.1 billion yuan ($8.4 billion) of base money into the system.[26] In 1999, such operations increased the monetary base by 192 billion yuan ($23.1 billion) which accounted for 52% of the annual increase in the monetary base. The buying of foreign exchange by the Bank added another 101.3 billion yuan ($12.2 billion) to the monetary base, thereby creating a total of 293.3 billion yuan ($35.3 billion) – an amount equivalent to nearly 80% of the annual growth of the monetary base.[27]

In addition to these three main instruments of monetary policy, the PBC uses other requirements (such as the loan/deposit ratio and limits on legal lending) to regulate the money supply. It also uses moral suasion (extra-legal pressures) quite effectively to influence bank behavior because the main financial institutions are owned by the state.

Weaknesses of the Chinese Banking System

When compared with banks in industrialized countries or to international standards, Chinese banks have some major weaknesses. Most of the problems have been caused by years of central planning in which banks were an intermediary through which the central government carried out its national plans. As the economy has become more open, market oriented, less dependent on direction from Beijing, and more reliant on equity markets, China's banks are being compelled to transform themselves from conduits for government subsidies into financial institutions subject to international standards and market pressures. This has exposed several weakness, including: (1) relatively low capital-asset ratios, (2) declining net-worth[28] of state-owned banks, (3) insufficient provision of set-asides to cover losses on loan accounts, (4) low (less than 1%) rate of profitability, and (5) a large proportion of non-performing loans.[29]

[25] *Almanac of China's Finance and Banking, 2000*, op. cit., p. 17.

[26] *Almanac of China's Finance and Banking, 1999, op. cit.*, p. 20.

[27] *Almanac of China's Finance and Banking, 2000, op. cit.*, p. 19.

[28] Net worth = retained profits and other surpluses plus paid-up capital. This approximates the sum of Tier 1 and Tier 2 capital under the Basle Accord.

[29] The Standard & Poor's Rating group estimated the share of non-performing loans in 1997 to be around 24%, some analysts suggest the ratio as high as 40%. See Cho (1999)*, op. cit.*, p. 42.

The Governor of the PBC, Dai Xianglong, in an address in 1999, candidly pointed out that China's financial industry is not free of problems and risks. He listed the major problems as the excessively large proportion of savings in the money supply (RMB 5.4 trillion out of RMB 10.5 trillion), the high leverage ratio of the state-owned enterprises, the high ratio of non-performing loans of the state commercial banks, and the insolvency of a handful of small- and medium-sized financial institutions.[30]

As judged by Western financial rating institutions, Chinese banks have problems, although when probable government support is considered, some are considered to be strong. The Fitch ratings (which take into account probable government support) for the Bank of China and Industrial Commercial Bank of China, for example, are BBB+.[31] Moody's Bank Financial Strength ratings (which assess intrinsic strength without outside support), place the Bank of China as D- and the Industrial Commercial Bank of China as E+.[32] These ratings are low and imply that the banks are likely to require government assistance at some point.

There are two major approaches to assessing the problems with banks in China. The first is to evaluate the probability of insolvency and assess the probability and effectiveness of intervention by Beijing. The second is to evaluate the effects of the banking problems in view of China's obligations to the world community and the operation and growth of the Chinese economy.

Insolvency

Those who frame China's banking problems in terms of the probability of bankruptcy of the system or widespread banking panic view the risks as relatively low because of the Chinese government's involvement in the economy. In essence, this argument rests on the fact that a sizable proportion of the non-performing loans never were intended to be repaid anyway. They were government subsidies funneled through state-owned banks to state-owned enterprises intended to carry out the goals of the planned economy or to accomplish other state priorities, such as maintaining employment. The fact that the loans have become "non-performing" is not surprising to either the lenders or the borrowers, since most of the lenders did not expect the loans to be collectible even at the time they were first made. They were policy loans.[33]

---

[30] Dai Xianglong, Opening Address, in The Bank of International Settlements, Monetary and Economics Department, *Strengthening the Banking System in China*: *Issues and Experience*, BIS Policy Paper No.7, October 1999, p. 13.

[31] Fitch, Inc. Fitch Ratings. The ratings are A (very strong), B (strong), C (adequate), D (has weaknesses), and E (very serious problems).

[32] *Mergent Bond Record.* June 2001, pp. 608-10. Banks rated D possess adequate financial strength but may be limited by factors such as weak financial fundamentals or unstable operating environment. Banks rated E possess very weak intrinsic financial strength requiring periodic outside support or suggesting an eventual need for outside assistance.

[33] Lau (1999), *op. cit.*, pp. 73-74.

Under this framework, it can be argued that banking concepts developed for privately held commercial banks should not apply directly to China's state-owned banks. Even under the Basle Accord for estimating the capital adequacy for banks, the degree of risk that can be assigned to loans to domestic public sector entities is less that half the risk for loans to private sector borrowers.[34]

In China's case, its "Big Four" state-owned commercial banks hold some 70% of the country's financial assets with their main debtors being large enterprises that are also state-owned. The risk weights on their loans, therefore, would be expected to be smaller than 100% – the exact number depending on the government's willingness to bail them out or to let them collapse. In cases where Beijing is likely to rescue an unprofitable SOE, Chinese banks could require less capital to back loans to that enterprise and still meet the capital-asset ratio stipulated in the Basle Accord.[35] In theory, one could assign a risk probability to each SOE depending on the importance of the SOE to the government, the nature of the product produced, and the amount of employment it provides. In the face of rising unemployment and worker discontent in China, SOE employment has become an important consideration in determining whether Beijing would allow an enterprise to go under. For the government, too many unemployed workers could intensify social discontent and threaten civil order. Civil unrest, in turn, could threaten Beijing's rule, economic growth, and undermine economic reform.

The Chinese government already has intervened to replenish the capital base of the state-owned banks. In 1998, for example, Chinese authorities lowered bank reserve requirements which freed funds that the banks then used to buy special government bonds worth RMB 270 billion (U.S.$32.5 billion). With the proceeds from the sale of the bonds, the government bought subordinated debt of the commercial banks thereby providing them with more capital and enabling them to meet the required capital-asset ratios.[36] This infusion of capital amounted to some 3.5% of GDP.

The problem of policy loans in China is analogous to problems in other countries of political interference in the lending process, loans extended on the basis of relationships and connections (cronyism), and other non-financial determinants of lending that have channeled scarce financial resources to favored borrowers. In Japan, the problem with non-performing loans can be traced partly to excessively close ties among industrial groups, in South Korea to political pressures and similarly close business ties, and in Indonesia to family connections. Even though governments may be willing to bail out banks that eventually run into trouble because of such questionable lending, unless the underlying lending process is

---

[34] Basle Committee on Bank Supervision, *International Convergence of Capital Measurements and Capital Standards*, Basle, July 1988, Annex 2, p. 21.

[35] Under the Basle criteria, an 8% capital adequacy ratio means that the ratio of capital to assets must be 0.08 or higher. Loans are counted as assets, so that a loan with a risk weight of less than 100% (1.0) implies that a bank would need less capital to back that loan.

[36] Lau, Lawrence J, "The Macroeconomy and Reform of the Banking Sector in China" in the Bank of International Settlements (BIS), Monetary and Economics Department, *Strengthening the Banking System in China*: *Issues and Experience*, BIS Policy Paper No.7, October 1999, p. 73.

rationalized, a higher than expected level of non-performing loans is likely to emerge.

Profitability

Since asset quality may not reveal the true risks in Chinese banks, their rate of profitability may be a better indicator. Profit rates at less than 1% are low and seem to be falling.[37] Even these low profitability rates are probably overstated. Under Chinese accounting practices, even after debt service payments have stopped, banks are required to record accrued interest as income for two years. When loans are rolled over, the interest due is capitalized and reported as income. Pre-tax profits also are inflated by inadequate provision for non-performing loans, lack of payments for deposit insurance, and the lack of consolidated financial reports that would include losses by subsidiaries. In addition, certain subsidies provided by the Finance Ministry are customarily included as profits.[38]

In terms of profitability, the three policy banks and four state-owned banks come out the worst. Other commercial banks seem to be doing better. Still, it is doubtful that profitability should be the main criterion to assess the financial condition and economic viability in the Chinese situation. The state-owned enterprise exist to achieve other national objectives – such as sustaining employment.

Regardless of whether Chinese banks have an implicit government guarantee against insolvency, if they want to compete in the global marketplace and issue their shares on international equity markets, they eventually will have to clean up their balance sheets and operate according to international standards and market principles much like banks in other industrial nations. This will require that Chinese banks take action to reduce their huge accumulation of nonperforming loans.

Non-Performing Loans

Despite efforts by the Bank for International Settlements and other international financial organizations, countries do not all adhere to a uniform definition of non-performing loans (NPLs) or non-performing assets. Different countries have different ways of classifying NPLs and valuing foreclosed assets.[39] China currently

[37] For the four state-owned banks, Cho (1999) gives higher figures (Figure 5, p. 42) than those mentioned in Table 2 in this paper. Both estimates relate to return on assets but Figure 5 does not clearly indicate that the earnings are represented by net profits after tax which is the basis for the calculations in Table 2 in this report.

[38] See: Lardy, Nicholas R., "The Challenge of Bank Restructuring in China' in the Bank of International Settlements (BIS), Monetary and Economics Department, *Strengthening the Banking System in China*: *Issues and Experience*, BIS Policy Paper No.7, October 1999, pp. 21-30. Presented at a conference jointly organized by the Bank of International settlements and the People's Bank of China held in Beijing on March 1-2, 1999.

[39] Cooke, David and Foley, Jason, *The Role of the Asset Management Entity: An East Asian*

(continued...)

classifies loans as normal, special mention, past due (substandard), doubtful, or bad (loss). Past due loans are those for which repayment of principal is in arrears; doubtful are those for which the arrearage has exceeded one year.[40] Bad or "loss" loans are those which are two years or more overdue. This is quite a liberal definition of non-performing loans, since the United States and most industrialized countries classify any loan for which interest payment is past due for at least 90 days as non-performing.[41]

Table 2. Rate of Return on Assets of Selected Chinese Banks, 1999

Banks	*Rate of Return (%)**
Policy Banks	
China Development Bank	0.15
Export-Import Bank	0.24
Agricultural Development Bank	0.14
State-owned Commercial Banks	
Industrial and Commercial Bank of China	0.11
Agricultural Bank of China	-0.01
Bank of China	0.17
China Construction Bank	0.05
Other Commercial Banks	
Bank of Communications	0.50
CITIC Industrial Bank	0.72
China Everbright Bank	0.40
Hua Xia Bank	0.59
Minsheng Banking	0.99

39 (...continued)
Perspective, A Study of Financial Markets, Barent Group (USA), p.63, note 2.

40 Chan, Terry, *Bank Industry Risk Analysis: China,* Standard & Poor's Ratings Direct [http://www.standardpoor.com/Forum/RatingsAnalysis/FinancialInstitutions/Articles/092000_ChinaBank.html]. The *Almanac of China's Finance and Banking, 1999* mentions a five-category system of loan classification but does not describe the classification. (pp. 50-51) However, Walker mentions the five categories as normal, special mention, substandard, doubtful and loss. See Walker, John L., "Financial Reform in China' *ChinaOnline,* [http://www.chinaonline.com/commentary_analysis/instreform/cur].

41 Cooke, David and Foley, Jason, *op. cit*.

* Estimates based on the *Almanac of China's Finance and Banking, 2000*, Tables 33 to 57, pp. 252-283. The rate of return is profit before income taxes divided by total assets.

In China, the actual magnitude of the NPL problem is not known, but it is large and growing. In 2001, the Chinese government and Bank of China reported that the NPLs held by China's banks total $218 billion or 27% of total lending. As shown in **Figure 2**, this is considerably higher than even the 18.5% in Indonesia or 16.3% in Japan. A 2001 study by Ernst & Young (an accounting and business services firm), however, put the total for China's NPLs at $480 billion or 44% of total bank lending[42] which is lower than the corresponding estimates for Indonesia or Thailand but more than those for the Philippines, Japan, Malaysia, South Korea, or Taiwan. Standard & Poor's estimates that 50% of China's bank loans are nonperforming.[43] The 40 to 50% level puts China's NPL problem in the same range as other East Asian nations at the onset of the Asian financial crisis. In 1997, just before the financial crisis, the share of NPLs to total loans was about 70% for Indonesia, 35% for Korea, 30% for Malaysia, and 50% for Thailand.[44] For China's non-banking financial institutions (trusts, investment companies, and rural cooperatives), the NPL levels appear to be even higher.[45]

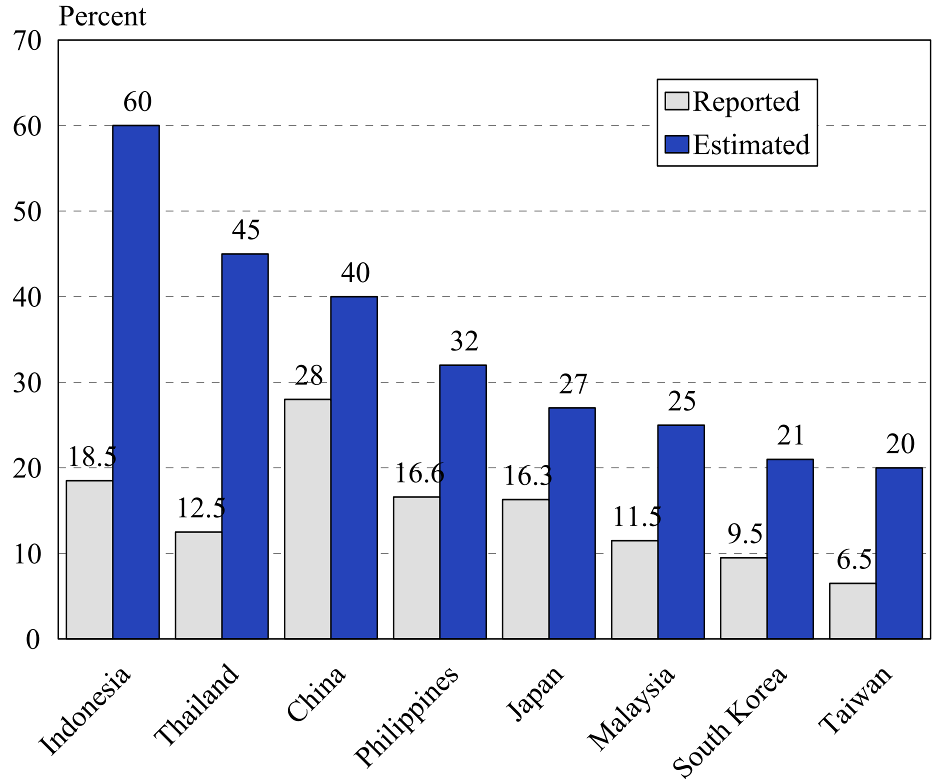
[42] Chandler, Clay. Trying to Make Good on Bad-Debt Reform; China Selling Bank Assets to Solve Problem. *Washington Post*, January 15, 2002. P. E01.

[43] Mukherji, Joydeep. View From the Silk Road: Comparing Reform in China and India. Standard and Poor's Ratings Direct, January 24, 2002.

[44] *Ibid*., Table 1, p. 4.

[45] Lardy (1999), *op. cit.*, pp. 28-9.

Figure 2. Total Non-Performing Bank Loans as a Percent of Total Bank Lending for Selected Asian Economies, 2001



Source: Respective Central Banks for Reported. Estimates by Ernst & Young

As a percent of gross domestic product, China's level of NPLs is fairly high – between 28 and 50 percent. China's total public debt, however, is relatively low at 14.6% of GDP, so adding total NPLs to total public debt gives a total of 64% or less of GDP, a figure that does not push China's total debt into atmospheric territory. In Japan, Indonesia, Canada, and Italy, total public debt exceeds 100% of GDP.[46]

If the non-performing loans of the state-owned enterprises are considered to be sovereign debt, therefore, the burden on the Chinese government would be large but not excessive relative to sovereign debt in other nations. The Chinese government also seems inclined to support its state-owned banks, should they require outside help.

The excessive levels of NPLs in China's banking system also can be viewed as a manifestation of more fundamental problems dealing with governance in the Chinese economy. That is, the bad loans have resulted primarily from the structure of how lending decisions are made and how the Chinese economy operates. Most of the nonperforming loans were made to uneconomic state-owned enterprises with

[46] According to the Bank for International Settlements, public debt as a proportion of GDP was 53% in India, 107% in Indonesia, 23% in South Korea, 65% in Malaysia, 84% in Singapore, 30% in Taiwan, 64% in Thailand, 102% in Canada, 58% in France, 60% in Germany, 110% in Italy, 131% in Japan, 41% in the UK, and 58% in the United States.

considerations of profitability and probability of repayment secondary to policy considerations or personal/political connections. As long as loans are extended for non-economic purposes, the proportion of them that eventually become nonperforming will naturally remain high.

The Chinese government has recognized the problem with so-called policy lending and has been attempting to rectify it. In 1994, Beijing created three policy banks, and, from 1995, the four state-owned commercial banks were made responsible for their profits and losses. Under the 1995 Commercial Banking Law, the government attempted to separate policy lending from commercial lending. The government ostensibly is not to intervene in the commercial banking business. Banks are to make their own lending decisions, although they cooperate with the state-owned banks in lending to certain priority sectors and enterprises. The question remains, however, of how much influence the state-owned banks have in the lending decisions of the other commercial banks.

As Chinese banks have had to cope with problems of NPLs caused partly by policy lending, they have also been confronted with corruption and purely illegal activities by banking officers. While these problems can occur in the banks of any country, the potential for them in Chinese banks appears particularly great because of the rapid transition to a market economy; relatively new oversight methods, regulations, and institutions, and a culture of corruption that the Chinese government is attempting to curb in all parts of the government. For example, in disposing of nonperforming loans at one bank, Chinese authorities discovered a RMB70 million ($8.4 million) loan used to finance the constructions of a gold and jade replica of the world's first seismograph (invented in China around 220 AD). The replica included 50 kilograms of gold, 5,000 precious rubies, sapphires, and pearls, and 8 decorative toads carved from emeralds inlaid with diamonds.[47] Recent audits of Chinese banks have uncovered so many problems with false reporting of profits and losses, irregular operations, poor-quality credit assets, and outright fraud that a staff worker of the National Auditing Office asserted that the office must ignore cases involving less than 100 million yuan ($12 million) because they already are too busy dealing with larger cases.[48]

In a case that involved the United States, in January 2002, Wang Xuebing, the head of China's Construction Bank and formerly head of the Bank of China was arrested after the U.S. Office of the Comptroller of the Currency imposed a $20 million fine, its largest ever, on the Bank of China for irregularities during Wang's time in charge of the Bank's New York office. The incident has reportedly revealed systemic problems in China's banking system in which it has no effective policing mechanism, low pay, a lack of ethics in the business culture, and an abundance of opportunities for corruption.[49]

---

[47] McGregor, Richard. Asia-Pacific: Some Priceless Tales of What China's Banks Lent Money For. *Financial Times*, March 22, 2002. (Internet Edition)

[48] China – An Audity: What Bank Auditors Face in China. ChinaOnline, February 15, 2002. (Translated from the Feb. 5, 2002, *Jingji Guancha Bao.*)

[49] Pomfret, John. In China's Market Transition, Some Pay Price; Prominent Banker's Fall (continued...)

A related question centers on the overall efficiency of the Chinese economy. When banks channel scarce resources into relatively inefficient enterprises or projects with low or non-existent returns, overall economic efficiency and the ability of Chinese businesses to compete in international markets are impaired. Currently, China is able to compete primarily on the basis of its low-cost and plentiful labor. Other Asian economies, such as South Korea and Thailand, however, have discovered that low-cost labor does not stay low-cost for long, and uneconomic investments in office-building construction, real estate ventures, and unprofitable business ventures can drag down a whole economy. An indicator of this problem is the fact that domestic credit has been growing faster than gross domestic product. The domestic credit to GDP ratio rose from .87 in 1995 to 1.17 at the end of 1999. This means that economic productivity has been lagging behind credit expansion and opens the possibility that lending growth has been for unproductive or under-productive purposes.[50]

China's banks also must become more internationally competitive. Since the country now is a member of the World Trade Organization, it has committed itself to opening its banking market to foreign banks within five years (allowing them to compete for domestic deposits). By then, if China's banks still are carrying a large burden of NPLs, they will have great difficulty competing, not only with foreign banks, but with new private Chinese banks that are being incorporated.

Attempts to Resolve the Banking Problems

The Chinese government is tackling its banking problems through several avenues. The first is by addressing the problem of non-performing loans. It also is pursuing consolidation, mergers, and closures as well as allowing in foreign banks and some privatization.

Non-Performing Loans

China is attempting to resolve the problem of nonperforming bank loans through two avenues. The first, as mentioned above, has been to place lending on a more commercial basis and to channel so-called policy loans through special policy banks. This is an attempt to reduce the probability that future loans will go sour. The second approach is to reduce the current accumulation of NPLs being carried by banks. The target for Chinese banking policy is to bring the level of non-performing loans in the state commercial banks to the level in developed countries within three to five years after China's entry into the World Trade Organization (December 2001).

Countries usually take either or a combination of three approaches to NPLs depending on how serious the problem is: (1) provide assistance to banks; (2)

---

[49] (...continued)
Illuminates Corrupt System. *Washington Post*, February 16, 2002. P. A1.

[50] Chan Terry and Wayne K. Gee. Bank Industry risk Analysis: China. Standard & Poor's *Ratings Direct*, September 20, 2000.

provide assistance to debtors; or (3) intervene directly and take over and manage the problem assets (bad loans) of banks.[51]

In the first approach, the government tries to relax various kinds of restrictions on the banks with regard to reserve requirements, loan classification, and loan-loss provisioning. For instance, during 1995 and 1996, the South Korean government relaxed the provisioning requirements for non-performing assets and for losses on securities portfolios. In 1998, the Malaysian government lowered reserve requirements and relaxed restrictions on lending to the property and equity sectors. In the Philippines, the government lowered the requirements regarding the reserves against bad loans. Such regulatory forbearance often achieves only marginal results, and in many cases, the problems worsen.

The policies of regulatory forbearance are often supplemented by financial assistance, particularly in the form of short-term liquidity assistance through the central bank, to the troubled banks. Some countries also provide long-term capital assistance in form of debentures, with options of being converted into equity in the bank. Sometimes financial assistance is geared to facilitating a merger with a healthier bank. The provision of financial assistance is often criticized on grounds of moral hazard, because such a policy ultimately protects bad bank managers against their own imprudent management. Since the decision to assist a bank in trouble is, by and large, a political decision, it is possible that the choice of a bank to be assisted is made on the basis of the political influence of the owners of a bank. This happened in Indonesia during the Asian financial crisis. Similarly, private banks in Sweden complained that financial assistance primarily went to a state-owned bank which used the resources to take market share away from private banks.

As an attempt to reduce the overhang of NPLs, the government may try to facilitate or mediate debt restructuring negotiations. Some countries establish corporate debt restructuring agencies in order to encourage voluntary meetings between creditors and debtors and to obtain independent assessments of the viability and the worth of the indebted company. Sometimes, debtors are given financial assistance to meet their increased costs from rising interest rates or losses arising from a devalued currency. Several East Asian countries, such as Indonesia, South Korea, Malaysia, the Philippines, and Thailand have used the debt restructuring agency approach.[52]

A much more interventionist approach requires the government to take over the troubled bank and run it until a permanent solution is found. The failing bank may be kept under conservatorship, with a new management running the operations. Sometimes, a "bridge bank" is created to takeover the deposits and assets and for running the operation of the failing bank for a short-period. In some cases the government decides to intervene informally. In this case, the government does not take control of the failing bank but only works with the bank management to find a

[51] Cooke, David and Jason Foley, *The Role of the Asset Management Entity: An East Asian Perspective*, p. 9-10.

[52] *Ibid.,* p. 11.

solution to the problems facing the bank. The interventionist approach may sometimes involve liquidation of an insolvent bank.

Asset Management Companies

The interventionist approach often involves the creation of Asset Management Companies (AMCs) to acquire, manage, and recover illiquid or non-performing assets of a financial institution. The AMCs can be either bank-based or government-based. The latter is used when the problem is serious and the bank management is not able to run properly a bank-based AMC. In a government-based AMC, the government takes over the non-performing assets from a bank and replaces them with government bonds. The non-performing assets belong to the government, but they are managed by the AMCs. The AMCs strategy is generally linked to bank restructuring and recapitalization. In Asia, Japan, South Korea, Malaysia, Thailand, and Indonesia have established AMCs in some form.

China established four asset management companies in 1999, beginning with China Xinda Assets Management Company on April 20. It was established with registered capital of RMB 10 billion ($1.2 billion) wholly provided by China's Ministry of Finance. Three other AMCs, China Oriental Assets Management Company, China Greatwall Assets Management Company, and China Huarong Assets Management Company, also each began with registered capital of RMB 10 billion injected by the Ministry of Finance.[53]

According to the *Almanac of China's Finance and Banking*, the main functions of the AMCs include the following: (1) issuance of bonds, (2) borrowing from financial institutions and from the People's Bank of China, (3) purchase and management of non-performing loans of commercial banks, (4) recovery of overdue debts and replacement, (5) transfer and sale of assets, (6) restructuring of debts and reorganization of enterprises, (7) conversion of debt into equity and temporarily holding of shares, (8) underwriting bonds and shares, (9) direct investment, (10) securitization of assets, and (11) auditing and liquidation of enterprises.

Table 3. China's Asset Management Companies (AMCs) and Matched State-Owned Banks

Asset Management Companies	Registered Capital	State-owned Banks
China Great Wall AMC	RMB 10 billion	Agricultural Bank of China
China Huarong AMC	RMB 10 billion	Industrial and Commercial Bank of China
China Xinda AMC	RMB 10 billion	China Construction Bank and China Development Bank
China Oriental AMC	RMB 10 billion	Bank of China

Source: *Almanac of China's Finance and Banking, 2000.*

[53] *Almanac of China's Finance and Banking, 2000, op. cit.*, pp. 33-36.

The AMCs are to take over the following categories of NPLs from the state-owned banks: (1) loans made before 1995 and overdue for more than one year by the end of 1998, (2) bad loans of state-owned banks at the end of September 1999, (3) loans extended after 1995 which are to be converted into equity, and (4) part of the NPLs advanced by the China Development Bank.[54]

The way the AMCs operate is that bank assets (loans) classified as "normal" and "special mention" are to remain with the bank. The "substandard" (past due) and "doubtful" loans are to be transferred to the AMC, and the assets classified as "bad" (loss) are to be written off by the bank. The AMCs issue bonds to their counterpart state banks in exchange for their NPLs at face value.

As of December 2001, there were approximately $170 billion (face value) in NPLs between the banks and the AMCs. This amounted to about 15% of GDP. One of the major ways of disposing off the NPAs has been debt-equity swaps. The AMCs approach a state-owned enterprise to provide equity to the AMC in exchange for the debt the state-owned enterprise owed to the state-owned commercial bank. Once having received the equity, the AMC could retain the equity for a time or sell it.[55] By the end of 1999 the State Economic and Trade Commission (SETC) had recommended 600 enterprises as potential for the debt-equity swaps, out of which framework agreements were reached with 73 enterprises for RMB 95.2 billion yuan.[56] For example, by August 2000, China Huarong AMC had acquired NPLs totaling RMB 407.7 billion related to 72,000 borrowers nationwide in China.

According to the accounting firm, Ernst & Young, the AMCs have gotten off to a good start in collecting and resolving their NPLs. Early results indicate that Chinese borrowers prefer to negotiate discounted payoffs in favor of protracted litigation. The AMCs recovered as much as 50% of outstanding principal during the first 18 months of operations.[57]

The AMCs have been seeking foreign investors to purchase portfolios of NPLs. Xinda AMC has reached agreements with two foreign companies in setting up joint-ventures for handling NPLs. China Huarong AMC has announced two portfolio sales of NPLs to foreign investors. In the first, announced on November 29, 2001, China Huarong Asset Management Corporation agreed to sell a portfolio of NPLs totaling RMB10.8 billion (about $1.3 billion) to an international consortium led by Morgan Stanley including Lehman Brothers, Salomon Smith Barney, Zhongjin Fengde, and KTH Capital Management, Ltd. The portfolio contained loans by 254 borrowers in 18 cities and provinces throughout China.[58] In the second, announced on December

---

[54] *Almanac of China's Finance and Banking, 2000, op. cit.*, pp. 36.

[55] Walker, John L., "Financial Reform in China." ChinaOnline, [http://www.chinaonline.com/]

[56] *Ibid.*, pp.37-8.

[57] Ernst & Young. *Non-Performing Loan Report: Asia 2002*, Executive Summary. November 2001. P. 5.

[58] Ernst & Young. China Announces Winning Bid for First Ever Nonperforming Loan Sale, (continued...)

20, 2001, China Huarong AMC stated that it had sold a portfolio of NPLs with a face value of approximately RMB 2 billion (US$240 million) to a Goldman Sachs sponsored investment fund. This structured transaction was priced at 10% of the outstanding principal balance plus a 50% participation to Huarong after the investor receives a preferred return.[59]

The sales to foreign investors carry some uncertainties. What will local authorities do if a foreign investor insists on laying off surplus labor, an act that may be unacceptable to authorities concerned about rising unemployment and whose consent is needed in such lay offs. The other uncertainty concerns the implementation of court verdicts. It is common experience in China that if a foreign company is involved in a dispute with a local company and the court verdict goes in favor of the foreign company, the local enforcement officials delay acting on the judgement. Reportedly, the Great Wall AMC had $3.6 billion indictment-related assets, a little more than half of which were in doubt as a result of failure to implement a court verdict.[60]

While the AMCs appear to be off to a reasonable start, they also appear to be underfunded – initial capital of only RMB 40 billion ($4.8 billion) for all four AMCs to handle NPLs totaling as much as $480 billion.

Consolidation, Mergers and Closures

In the aftermath of the 1997-99 Asian financial crisis, Asian governments have been encouraging bank mergers to strengthen their capital adequacy and financial viability. In China's case, it dodged the worst effects the financial crisis, and the scale of bank failures and consolidations there have remained at a relatively low level. The People's Bank of China, however, has consolidated some small- and medium-sized trusts and investment companies exposed to high risks. It also closed down 1,600 insolvent urban and rural cooperatives.[61] The PBC also encouraged the state-owned commercial banks to reduce the numbers of their branches, particularly by merging municipal and provincial branches. The government has also attempted several times to consolidate International Trust and Investment Companies (ITIC) that had proliferated in the 1980s to meet the growing demand for foreign funds and to act as intermediaries between foreign creditors and domestic enterprises in need of funds. Even though licensed to conduct foreign business, including raising foreign capital, some of these companies also conducted banking business in

---

[58] (...continued)
Financial Advisor Ernst & Young Sees Transaction Opening Door to Greater Global Investor Interest in NPLs. News Release. Beijing, China, November 29, 2001.

[59] Ernst & Young. As Winter Sets In, NPL Sales Start to Snowball; Huarong Completes Second Sale of Non-performing Loans to Goldman Sachs Investment Fund. News Release. Beijing, December 20, 2001.

[60] Wang Huidong, 'Debt-to-Equity Swaps Trade SOEs Out of Plight,' *Beijing China Daily (Business Week Supplement)* (Internet version) in English (FBIS transcribed)

[61] *Almanac of China's Finance and Banking, 2000, op. cit.*, p. 32.

disguise.[62] Their numbers were brought down from 620 in 1982 to only 239 by the end of 1998. From 1993 the ITICs were asked to sever their connections with the banks.[63]

Since 1997 four medium-sized financial institutions, Hunan Development Bank, China Agribusiness International Trust and Investment Company (AITIC), China Venture Technology Investment and Trust Company (VITIC) and Guangdong International Trust and Investment Company (GITIC), have been closed.[64] The GITIC was a high profile operation with over 200 subsidiaries. It was China's best known raiser of funds on foreign markets. However, as a result of imprudent investment policies, inadequate supervision, and various alleged illegalities, it had amassed a liability of RMB 36.2 billion, while its assets did not total more than RMB 21.5 billion.

When GITIC went insolvent, almost half the claims were by foreign creditors. Since the foreign debts were not approved by the State Administration of Foreign exchange, they were technically illegal, and the central government refused to accept any liability. Even in the case of registered debts which were legal, the state decided to treat them like domestic debts to be paid back out of realized resources after liquidation. In the absence of the government decision to honor the registered foreign debts in their entirety, foreign creditors had to bear considerable losses.[65] The Chinese government's refusal to bail out GITIC and to fully reimburse foreign creditors had mixed consequences; in the short-run, it generated a lack of confidence among foreign creditors. However, it also confirmed the government's determination to reform the Chinese financial system, thus having a positive long-term consequence.

The only major acquisition and merger of a banking institution was that of China Investment Bank with the Everbright Bank of China.[66]

Foreign Banks

Gradually, China is allowing foreign banks to operate domestically in order to increase competition in the financial sector and to improve efficiency by introducing modern banking practices. It is also hoped that they might (by providing financial services to foreign businesses) serve as an additional inducement for foreign investment.[67] In Beijing, however, there has been a lurking fear that nascent

---

[62] Jun, Zhu, 'Closure of Financial Institution in China,' the Bank of International Settlements (BIS), Monetary and Economics Department, *Strengthening the Banking System in China*: *Issues and Experience*, BIS Policy Paper No.7, October 1999, p. 309**.**

[63] *Ibid.*, pp.311-2.

[64] *Ibid.*, pp. 311-2.

[65] Ibid., pp. 313-4.

[66] *Almanac of China's Finance and Banking, 2000, op. cit.*, pp. 31-32., 114.

[67] Chen, Ji and Thomas, Stephen C., "Banking on China," *The China Business Review,* U.S.-China Business Council, November 3, 1999.

(continued...)

domestic banks would not be able to compete with well-capitalized foreign banks with their access to world-wide financial markets and that foreign banks might take disproportionate control over the domestic economy. Such fears have not been uncommon in other countries – many of whom impose restrictions on foreign ownership of banks.[68]

In 1979, after much internal debate, foreign banks were allowed to begin to operate again in China. The first was the Export-Import Bank of Japan which was allowed to open a representative office. In 1982, Hong Kong's Nanyang Commercial Bank also opened a branch. From 1994 foreign banks were allowed to conduct foreign currency business for foreign and overseas Chinese enterprises, individuals, and for Chinese SOEs needing foreign currency. Foreign banks were not allowed to deal in renminbi except on an experimental basis in the Pudong district of Shanghai and in Shenzhen (the city adjoining Hong Kong).

By the end of 1999, the number of financial institutions established in China by foreign-funded banks and enterprise groups totaled 176, including 20 locally registered entities (7 joint-venture banks, 6 wholly foreign funded banks and 7 foreign finance corporations) and 156 branches of foreign-funded banks. By the end of 1999, 25 foreign-funded banks were allowed to conduct renminbi business, 19 in Shanghai and 6 in Shenzhen.[69] From 1999, foreign banks are permitted to operate in any Chinese city, and geographic restrictions on doing RMB business were relaxed. The six foreign banks authorized to conduct local-currency business in Shenzhen can now have clients from Guangdong and Hunan provinces and the Guangxi Zhuang Autonomous Region. The nineteen foreign banks in Shanghai can, within certain limitations, undertake local-currency business with clients in Jiangsu and Zhejiang provinces.[70]

Some Chinese banks also are allowing foreign investors to secure a stake in their operations by acquiring their shares. London's HSBC Holdings became the first commercial bank to secure a stake in a mainland Chinese bank when it acquired an 8% share of the Bank of Shanghai in December 2001. The investment arm of the World Bank, the International Finance Corporation, also raised its stake in the Bank from 5 to 7%. Previously, the governor of the PBC stated that foreign investment in the country's shareholding banks would be welcomed up to a 25% level. Other Chinese banks are preparing to list their shares on stock exchanges with the expectation that foreigners will invest in their operations.[71]

---

[67] (...continued)
[http://www.chinabusinessreview.com/9911/chen.html]

[68] For instance, no one foreign bank can have more than 10% of ownership in a Canadian or Australian bank. Denmark limits the ownership at 30 % and south Africa at 50%.

[69] *Almanac of China's Finance and Banking, 2000, op. cit.*, pp. 134-5.

[70] Chen and Thomas (1999), *op. cit.*

[71] China: Banks Open Up to Foreign Investment. Janet Matthews Information Services. Quest Economics Database. February 15, 2002. P. 12.

As part of its accession agreement to the World Trade Organization, China agreed to open the local currency business to foreign banks within five years of accession (by December 2006) and to allow foreign banks to conduct consumer banking business. These actions certainly will intensify competition with domestic banks. Chinese authorities are proceeding with financial reforms partly to meet this challenge.

What seems apparent is that Chinese banks are ill prepared to compete with foreign financial institutions in head-to-head competition without government help and some protection. Still, even though some analysts argue that opening the banking sector will cause many of them to fail, Nicolas Lardy, a leading expert on the Chinese economy, thinks that by 2007, the market share of foreign banks is unlikely to rise above 2 or 3 percent.[72] Standard & Poor's, a financial rating agency, also has stated that the heightened competitive pressures on Chinese banks after WTO accession may be mitigated by their established corporate and government ties, the underdeveloped domestic market, and other structural barriers.[73] Existing Chinese banks already have an extensive network of branches, and Beijing seems to be able to find ways to protect its favored industries.

Privatization

The role of the state-owned commercial banks (SOCBs) has been on the decline in most emerging economies. During the 1990s, the share of the SOCBs in total bank assets in Central Europe declined from nearly half to about 20% and in Latin America to only 15%. In Indonesia, South Korea and Thailand, their share has increased because of temporary nationalizations resulting from the Asian financial crisis.[74]

In China, the share of SOCBs, so far, remains undiminished. Beijing apparently has no immediate plans for privatization of the state-owned banks. However, the governor of the People's Bank of China indicated that the reform of these banks will proceed in three stages: first, operation and management systems are to be ungraded; second, ownership of the banks is to be opened to domestic enterprises and individuals as well as foreigners, but the state will keep a controlling share, and third, the banks are to be listed on the stock exchange. According to the Governor the whole process may take five or more years.[75]

---

[72] Lardy, Nicolas R. *Integrating China into the Global Economy* (Washington, Brookings Institution, 2002).

[73] Impact of WTO Pact on Chinese Banks May be Muted. *Standard & Poor's CreditWire*, March 16, 2000.

[74] Hawkins and Mihaljek (2001), *op. cit*, pp. 7-16.

[75] Xu, Han, 'The PBOC Governor Dai Xianglong Says State Commercial Banks Will be reformed in Three Phases; Foreign Investors Encouraged to Buy shares of Commercial Banks,' in *Beijing Jingji Ribao October 2, 2001.* (Internet Version) Translated by FBIS CPP 2001/1003000042.1

China, however, already has many private lending institutions. These, along with foreign financial institutions, are likely to continue to increase their presence in the Chinese economy.

How Vulnerable is China to an Asian-Type Financial Crisis?

If China's banking problems could all be contained within the country, they would not be a major concern to the Western world. Financial turmoil in China, however, could spill over into the world financial system through two major channels. The first is through contagion in the same manner that the failure of several finance companies in Thailand ignited the 1997-99 Asian financial crisis. The second is through the political turmoil that could ensue should the Chinese economy fail. Indonesia and Argentina are two obvious examples of what can happen to society and political order when a country's financial system collapses. With a quarter of the world's population living in China, economic and political turmoil, such as occurred during China's Great Leap Forward or Cultural Revolution, has a direct impact on the rest of the world. In this section, we attempt to evaluate how vulnerable China is to an Asian-type financial crisis.

Broadly, two sets of explanations are put forward for the Asian financial crisis.[76] The first emphasizes weaknesses in the financial systems based on imprudent short-term international borrowing to fund long-term lending to fund investments of questionable value. The second attributes the crisis to the "contagion effect and financial panic" that was exacerbated by the herding behavior of market participants. Creditors and investors with short-term claims withdrew suddenly from markets or refused to roll over outstanding payment obligations in several countries simultaneously. Massive capital outflows undermined the Asian currencies which had been on fixed pegs causing drastic currency depreciation, soaring interest rates, and shortages of foreign exchange.

The Chinese financial system has some of the same systemic weaknesses of its Asian counterparts. Bank supervision, though gradually being tightened by the People's Bank of China, is lax by modern banking standards. Particularly, in the case of the state-owned commercial banks, political rather than economic and commercial considerations play an important role in decision making with regard to loans. Risk analysis is in its infancy, and bank supervisors rarely possess adequate training for the duties they are required to perform. The banks have a high proportion of non-performing loans, and for state-owned banks, a low rate of return on assets and net worth that is virtually negative.

On the other hand, China has some distinct advantages over its neighbors. Even during the Asian financial crisis, China achieved relatively high rates of growth which have continued into 2002. As indicated in **Table 4**, however, other Asian

---

[76] Asian Development Bank, "The Asian Crisis and Lessons for Macroeconomic and Financial Management" (Manila: Asian Development Bank, 2001). [http://www.adb.org/Documents/Speeches/1999/ms1999033.asp]

nations also had high growth rates in 1996-97 leading into the financial crisis. High growth, in itself, is not a sufficient condition to keep a nation from facing financial crisis. In 2001, moreover, many of the Asian nations registered recessionary growth rates and recovery from the global economic slowdown is occurring only haltingly. While China's continued economic growth bodes well for its ability to avoid an immediate financial crisis, the experience with other Asian nations shows that high growth rates can drop precipitously, particularly if they are based on uneconomic investments and government deficit spending.

The macroeconomic weakness that precipitated the Asian financial crisis was the rising current account deficit in the troubled economies of Thailand, South Korea, and Indonesia. If a nation's deficit on current account reaches 4% of GDP, that is a warning signal that financial danger lies ahead. As shown in **Table 4**, in China's case, its current account balance at $20 to $30 billion remains positive at 2 to 3 percent of GDP. As long as this account remains in surplus, it is unlikely that China will experience a foreign exchange shortage such as occurred in Thailand, Indonesia, and South Korea. China's current account surplus, however, is shrinking, and may turn into a small deficit by 2004. This deficit may continue through the decade.[77]

Even if a nation runs a current account deficit, it can finance it through foreign capital flows into the country. This foreign investment can take the form of foreign direct investment which goes into purchasing controlling shares of companies or establishing subsidiaries or joint ventures. It also can take the form of portfolio investment which goes primarily into non-controlling equity shares or securities. In the case of China, foreign direct investment (FDI) has remained high at about $40 billion per year – even during the Asian financial crisis. Since this source of foreign exchange is for direct investments – much of it going for actual plant and equipment, it is much less volatile than portfolio investment which can flee a country as quickly as it entered.

Table 4. Growth and Current Account Balances, 1996-97, 1999-2001

Country or region	Real GDP				Current Account Balance			
	1996-97	1999	2000	2001	1996-97	1999	2000	2001
	Annual Percentage Change				As a Percentage of GDP			
China	9.2	7.1	8.1	7.3	2.2	1.7	3.1	2.7
Hong Kong	4.8	3.0	10.5	-0.3	-2.1	5.6	5.0	3.0
S. Korea	5.8	10.9	8.6	2.5	-3.1	6.0	2.5	2.1
Taiwan	6.4	5.4	5.9	-2.0	3.2	2.9	2.9	5.6

[77] DRI-WEFA forecast.

Country or region	Real GDP				Current Account Balance			
	1996-97	1999	2000	2001	1996-97	1999	2000	2001
Indonesia	6.3	0.8	4.8	3.3	-2.9	4.1	5.2	3.0
Malaysia	8.7	6.1	8.3	-0.4	-5.0	16.8	13.3	6.1
Philippines	5.5	3.4	4.0	2.3	-5.1	9.5	12.1	5.1
Thailand	5.1	4.2	4.4	1.0	-5.1	10.2	7.5	4.2

Source: DRI-WEFA, Inc.

This high level of FDI into China has been a clear endorsement of foreign investors regarding the health of the Chinese economy. China has been the largest recipient of FDI in East Asia – 50% more than the FDI received by all the East Asian countries included in **Table 5** (except for Hong Kong which is now part of China).

The primary method by which a country defends against a run on its currency is by selling foreign exchange from its reserves and buying the domestic currency that is being dumped on international markets. For China, its foreign exchange reserves (minus gold) have risen from $75 billion in 1995, to $158 billion in 1999, and further to $212 billion in 2001. This is a huge war chest that can be used to counter sudden downward pressures on the renminbi exchange rate. In the Asian financial crisis, countries with large foreign exchange reserves, as was the case with China and Hong Kong, were able to keep their exchange rates stable, or in Singapore's case, suffered only modest depreciation. Countries with insufficient reserves experienced severe depreciation of their currencies because they did not have the financial resources to defend them.[78] For China, the current $200 billion plus in foreign exchange reserves is large compared with the reserves of other countries. In 2001, Indonesia had reserves of $25 billion, Malaysia $33 billion, the Philippines $13 billion, Singapore $74 billion, and South Korea $97 billion.

Table 5. Inflow of Foreign Direct Investment into Selected Asian Countries, 1985-2000

($billion)

Country	1985-95*	1997	1998	1999	2000
China	11.7	44.2	43.8	40.3	40.8
Hong Kong	4.0	11.4	14.8	24.6	64.4
Indonesia	1.4	4.7	-0.4	-2.7	-4.6

[78] Hawkins, John and Turner, Phillip, *Managing Foreign debt and Liquidity risks In Emerging Economies: An Overview* (Basle: BIS, 1999), p. 29.

Country	**1985-95***	**1997**	**1998**	**1999**	**2000**
Korea	0.8	2.8	5.4	10.6	10.2
Malaysia	2.9	6.5	2.7	3.5	5.5
Philippines	0.7	1.2	1.8	0.7	1.5
Singapore	4.3	13.0	6.3	7.2	6.4
Taiwan	1.0	2.2	0.2	2.9	4.9
Thailand	1.4	3.6	5.1	3.6	2.4

* Average annual inflow.
Source: UNCTAD, *World Investment Report, 2001*: *Promoting Linkages*. (Geneva: UNCTAD, 2001.) Relevant country fact sheets.

In addition to the use of foreign exchange reserves to counter speculators and investors who are fleeing a currency in trouble, exchange reserves also may become necessary to repay loans denominated in dollars or other international currency. In the years leading up to the Asian financial crisis, borrowers were obtaining short-term international loans to fund long-term domestic lending. As long as international banks were willing to roll over the loans as they came due, the borrowers had no problem managing them. Many of the borrowers were quasi-national banks whose debt was considered semi-sovereign and, hence, low risk. As financial institutions in the borrowing nations began to face insolvency and their short-term debts fell due, however, skittish lenders refused to roll over their loans. This precipitated a crisis as investors and lenders stampeded out of Thailand, Malaysia, Indonesia, the Philippines, and South Korea. One indicator of risk for a nation, therefore, is the extent of its borrowing in foreign currencies that is short-term (less than one year).

In this respect, the Chinese situation has been significantly different from its neighbors. As indicated in **Table 6**, at the end of September 2001, $21.8 billion out of total foreign currency debt to international banks of $54.4 billion (40.1%) was short-term. This amounts to about 10% of China's foreign exchange reserves and about the level of annual current account surplus – which is declining. In South Korea's case, in 1997, at the onset of the Asian financial crisis, as much as 60% of its borrowing was short-term. For China, moreover, reliance on short-term debt has been rising.

Table 6. International Banks' Claims on Selected Asian Countries, End-September 2001
(Billion U.S. Dollars)

	Total Foreign Claims in Non-Local Currencies	Distribution by Maturity		
		Up to and Including One Year	Over One Year	Unallocated
China	54.4	21.8	19.1	13.5
Indonesia	36.5	18.2	16.7	1.6
Malaysia	20.3	6.9	11.9	2.4
Philippines	15.7	5.8	8.7	1.2
Korea, Republic	54.1	32.0	13.4	8.6
Taiwan	15.4	10.4	3.2	1.8
Thailand	23.9	9.5	9.9	4.5

Source: BIS, *BIS International Consolidated Banking Statistics for the Second Quarter of 2001,* Press Release, 29 October, 2001, Table 4, p. 7.

A factor in lessening the likelihood that China will suffer from an international liquidity crisis is that its RMB is non-convertible on capital account. That implies that RMB cannot be converted into foreign exchange for capital account transactions. In other words, RMB cannot be converted into foreign exchange without government permission for use in international transactions related to foreign direct and portfolio investments, bank loans, and deposits. (The RMB is convertible for current account or trade transactions.)[79]

Another factor for stability in the Chinese banking system is that it allows citizens to hold foreign currency accounts. The banking system, therefore, is able to keep foreign exchange within the system and thereby, "domesticate" capital flight.[80] Citizens with dollars, for example, can simply deposit them in their Chinese banking accounts rather than use a Swiss or other international account. According to the People's Bank of China, the foreign exchange deposits in the Chinese banking system amounted to $113.7 billion at the end of June 2000.[81] This sum alone was almost twice as much as the claims of international banks on China.

---

[79] Of course, investors or businesses in need of foreign exchange for capital account transactions can circumvent restrictions by disguising foreign exchange for capital account transactions as a current account transaction.

[80] McCauley, Robert N., and Y.K. Mo. "Foreign Currency Deposits of Firms and Individuals with Banks in China," *International Banking and Financial Market Developments, BIS Quarterly Review,* August 2000, 35.

[81] *Ibid.*, p. 37.

The risk of an external liquidity crisis for China, therefore, currently seems low but might arise if the world-wide recession and import liberalization required by entry into the World Trade Organization pushes the country's current account substantially into deficit. A prolonged recession also could reduce the inflow of foreign capital. China, therefore, would have to depend on its foreign exchange reserves which now are ample but cannot last forever.

For China, a domestic liquidity crisis or credit crunch is less likely because the government is continuing to guarantee the bank deposits, particularly, in the state-owned banks. As long as the economy is growing at a reasonable rate, Chinese depositors have no reason to loose confidence in the banking system. Equity and bond markets are still relatively underdeveloped and not providing alternatives to bank deposits for the bulk of the population. China, moreover, has a high rate of savings – roughly 35% of GDP. The prospect that households will be required to pay for education and health further increase the incentive for households to save more. The prospect of buying one's own house – which the government is promoting – may provide further incentives to save more. In fact, the regular flow of deposits into China's financial institutions is rising at rates higher than the rate of growth of GDP. Despite the various problems of Chinese banks, their deposits continue to grow. The Chinese banking system is, by no means, illiquid.