Current Problems and Reforms of Chinese Financial System

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Abstract

China's non-performing loans were as high as 35 percent of state banks' total loans, or about RMB 3,549 billion (about 40 percent of its GDP) in 2000. The adequacy ratios of the four state banks were only between 1.4 percent to 4.6 percent in September 2000. Moreover, non-bank financial institutions as a group as early as 1996 had non-performing assets equal to 50 percent of their total assets. By Western accounting standards, China's most financial institutions are insolvent. Be conventional standards for measuring financial sector robustness, China is past the point at which a systemic banking crisis might be expected.

China faces enormous risks delaying the state bank reforms due to increasing capital account leaks, increasing large proportion of household deposits in banks' total liabilities, and gradual structural shift of Chinese saving behavior. China needs to resolutely address the financial reforms soon to avoid a financial crisis, which will lead to a broad anti-regime coalition against the Chinese government. Nevertheless, China faces enormous difficulties. First, the 2000 Chinese official estimate puts the financial cost of restructuring the state banks at RMB 2,260 billion ($273 billion), or close to 30 percent of GDP. Second, the current AMC scheme is fraught with difficulties. Finally, the required financial sector reforms are closely interlinked with many other reforms such that a sequential or partial approach will not be effective.

Keywords: Chinese financial system, Chinese financial reforms, state-owned commercial banks, non-performing loans, asset management companies, capital adequacy ratios, financial crisis.

The Inefficiency and Non-Performing Loans of State-owned Banks

As of 1996, China's four state-owned commercial banks (SOCB) together account for more than 90 percent of bank assets and two-thirds of financial assets. At the end of 2000, four SOCBs still account for over 70 percent of total banking system assets. Nevertheless, these four banks are very inefficient. The rate of return on assets of China's four largest state-owned banks fell from 1.4 percent in 1985 to only 0.2 percent in 1997. In addition, there is a mountain of non-performing loans [*buliang daikuan*, NPLs], including past due loans, doubtful loans, and bad debt, for these four state banks. According to Dai Xianglong, governor of the People's Bank of China, NPLs as a share of their total loans increased from 20 percent at year-end 1994 to 22 percent at year-end 1995, and then to 25 percent at year-end 1997. The 2000 estimate by the research department of China's central bank put the aggregate NPL problem at about RMB 2,236 billion ($270 billion) or close to 30 percent of GDP. In March 2001, Dai Xianglong admitted that, without transferring NPLs to the assets management companies (AMCs), China's NPLs were as high as 35 percent of state banks' total loans, or about RMB 3,549 billion (about 40 percent of its GDP) in 2000.[1] And, there are questions about how lax China's definition of NPLs is in the first place.

In May 2001, president of Bank of China, which is the most prestigious and third largest of the state-owned commercial banks, said in public that the bank's NPLs amounted to 28.8 percent of assets, after 20 percent of the bank's loan portfolio had been transferred to the Dongfang asset management company.[2] According to Pieter Bottelier, a professor at Johns Hopkins University School of Advanced International Studies, the aggregate stock of remaining NPLs in four SOCBs plus those transferred to the AMCs may range from RMB 4,000 to 4,500 billion (45-50 percent of GDP) at the end of 2000.[3]

Moreover, non-bank financial institutions as a group, which includes not only trust and investment companies but also credit cooperatives, finance companies, and leasing companies, as early as 1996 had non-performing assets equal to 50 percent of their total assets. Over the first half of 1999 the reported capital of rural credit cooperatives plunged from RMB 34,370 million

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[1] Nicholas R Lardy, "When Will China's Financial System Meet China's Needs?," presented at the Conference on Policy Reform in China, Center for Research on Economic Development and Policy Reform, Stanford University, November 18-20, 1999, p. 6. Nicholas R. Lardy, "The Challenge of Bank Restructuring in China," in Bank of International Settlements (ed.), *Strengthening the Banking System in China: Issues and Experience* (Basel, Switzerland: Bank of International Settlements, 1999), p. 26. Shalendra D. Sharma, "Weathering the Asian Financial Crisis: China's Economic Strengths, Weaknesses, and Survivability," *Issues & Studies*, vol. 36, no. 6 (November/December 2000), p. 100. Pieter Bottelier, "The Impact of WTO-Membership on China's Domestic Economy," speech at Johns Hopkins University School of Advanced International Studies, China Forum, November 14, 2000, pp. 6-7. Zhang-rong Kang, "Dai Xianglong: Commercial Banks' NPLs Account for 25%," *Gongshang Shibao* [Commerce Times], March 27, 2001.

[2] James Kynge, "Governor Liu Increases Pressure to Clean Out the Stables," *Financial Times*, May 16, 2001, p. 30.

[3] Pieter Bottelier, "China's Domestic Debts: Will They Interfere with Financial Sector Liberalization and WTO Commitments? Issues and Strategies," Discussion paper for Wilton Park Conference #654 on Economic and Enterprise Reform in China: the Challenges for Government and Business, November 5-8, 2001, pp. 5-6.

to a *negative* RMB 7,480 million. The risks that this insolvency poses are substantial since rural citizens have more than RMB one trillion deposited in savings accounts in these institutions.[4] Equally alarming is that, according to economist Ma Jun by the end of 1997, about 90 percent of the trust and investment corporations in China were effectively insolvent.[5]

China's four major banks as a group have also a negative net worth and thus are insolvent by Western accounting standards. For example, the total net worth of these banks at year-end 1995, including paid-in capital, surpluses, and retained profits, stood at only RMB 269 billion, while the 1995 state bank NPLs was about RMB 867 billion (22 percent of total loans). In addition, state bank capital adequacy ratios fell rapidly from 8.8 percent of assets in 1989 to only 4.0 percent of assets in 1996, far less than the 8 percent Basle standard Chinese central bank adopted in 1994 and subsequently incorporated into the Chinese Commercial Bank Law. Even after a RMB 270 billion capital injection in 1998, the adequacy ratios of the four banks were between 1.44 percent to 4.57 percent [with the exception of the 8.5 percent of the Bank of China] in September 2000.[6]

Beijing's Task and Difficulties

In the lesson of the 1980s and 1990s, a large number of countries experienced systemic bank problems when NPLs, net of provision, reach 15 percent of total loans. For example, the share of NPLs in banking lending portfolios was 15 percent in Thailand and 16 percent in Korea just before the onset of their financial crises in 1997. China's state bank NPLs appear to have reached at least 25 percent between 1997 and 2001. By conventional standards for measuring financial sector robustness, China is past the point at which a systemic banking crisis might be expected.[7]

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[4] Nicholas R Lardy, "When Will China's Financial System Meet China's Needs?," presented at the Conference on Policy Reform in China, Center for Research on Economic Development and Policy Reform, Stanford University, November 18-20, 1999, pp. 7-8.

[5] Jun Ma, *The Chinese Economy in the 1990s* (New York: St. Martin's Press, 2000), pp. 64-65.

[6] Nicholas R. Lardy, *China's Unfinished Economic Revolution* (Washington, D.C.: Brookings Institution Press, 1998), p. 119. Nicholas R Lardy, "When Will China's Financial System Meet China's Needs?," presented at the Conference on Policy Reform in China, Center for Research on Economic Development and Policy Reform, Stanford University, November 18-20, 1999, pp. 6-7. Haocheng Gong and Guoqing Dai (eds.), *2000 Zhongguo Jinrong Fazhan Baogao* [2000 China's Financial Development Report] (Shanghai: Shanghai Caijin Daxue Chubanshe, 2000), p. 87. Meifang Deng, "PRC Academic on Development, Problems of China's Banking Industry" (in Chinese), Beijing Zhongguo Xinwen She, October 30, 2001, in FBIS-CHI-2001-1030.

[7] Nicholas R. Lardy, "Sources of Macro Economic Instability in China," in David Shambaugh (ed.), *Is China Unstable? Assessing the Factors* (Washington D.C.: George Washington University, 1998), p. 55. Helmut Reisen, "Domestic Causes of Currency Crises: Policy Lessons for Crisis Avoidance," OECD Development Centre, Technical Papers, no. 136, June 1998, p. 23.

Although technically insolvent, China's state banks remain liquid because of their enormous and still rapidly growing private deposit base, reflecting China's extraordinarily high savings rate. A financial crisis has been avoided only because households continue to add enormous amounts of funds to their savings accounts in the banks. However, they are essentially participants in a shell game that will last only as long as people believe that they can access their money, that they have no real investment alternatives, and that they are not confronted with galloping inflation. In the long run, this situation is not sustainable.

China faces enormous risks delaying the state bank reforms. First, China's capital account leaks and the leaks will almost inevitably become larger. This places enormous dynamic pressure on China's financial reforms.[8] Second, any growth slowdown is likely to expose dramatically the underlying weakness of the domestic financial system. Slower growth would cut into the operation profits of many SOEs, and thus undermine further the financial position of China's major banks.

Third, the proportion of household deposits in banks' total liabilities increased sharply from 8 percent in 1978 to near 50 percent in 1996, and further up to 70 percent in 1999. As the share of household deposits in total liabilities increased, any small change in households' saving behavior might lead to a major change in banks' liabilities that could not be easily controlled by the government. A large part of these savings is invested by the banks in SOE loans that are non-recoverable, but the government's implicit deposit guarantee protects confidence and system stability. Therefore, a banking crisis in China is most likely to be precipitated when domestic savers lose confidence in the government's implicit guarantee of the value of their deposits in banks.[9]

This loss of confidence could be triggered by a growth slowdown that weakened the domestic banking system, by the prospect of a major devaluation in response to a large emerging current account deficit and a sharp fall in inward foreign direct investment, or by any other economic, social, and political crisis. For example, China's leaders have failed to cut interest rates fast enough (real rates were about 10 percent in 1998) to boost domestic demand, perhaps because they fear that domestic savers will be panic and seek hard-currency havens, despite an

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[8] Pieter Bottelier, "China: Dynamics of Economic Reform and Institutional Development," mimeo, April 1999, pp. 10-11.

[9] Nicholas R Lardy, "When Will China's Financial System Meet China's Needs?," presented at the Conference on Policy Reform in China, Center for Research on Economic Development and Policy Reform, Stanford University, November 18-20, 1999, pp. 2-3. Jun Ma, *The Chinese Economy in the 1990s* (New York: St. Martin's Press, 2000), p. 66.

officially closed capital account. If households in large numbers attempted to withdraw their savings, the insolvency problem of China's largest banks could become a liquidity problem. Even in the absence of significant withdrawals of savings deposits, the abrupt decline in inflows of funds would threaten to curtail the ability of banks to continue to expand their lending to SOEs in a relatively non-inflationary manner.[10]

Fourth, small city-based commercial banks, and rural and urban credit cooperatives, have found it increasingly difficult to collect and retain deposits. In addition, while liquidity at large Chinese banks could remain strong over the medium term, over time, as China's capital markets develop, more savings will inevitably be attracted away from banks into stocks, bonds, and other investments. This structural shift, though likely a gradual process, poses a long-term threat to the funding stability of China's banks.[11]

With these risks, delay in banking reforms would make problems worse. According to the Japanese banking saga, delay in banking reform will only allow NPLs to grow and erode bank capital.[12] According to the Chinese State Statistical Bureau, Chinese economic and financial risk was barely within the security range and the composite index of financial risk has tended to increase year by year. The financial index system includes five aspects ranking from high to low in order: bank internal stability, T-bond risk, macro-economic steadiness, bubble hazard risk, and foreign capital impact risk. The financial risk index in 1999 was 47.6, 11.8 higher than that of 1991, almost approaching the ceiling of the security range (50).[13]

The World Bank warned in 1997 that China faces a significant risk of major bank insolvency and a banking crisis.[14] Bottelier warns that a financial time bomb is ticking, and it has to be defused as quickly as possible. In particular, Beijing has a very short time to address the banking reforms because the time available for it to meet conditions under its current WTO commitments is extremely short.[15]

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[10] Nicholas R. Lardy, *China's Unfinished Economic Revolution* (Washington, D.C.: Brookings Institution Press, 1998), pp. 106-107, 200-202. "Red Alert," *The Economist*, October 24, 1998, p. 23.

[11] Moody's Investors Service Global Credit Research, "China: Banking System Outlook," August 2000, p. 8.

[12] Y.K. Mo, "A Review of Recent Banking Reforms in China," in Bank of International Settlements (ed.), *Strengthening the Banking System in China: Issues and Experience* (Basel, Switzerland: Bank of International Settlements, 1999), p. 101-103.

[13] Yihua Shi, "PRC Statistics Bureau Data Show Financial Risk Surging Year by Year," Beijing *Renmin Ribao* (Internet Version), November 15, 2000, in FBIS-CHI-2000-1115.

[14] World Bank, *China 2020: Development Challenges in the New Century* (Washington, D.C.: World Bank, 1997), pp. 30-31.

[15] Pieter Bottelier "China's Economy at the Turn of the Century: The Significance of WTO Membership for Continuing Reform," CSIS China Economic Outlook, January 2000,

A banking crisis in China would be a disaster. Nicholas Lardy, an economist specializing in China's banking reforms, warns that a bank-run "would likely lead to a collapse of credit and thus a major recession, something not experienced in China for almost four decades."[16] A banking crisis in China will most likely result in an inflationary spiral and thus massive popular discontent. Pei Minxin warns that the impact of a full-blown banking crisis on political instability is far more lethal than high unemployment because a banking crisis would hurt virtually everyone while unemployment principally affects only one segment of society, namely, manufacturing workers. A broad anti-regime coalition is therefore more likely to emerge following a banking crisis than high unemployment.[17]

The government was fully aware of this problem. In early 1998, it announced the plan to recapitalize major banks through issuing RMB 270 billion ($32.6 billion) in treasury bills, to improve commercial banks' independence, and to strengthen bank supervision. The recapitalization plan raised the capital of the state-owned banks to RMB 478 billion from RMB 208 billion. In addition, the central government has also committed substantially more funds to finance the write-off of enterprise bad debts. This program began in 1996 with an allocation of RMB 20 billion to write off bad debts to banks of enterprises that were being restructured. The funds earmarked for this purpose were RMB 30 billion in 1997 and RMB 40 billion in 1998.[18]

However, the RMB 270 billion capital injection in 1998 and the RMB 90 billion funds for the SOEs in 1996-1998 are not likely to be sufficient to recapitalize the banks and solve the NPL problem. Recapitalization of the financial system, according to Lardy, would require an injection equal to about $260 billion, or RMB 2,158 billion (27 percent of China's GDP), in 1998. The 2000 estimate by the research department of China's central bank puts the financial cost of restructuring the state banks at RMB 2,260 billion ($273 billion), or close to 30 percent of GDP. Note that in 1998 the expenditures of Chinese central government were only RMB 312.6 billion. The recapitalization needs pose a staggering threat to China's fiscal sustainability. Lardy argues that any serious attempt to recapitalize the financial system will immediately push government debt to a level over 50 percent of GDP. Ultimate costs could be higher, particularly because the

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http://www.csis.org/asia/chinaecon/ceo0100.html, accessed February 2, 2001, p. 6 of 7.

[16] Nicholas R. Lardy, "China's Economic Growth in an International Context," *Pacific Review*, vol. 12, no. 2 (1999), p. 163.

[17] Minxin Pei, "Is China Unstable," Foreign Policy Research Institute Wire, July 1999, http://taiwansecurity.org/IS/Pei-990707.htm, accessed November 9, 2000.

[18] Nicholas R. Lardy, *China's Unfinished Economic Revolution* (Washington, D.C.: Brookings Institution Press, 1998), p. 207.

flow of new bad loans to the SOEs by state banks does not appear to have been halted.[19]

To prepare the four state banks for WTO, China has begun to transfer massive amounts of NPLs from the banks to state-owned AMCs. The AMCs will initially issue bonds to finance their purchase of loans, but these loans are implicitly guaranteed by the Ministry of Finance and will inevitably end up being paid off by the government.[20] This means that the state itself is assuming responsibility for all or part of the NPL portfolio of the state banks. In 1999 and 2000, RMB 1.4 trillion ($169 billion or about 16 percent of GDP) worth of nominal value NPLs has been transferred to the AMCs. *Renmin Ribao* reported that the proportion of non-performing assets has dropped by nearly 10 percent. Nonetheless, in March 2001, Dai Xianglong admitted that there were *still* 25 percent of state banks' loans after the AMCs absorbed RMB 1.4 trillion of state bank's NPLs as of the end of 2000.[21]

Many senior Chinese officials and other analysts admit that the ambitious scheme is fraught with difficulties. The AMCs face shortages of experienced and qualified personnel. There is no adequate operating and legal framework for the AMCs. Unrecoverable loans are enormous while domestic and international investor interest in the NPLs is probably limited even at substantial discounts. Finally, the AMCs are not independent and need to obtain senior government approvals for many transactions.[22]

Furthermore, the required financial sector reforms are closely interlinked with many other reforms such that a sequential or partial approach will not be effective. In essence, declining tax revenues relative to the size of the economy until 1995 have led the government to force

[19] Nicholas R. Lardy, "The Challenge of Bank Restructuring in China," in Bank of International Settlements (ed.), *Strengthening the Banking System in China: Issues and Experience* (Basel, Switzerland: Bank of International Settlements, 1999), p. 34. Pieter Bottelier, "China's Economic Reforms and American Interests," Charles Neuhauser Lecture, Fairbank Center for East Asian Research, November 30, 2000, p. 10. Y.K. Mo, "A Review of Recent Banking Reforms in China," in Bank of International Settlements (ed.), *Strengthening the Banking System in China: Issues and Experience* (Basel, Switzerland: Bank of International Settlements, 1999), pp. 93-101. Nicholas R Lardy, "When Will China's Financial System Meet China's Needs?," presented at the Conference on Policy Reform in China, Center for Research on Economic Development and Policy Reform, Stanford University, November 18-20, 1999, pp. 20-37.

[20] Chinese Minstry of Finance has accepted responsibility for ultimate AMC losses, but legally this does not amount to the same thing a formal guarantee for AMC bonds.

[21] Zhenjun Han and Honghe Zhang, "Major Progress Scored Five Areas of Reform in State-Owned Enterprises" (in Chinese), Beijing Xinhua Domestic Service, March 6, 2001, in FBIS-CHI-2001-0306. Pieter Bottelier, "The Impact of WTO-Membership on China's Domestic Economy," speech at Johns Hopkins University School of Advanced International Studies, China Forum, November 14, 2000, pp. 6-7. Tian Li, "PRC's Dai Xianlong Discusses Current Financial Issues" (in Chinese), Beijing *Renmin Ribao* (Overseas Edition), January 23, 2001, in FBIS-CHI-2001-0123. Zhang-rong Kang, "Dai Xianglong: Commercial Banks' NPLs Account for 25%," *Gongshang Shibao* [Commerce Times], March 27, 2001.

[22] World Bank, "China," *China Quarterly*, March 20, 2000, p. 5.

excessive social obligations on SOEs. These pressures as well as increasing competition contribute to the declining financial performance of SOEs, which need to borrow heavily from the state banks. In the 1990s, the loans of state banks to SOEs accounted for about 81 percent of the total loans of state banks. This, in turn, is a major contributor to the insolvency of large parts of the banking system. These three problems are closely interrelated with each other.

For example, bank reform slowed in 1998-99 as the difficulties of embarking on SOE reform in the midst of the AFC became apparent. In both 1998 and 1999, Beijing advised the state commercial banks to increase their financial support of ailing SOEs. As a result, the ratio of the loans outstanding relative to gross domestic output rose from 86 percent at year-end 1995 to 109 percent at year-end 1998. Much of this rapid growth of lending appears to have been used to pay for SOE inputs, workers' wages, pensions of retirees, and so forth.[23]

[23] Nicholas R Lardy, "When Will China's Financial System Meet China's Needs?," presented at the Conference on Policy Reform in China, Center for Research on Economic Development and Policy Reform, Stanford University, November 18-20, 1999, pp. 30-32.

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------, "China," *China Quarterly*, March 20, 2000.

The gold exchange standard system was installed to conserve gold and increase the international money supply with the expansion of international relations. It was based on the postulate: currency, convertible into gold at a fixed rate, (trading currency) is the price of gold. It acts as means of circulation and means of international accumulation. A conservative view. This system is paradoxical, it is based on an internal contradiction - a paradox or the dilemma of Triffin (the economist who first identified it in the late 50-ies). Indeed, in order for the system to function, it must satisfy t The Chinese economic reform refers to the program of economic reforms termed "Socialism with Chinese characteristics" and "socialist market economy" in the People's Republic of China (PRC). The reforms were started by reformists within the Communist Party of Chinaâ€”led by Deng Xiaopingâ€”on December 18, 1978, during the "Boluan Fanzheng" period. The reforms went into stagnation after the 1989 Tiananmen Square protests, but was revived after Deng Xiaoping's Southern Tour in 1992. Chinaâ€™s reform and opening (gaige kaifang) is best known for introducing elements of a market economy into what had previously been a rigidly planned system. Agricultural communes were broken up and farming returned to a family basis.Â Chinaâ€™s old planned economy had many defects. The spontaneous partial changes in land contracting to households in rural areas in the early years of reform were fragmented and unsystematic, but they did not create the conditions for the meltdown of the planned economic system. Economic reform was put on the national agenda in 1984, when the third plenary session of the twelfth Central Committee of the Communist Party (CCCP) passed its â€˜Decision on the Reform of the Economic Structureâ€™.