Zen and the Art of Banking…

A critical review of the Chinese Banking Sector

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Declaration

I, the undersigned, hereby declare that the work contained in this assignment is my own original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

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Abstract

This study examines, broadly put, why the banking sector in China has not performed as well as other sectors of the economy when compared to international competitors, given that the economy as a whole has been performing so exceptionally at the time of writing and has been for the past two decades. The investigation examines reforms over the past twenty-six years to provide background to the issue as well as taking a view on the Chinese accession to the World Trade Organisation in 2001, providing analysis as to the effects of this accession as well as viewing the undertakings China has made, in general and specific to the banking sector, in terms of World Trade Organisation membership.

The methodology employed is descriptive and explanatory in nature and information is sourced from existing academic writing as well as from banking industry publications and research. The source of information for the study is mainly of a qualitative nature, including historical and historical comparative information. Furthermore, the research forms applied research in that it seeks to bring together previous basic and exploratory research in order to identify specific problems and present potential solutions.

Findings in the research include the burdensome effects of state-owned enterprises on the banking sector's largest constituents, problematic aspects of endemic non-performing loans and a culture of lapsing debt in China as well as problems regarding political interference in the banking sector by the state and local authorities. Further problems identified include reporting and supervisory concerns, taxation treatment problems and a lack of risk-based commercial lending criteria in big Chinese banks. Analysis is provided into the effect of current and past restrictions in the sector, the development and reform model China is using to globalise its banks and the 2005 investment surge into China's bank.

Recommendations are made regarding the foreign ownership of the Chinese banking sector, state recognition of bad-debts as state loans, debt-management through asset management companies and reform of the state-owned enterprises and the problems inherent to this initiative. Finally, recommendations as to the role of the regulator and the challenge of political will are highlighted.

Opsomming

Gegewe die indrukwekkende ekonomiese groei en goeie vertoning van die afgelope twintig jaar, ondersoek hierdie studie waarom die Sjinese bankwese nie, in vergelyking met ander sektore in die ekonomie, ewe goed presteer het in vergelyking met internasionale mededingers nie. Die werkstuk ondersoek die hervormings van die afgelope ses-en-twintig jaar en beskou ook Sjina se aansluiting by die Wêreld Handels Organisasie (WHO) in 2001. Die gevolge van Sjina se toetrede tot die WHO, asook Sjina se WHO ondernemings in die algemeen en, meer spesifiek, met betrekking tot die bankwese word analiseer.

Die metodologie wat gebruik word is beskrywend en verklarend van aard en inligting is bekom uit bestaande akademiese publikasies asook uit publikasies en navorsing wat deur die bankwese gedoen is. Die inligting wat gebruik is vir die studie is hoofsaaklik kwalitatief van aard en sluit historiese en historiese vergelykende inligting in. Die navorsing wat gedoen is, is toegepaste navorsing, in die sin dat dit probeer om bestaande basiese en verkennende navorsing bymekaar te voeg ten einde spesifieke probleme te identifiseer en om oplossins voor te stel.

Die bevindinge sluit in: die problematiese impak van staatsondernemings op die bankwese se grootste kliënte; die gevolge van nie-presterende lenings; die kultuur van lenings laat verval in Sjina; en politieke inmenging in die bankwese deur die staat- en plaaslike owerhede. Verdere probleme wat identifiseer is sluit in swak verslagdoening en oorsig in die bankwese, belasting reëls en ‘n tekorkoming aan kommersieële-lenings kriteria. ‘n Ontleding is gedoen oor die gevolge van huidige en vorige beperkinge in die bankwese, die ontwikkelings- en hervormings-model vir die Sjinese bankwese en die huidige (2005) toename in buitelandse beleggings in Sjinese banke.

Aanbevelings word gemaak rondom die buitelandse eienaarskap van Sjinese banke, die aanvaarding deur die staat dat nie-presterende lenings as staats-lenings beskou moet word, die bestuur van skuld deur bate-bestuur maatskappye, en die hervorming van staatsondernemings en daarmee gepaardgaande probleme. Laastens word aanbevelings gemaak oor die rol van ‘n bankwese reguleerder en word die uitdaging wat “politiek wil” stel beskou.

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Chapter 1: Introduction

Zen refers to a school of Mahayana Buddhism and has been defined as a number of things, including definition as a religion, a philosophy and a sect. The word Zen, in fairness to the subject matter of this study is, strictly speaking, Japanese – the Chinese term of Zen is Chan, although it is the author's view that this would make the study name somewhat obscure and far less interesting.

Zen as a school of thought emphasises enlightenment and, specifically, processes in a number of activities and manners, all of which are aimed at achieving enlightenment and general improvement of the mind and spirit.

Zen and the art of banking, with specific reference to the Chinese banking sector, is a critical review of the said sector – focusing on processes of reform which seek to effect a general improvement, not in mind and spirit but in profitability and long-term stability.

Sadly, that is as much analysis as Zen receives in this text. Banking, however, receives far more examination and analysis. The Chinese banking sector will be reviewed in detail, examining specific concerns and structural elements – providing the literature study specific to this text.

Attention will be given to the general economic reform from 1979 onward in China, with specific focus on state owned enterprises and the effect these have, currently, on China's banks. Additionally, the banking sector will be separately reviewed, focusing – in chronological order – on the reforms in the general banking sector as well as the areas of capital controls and exchange rate reform, given the vast implications the latter two items have on the banking and financial sectors (definitions below will differentiate actively between these two sectors).

Following the review of reforms and the background this provides, specific analysis regarding China's World Trade Organisation (WTO) entry in 2001 will be undertaken, specific to the banking sector. Key undertakings by China in terms of financial services, followed by specific undertakings in the banking sector only, are reviewed as well as general commitments in order to provide an understanding of the effects and implications of WTO entry.

Following this, a general overview of the situation at the World Trade Organisation entry will be undertaken – including analysis of the core problems of the banking sector and an examination of the positive and negative points surrounding non-state owned banks. This is followed by a review of the implications of internationalisation since the WTO entry in 2001, including the increasing of financial depth in the Chinese banking sector and the effect on state owned banks.

The above is followed by an examination of the situation in the Chinese banking sector at the time of writing and the changes and strengths and weaknesses since 2001 in the sector. This includes review of the spate of investment in the sector in 2005 by HSBC and other international banks as well the highlighting the problems which continue to dog the sector.

Finally, recommendations are made to solve some of the problems specifically identified in the text. These include recommendations on foreign bank ownership, state-enterprise reform, amongst others – this section serves as the thesis of the text. First, however, a brief overview of the methodology used throughout the study is undertaken, below.

Chapter 2: Methodology

This study aims to critically review the Chinese banking sector and identify the problems and shortcomings in the said sector since WTO accession in 2001[1].

The information used in this study is comprised of existing statistics and both existing academic papers on the subject of China, broadly, and the use of financial industry specific papers and analysis obtained through persons working in the industry in London, United Kingdom, and through personal experience in asset and investment management analyst employment experience in researching financial institutions in China. Additionally, information from Bloomberg trading desks has been used in verifying and, in some cases, sourcing information about the sector.

The core source of information for the study is of a qualitative nature, including historical and historical comparative information obtained through the above mentioned sources as well as extensive background reading to develop an understanding of the banking sector as a whole as well as the Chinese sector, specifically. The text, furthermore, functions as applied research in that it seeks to bring together previous basic and exploratory research in order to identify specific problems and present potential solutions.

As the text is a *review* of the chosen subject matter, the study forms largely descriptive research and does not seek to provide any exploratory matter. Rather, conclusions drawn and recommendations made could be explanatory in nature, given the analysis inherent to the reaching of said conclusions. Additionally, some chronological research and presentation is used in the text as well as a cross-sectional approach when detailing current event in the sector chosen as subject matter. The data collection method used is largely existing research and statistics, freshly examined and drawn together

Additionally, the author has strived, in so much as this is possible, to provide objective and non-biased information, presenting both positive and negative aspects of the subject matter as far as is possible. Undertaking research such as this implies a certain degree of interest and passion for the subject matter and for that no apology or explanation is made other than the inherent interest

[1] The timeframe was chosen owing to China's 2001 ascension to the World Trade Organisation and the subsequent economy wide reforms and liberalisation that took place in the Chinese economy.

in the field. It is submitted that enthusiasm and interest in the field may somewhat skew the objective nature of the research but this has, as far as is humanly possible, been consciously avoided.

The research is focused to banks rather than the wider financial services sector as a whole owing to constraints implicit in the rationale for this text. Furthermore, specific focus is given to state-owned (sometimes referred to, for convenience later in the text, as state banks) as these comprise the largest section of the sector and, to a large degree, factors affecting said banks provide valid conclusions for the rest of the sector.

Finally, the research question as formulated for this research study is, specifically, why Chinese banks perform, compared to international competitors, so poorly. This is examined in the climate and against the background of massive economic growth within China for the last two decades where other sectors have performed far better in terms of international comparison. For clarification then, the rationale from a research question point of view is, broadly put, why has the banking sector in China not performed as well as other sectors of the economy when compared to international competitors.

Chapter 3: Definitions

Before beginning the literature study for this text, a few definitions are important in terms of improving the general comprehensibility of the text as well as for reasons for clarity in later arguments.

The most important definition is that of the banking sector and the differentiation between the banking sector and the financial services sector as a whole. Financial services includes insurance, non-financial intermediaries, institutional investors (pension funds or mutual funds), investment trusts and some forms of investment management houses as well as banks as defined below.

The banking sector, more strictly defined, is understood to be those institutions that take deposits, provide loans and seek to make an income from the differences between interest rate spreads (differences in rates). This definition includes, inter alia, investment banks, commercial banks) of a both retail and non-retail nature (i.e., providing services to individuals or natural persons as well as legal persons or organisations) and general deposit-capital provision banks. Included in this definition is investment banks or commercial banks entering secondary markets in government securities (bonds) or public equity (shares) as well as debt-instruments.

Whilst the above sectors are, to all intents and purposes differ dramatically in some instances, the fact that they all provide financial services and deal in a number of financial markets together, as intermediaries or parties to the same contracts, means that the lines between the two areas do blur from time to time. In some instances this does occur in the text below. This has, where is possible, been minimised and where it occurs specific attention is given to providing relevant analysis with explanations of the differences.

State owned enterprises (or SOE's) are another important factor to define. These comprise the industrial giants established in the command economy of the 1960's and 1970's in China under the non-market economy of the time. These enterprises were established during the industrialisation drive throughout China, undertaken by the central government. These institutions are historically inefficient and not, for the large part, profitable. Additionally, these organisations employ millions in China, especially in lesser-developed parts of the country (especially at present). These enterprises have been privatised in reforms over the last 20 years but still exist and form a material part of this text’s examination.

Non-performing loans (or NPL’s) are loans which are not serviced in terms of either interest or capital repayments (or both). Rolling over of said loans means letting these loans go uncollected and, in some instances, extending credit to the party loaning the capital or funds.

Chapter 4: China's Reforms (Literature Study)

The function of this portion of the text is to provide context and background to the investigation in to China's banking sector. This review examines general economic reforms as well as reform in the financial sector before examining the banking sector in some detail.

General economic reform – 1979 onwards

This section of the text provides the background and understanding for the later review and explores general economic reform, as detailed below. Following this brief general outline of economic reform, specific attention is paid to the reforms that were implemented in the financial and, specifically, the banking sector. Short reviews on the liberalisation of capital controls as well as the exchange rate are also provided; given the specific relevance of these areas for the later discussion and their pertinence to the banking field in general.

Chinese general economic reform began in 1979, after the passing of Mao Tse-tung. The reform process can be roughly divided into the periods 1979 – 1993 and 1993 – 2001. The latter period saw more far reaching economic reform after the Chinese Communist Party sought to establish the oxymoronic sounding "socialist market economy" after the 14th Central Committee (meeting) in 1993. This period saw China's multitudes of State Owned Enterprises (SOE's) essentially privatizing, as well as over-employment[2] in SOE's (and former SOE's) dropping sharply, contributing to rising unemployment in these relatively inefficient fields (Liew, 2001; Wang, 2000).

In the lead-up to the 2001 WTO accession, Chinese import tariffs were dropped by over 40% (from approx 66% in 1982 to approximately 15% in 2001); Non-Tariff Barriers (NTB's) were decreased uniformly over the same period and access (rights) to trade were expanded, particularly in the areas of finance (commercial banking), insurance, telecommunication, education, medical care, law firms, accounting firms and other intermediary institutions. This showed concrete results for the Chinese economy with a 7.5% real increase in trade in 2001 while world trade showed a 4% decline in the same period (Lardy, 2003). For the sake of brevity, a more detailed analysis of reforms enacted will not be undertaken here as such analysis

[2] A situation in which more labour is employed for a given production function than is needed (Liew, 2001; Lardy, 2002).

is not the subject of this text. These processes of reform culminated in the December 11, 2001 accession of China into the WTO.

Lagging SOE's

Before China began economic reforms, economic activity was dominated by SOE's, which geared production to meet development goals and which automatically received credit from the banking sector, according to a national development plan. Once liberalization began, it became apparent that SOE's could not keep pace with the needs of the evolving market economy. Analysis by Lardy (2000) reveals that SOE's are about 60% as efficient (as measured by value added) or profitable (as measured by operating profit ratio to assets) as foreign-funded or private enterprises.

Their low profitability leaves SOE's financially vulnerable. For example, interest coverage (the operating profit potentially available to cover interest expenses) in SOE's is as low as one-third of that observed in major industrial countries. Firm-level data for listed enterprises suggest that Chinese SOE's cannot generate enough cash flow to pay interest on about 20% to 30% of their total debt. A moderate rise in interest rates or a moderate drop in sales could cause 40% to 60% of the debts of all firms to become unserviceable (Lardy, 2000; Lardy 2002b; Bhattasali, 2002).

Liberalization and lagging SOE performance have allowed private enterprises to grow rapidly to meet domestic and foreign demand for Chinese goods. Firms with access to foreign financing and managerial expertise have done particularly well and thrived over their poorly managed and inefficient SOE counterparts. As a result, the share of output attributable to SOEs fell from 38% in 1994 to 26% in 1999, while the combined shares of individual-owned, shareholding, and foreign-funded enterprises rose from 24% to 41% over the same period. (Locally owned collectives account for the remainder). The SOEs also now account for a smaller share of employment—from 66% in 1994 to 51% in 2000. This is, overall, a good thing for the Chinese economy as the more effective enterprises are outgrowing the dated SOE's – however, SOE's provided massive employment in both rural and urban areas and scaling back SOE production means unemployment, as indicated above.

To prevent rising NPL's (Non-Performing Loans), the government also began, as indicated above, to restructure SOE's in an attempt to strengthening SOE finances and management – the privatisation process refereed to above. Large SOE's were encouraged to adopt commercial practices or - where possible – were privatised, while small SOE's were privatised – again as far as possible. As part of this process, nearly 26 million workers were separated from SOE'ss in 1998–2001 (17 million were rehired, 3 million became unemployed and 3 million retired). SOE's were also instructed to limit spending and that they could no longer assume that banks would provide financing in the face of large NPL's. According to a senior government official, nearly US $10 billion was spent in 2002 to close or merge unprofitable SOE's (China Online 2002). In 2001, 460 SOE's were shut down, and US $6 billion in NPL's were written off.

To summate, over-investment in property development, excess production capacity and a massive inventory build-up are symptoms of inefficient financial intermediation in China that have been experienced in the last 10 years. Although a series of important financial reforms have been undertaken, the results are compromised by the lack of related institutional reforms and inadequate competition in the financial and capital markets. More importantly, the bank restructuring required to resolve the problems of nonperforming loans poses a massive fiscal challenge. The Chinese banking sector was, historically, sorely underdeveloped and suffered constantly from bad debt problems and severe underutilization of a high domestic savings rate. Investor confidence had been hampered by three large scale bail outs of the four large state owned banks since 1998 and Chinese banks had proven themselves, over time, to be incapable of managing cyclic debt – which, Andy Xie of Morgan Stanley points out, results in economic growth generating bad debts. (The Economist, 2003a; The Economist, 2003b; The Economist, 2003c; The Economist, 2003d).

Economic reform – Banking Sector

In terms of relevance to the banking sector, the general economic reforms mentioned above led to substantial increases in incomes, the level of savings (as opposed to percentage of income saved) with banks and general bank deposits. The concomitant increase in capital available from the state banks through the above increased levels of bank deposits were mainly directed to stated owned enterprises (SOE's) – with little, if any, regard to credit quality[3] - during the 1980's and 1990's. These investment decisions and decisions pertaining to the direction of state bank funds as credit (loans) were, in theory, controlled by the central government but, in practice, sub-national government levels enjoyed a large degree of autonomy in choosing

[3] Credit quality being an expression of the risk attached to providing financial capital to an organisation. High-rated credit quality would imply lower risk of default on the repayment of the capital financing loan whilst low rating would impy a higer risk factor (Lardy, 2000).

investment areas and directing credit towards said investments from local branches of the state banks (Lardy, 2000; Bhattasali, 2002).

Prior to 1979, China's banking system was far from modern and played only a very limited role in promoting economic growth – reflecting the limited role of banks in a highly centralized planning system whose primary functions were collecting revenue from State-owned enterprises (SOEs) and allocating investment through budgetary grants (Wang, 2000). Under this economic model, banks simply provided credit needed by SOEs for their production plans and provided (or monitored) cash, used principally to cover labour costs and purchases of agricultural products. During this period, the People's Bank of China (PBC), as the sole bank, played a double role of being the central bank and the financier of enterprises.

As such, the banking system, and the above-described funnelling of funds from state banks, played a vitally important role in supporting the economic growth in the early-1990s. The key reason for this claim is that as state revenues declined[4] (partly resultant of massive spending on infrastructure development), the government's budget became increasingly constrained. The revenue gap was filled, both at national and regional government levels, by channelling more funds to SOE's, further fuelling economic growth – albeit at a large cost (Bhattasali, 2002).

Despite the exceptionally high propensity to save[5] of Chinese households (averaging 28% of GDP, year-on-year, from 1995 – 2005), the effect of the large portion of non-performing SOE loans (non-performing loans are referred to as NPL's in the financial industry) began to acutely affect the profitability of the banks by the mid 1990's (a timeframe consistent with the beginning of initial capital – as opposed to interest only – repayments at the time) by way of massive losses through NPL's and a series of credit crises during the mid-1990's (Lardy, 2000; Bhattasali, 2002).

These problems were, to an extent, masked by the above mentioned high savings rates – brought about, to an extent, by the lack of alternative vehicles for savings at the time in the banking sector – as well as the implicit deposit guarantee that state banks provided high levels of

[4] Revenue fell from 34% of GDP on average during the 1980's to under 12% on average in the mid 1990's. While some of this margin change is owing to increased economic growth, the fact that a concomitant increase in revenues did not occur points toward a discretionary spending problem for the Chinese government (Bhattasali, 2002).
[5] Propensity to save can be explained as the proportion of total income that an individual saves (i.e., does not spend on consumption of goods or services) (Mohr & Fourie, 1996).

liquidity to the banking system (i.e., there was very little concern over state credit lending – owing to the fact that more income would be poured into the banking sector pot through savings and, eventually, real private-led economic growth) (Lardy, 2000; Bhattasali, 2002).

The effect of the above mentioned decline in profitability and rapid increase, in the mid 1990's, of NPL's was to make clear the case for fundamental reform and modernisation of the Chinese banking sector.

Financial Sector Reform – Chronological: 1979-2001

This section serves to provide analysis regarding the various reforms undertaken from 1979 – when the so called "Open Door Policy" began – toward reforming the financial sector. These reforms, not mentioned above (to avoid repetition) are grouped in terms of their function, being policies to do with the growth of foreign banks, capital control liberalisation and exchange rate reform.

China's attempts to modernize its financial market, including the banking sector, have been slow and steady but have generally tended to focus almost exclusively on introducing new and stronger administrative oversight and – less relevant to this text – a diversification into different institutions (other areas of the financial markets) as a means to minimise risk. The only notable contradictions to this trend were a series of measures introduced in the mid-1990's in response to the problems occurring at the time – these are discussed in more detail below. One can distinguish four distinct phases of banking sector reform in China from the inception of the general economic reform programs up to the World Trade Organisation (WTO) accession in 2001 (Bonin & Huang, 2001; Boyreau-Debray, 2002)

Foreign banks were initially only allowed representative offices in China – implying that operating for profit as a bank was not allowed. These representative offices were geographically restricted to operate only in Beijing and the Special Economic Zones (or SEZ's) (ACFB, 1992). Regulations introduced in the first phase of reform referred to above in the mid-1980's allowed foreign banks in SEZ's to increase their business scope and become involved in profit-making activities such as loans, deposits, remittances and guarantees (ACFB, 1991; ACFB, 1992).

However, these allowances were limited to services provided in a foreign currency and involving foreign entities (embassies, overseas firms or foreign individuals) (ACFB, 1992). As such, foreign banks were still locked out of the lucrative Chinese domestic market both in terms of domestic foreign currency deals and traditional domestic financial services (ACFB, 1991; ACFB, 1992).

Phase 1

The first such phase is the period 1979 to 1986 which was characterised by the breaking-up of the mono-bank system (under which financial services were delivered through a single, state run, owned and administered institution) as well as the creation of specialised banks for various sectors of the economy, including the Industrial and Commercial Bank of China, China Construction Bank, Bank of China, and the Agricultural Bank of China – these are discussed in more detail below (Bhattasali, 2002; Hu & Zhou, 2001).

Geographical restrictions were relaxed in the late 1980's (second reform phase) and foreign banks were able to establish offices in 'open' cities such as Fuzhou, Tianjin and Nanjing. These decreased geographical constraints, however, did not open up any new business areas in terms of product offerings or scope of product available (Bhattasali, 2002; Claessens, et al 1998; Hu & Zhou, 2001).

In a key step toward of establishing a modern banking system, the government, in 1979, removed the monopolistic position of the People's Bank of China by establishing the Agricultural Bank of China, the Bank of China and the China Construction Bank. The Agricultural Bank of China was established to take over the People's Bank of China's rural banking business and supervisory authority of a network of 60,000 rural credit cooperatives that had been providing small-scale rural banking. The Bank of China was delegated to take over foreign currency transactions, while the China Construction Bank focused on the construction sector. The government completed a two-tier banking system by removing commercial banking activities from the People's Bank of China and transferring them to the Industrial and Commercial Bank of China, the fourth specialized bank, established in 1984. These financial institutions were called "specialized banks" (Hu & Zhou, 2001; Lardy, 2002; Lardy 2002b).

In 1983, the decision was taken to install the People's Bank of China as the central bank, removing ordinary banking business from it in 1984 with the formation of the last of the policy banks. However, it was not until 1986 that the People's Bank of China was explicitly made responsible for monetary policy and the supervision of the financial system, including money and capital markets under relevant laws and with legal provisions.

Additionally, foreign banks were, for the first time, allowed to open representative offices initially and by the end of this period said banks were also allowed to establish commercial branches, albeit with exceptionally limiting and very tight geographic, product, and customer restrictions. To a large degree this, along with the massive organisational and political problems inherent to entering the Chinese market, hamstrung all but the most specialised of operations to the point where doing business in China was still, despite the limited reforms at the time, far from economical (Lardy, 2000; Bhattasali, 2002; Fang, 2001;Mathieson & Roldos, 2001).

Phase 2

From 1987 to 1991, key occurrences are a rapid growth of non-bank financial intermediaries (thus broadening the market and providing more financial liquidity), the establishment of two state-owned insurance companies (in addition to existing PICC (the People's Insurance Company of China – established in 1949) – this was in line with the government's stated aim of diversification in the financial sector to minimise risk) and the beginnings of a capital market by the introduction of secondary market trading in government securities. The latter is exceptionally important as the scope of government securities is increased greatly as instead of being primary lending tools for the government, these were now able to function as market instruments and allow much greater scope for banks to generate profits from non-core activities (core activities had, historically, been fee-driven) and, to a limited extent, protect themselves from NPL risk through hedging using government securities such as bonds (Bhattasali, 2002; Lardy, 1998; Pomerleano & Vojta, 2001).

Furthermore, in 1987 the Bank of Communications, which was set up in 1908 in Shanghai and whose operations were merged to the People's Bank of China in 1958, again became independent as a joint-stock (not purely state-owned) bank. 1987 also saw the China International Investment Trust Corporation form the CITIC Bank – this merged with the China Investment Bank in 1999 as part of later reforms (Lardy, 2002; Lardy 2002b).

Phase 3

The third phase (1991 to 96) of reform is marked by greater diversification in financial markets and the establishing of two stock exchanges (Shanghai and Shenzen). Additionally, the inter-bank market for financial instruments developed and some interest rates became flexible. The latter ties in to second phase reforms and builds upon these, introducing additional financial instruments (e.g., options, swops and futures) which are derived from underlying securities such as stocks, bonds and debentures – broadly known as derivatives. The additional exchanges obviously contributed to the market activity as well – although such exchanges were delimited and classified into two separate classes and access to said classes was limited to foreigners (would could only access “B” shares – see below). 1994 also saw the release of financial services regulations which gave legal grounding to the central bank (The People’s Bank of China) examining, approving and controlling foreign financial institutions within China. 1996 marked foreign banks being allowed, for the first time, to provide local currency business within China – although, as noted elsewhere, only to foreign parties – through an innovative (in China) pilot scheme (Bonin & Huang, 2001; Cheng, 1999; Lardy, 1998).

The above regulations were the first comprehensive update to such legislation since 1982 and retained restrictions over operations of foreign banks and provided detailed and, some argued, onerous requirements for setting up business in China (e.g. capital requirements) – particularly given the limited scope of business for foreign banks. Such requirements included requirements like maintenance of a representative office for at least two years before application could be made to open a branch in China. Additionally, the foreign bank applying for a single branch would require capital of over US $ 20 billion (Lardy, 1998; Wong & Wong, 2001).
Furthermore, the Law of the People's Republic of China on the People's Bank of China (1995) was promulgated to define the functions and duties of the People’s Bank of China, formally, as a central bank. To further strengthen its authority as a central bank and reduce outside influence, the central bank significantly reformed its branch networks in 1998—namely, closing some of its provincial branches and establishing new branches which would be able to supervise across provinces (Lardy, 2002).

The mid 90’s also saw the government allow the entry of more joint-stock banks to the market, in the form of the China Merchant Bank, the Hua Xia Bank, and the Everbright Bank – all of which were set up in the first half of the 1990’s. It should, however, be borne in mind that the four big state banks constituted the majority of the market at approximately 86% of total deposits and loans (Lardy, 1998; Lardy, 2002b).

Phase 4

In the final (and pre-WTO accession) phase (1997 – 2001), the emphasis shifted to addressing the portfolio problems of commercial banks and governance of financial markets in their entirety. To a large degree, the WTO accession reforms began during this phase – as such this was a very busy period in reforms (as is evidenced by the number of reforms listed below). These entailed a restructuring of the central bank, creation of asset management companies to deal with a portion of NPL's[6], attempts to improve bank supervision and improve recognition of NPL's (previous policy was the banking equivalent of faith and hope – i.e., NPL's were often not recognised as managers (who had to authority to do so) would blindly keep from reclassifying massive SOE loans as non-performing in the apparent hope that these would miraculously begin performing. More realistically, one would also expect a large degree of pressure from local government officials keen on not upsetting the central government) (Bhattasali, 2002).

The pilot programme which began in 1996, mentioned above (phase three) continued into phase four and expanded, involving certain, selected foreign banks to accept Renminbi (RMB) deposits from foreign individuals who had lived in China for more than one year, from foreign enterprises (including enterprises from SAR's like Macao and Hong Kong) or re-deposits of RMB denominated loans to non-foreign funded enterprises – it must be stressed, however, that this was a highly restricted pilot and not the norm at the time. Additionally, these pilot-programme banks were allowed to offer RMB loans and provide loan guarantee services to foreign enterprises or non-foreign funded enterprises that received income in foreign currency (Bonin & Huang, 2002; ACFB, 1997).

The pilot programme above expanded from 1996 to 2001 at which point 31 foreign banks were approved to offer the above said services – 23 of these being in Shanghai and 8 in Shenzhen, indicating small clustering and continued geographic restriction (Bonin & Huang, 2002). At this point, asset value of these foreign banks in China was over RMB45 billion (ACFB, 2002) – however, this only accounted for a fraction under 2% of the total assets in the Chinese banking sector. The RMB share was even less, accounting for 0.34% (ACFB, 2002).

[6] A large portion of NPL's from the four largest state banks were transferred to these asset management firms in 2000 – this is examined in detail below.

The country’s WTO commitments, explained in more detail later in the text, involved China undertaking to expand the scope of business available to foreign banks, as detailed in the table, below:

<table>
<tr><th>WTO Entry (plus years)</th><th>0</th><th>1</th><th>2</th><th>3</th><th>4</th><th>5</th></tr>
<tr><td>Relaxation of geographic restrictions</td><td>Shanghai Shenzhen Tianjin Dalian</td><td>Guangzhou Qingdao Nanjing Wuhan</td><td>Jinan Fuzhou Chengdu Chongqing</td><td>Kunming Zhuhai Beijing Xiamen</td><td>Shantou Ningbo Shenyang Xian</td><td>No geographical restrictions</td></tr>
<tr><td>Relaxation of client coverage restrictions</td><td>On accession no limitation on foreign currency business</td><td colspan="4">Local currency business to Chinese enterprises only</td><td>No client restrictions</td></tr>
<tr><td>Relaxation of company licensing restrictions</td><td colspan="5">Total assets more than USD10 billion to establish subsidiary or joint venture. Total assets more than USD20 billion to establish a branch Further licensing requirements to engage in local currency business are 3 years business operations in China, being profit making for 2 consecutive years prior to the application.</td><td>No establishment restrictions</td></tr>
<tr><td>Activities allowed without exception</td><td colspan="6">Auto financing by non-bank financial institutions Provision and transfer of financial information / software Advisory, intermediary services including credit reference and analysis, investment mergers and acquisitions and portfolio research.</td></tr>
</table>

Table 1 (*from* Bonin & Huang (2002))

In addition to the above, sanctions, government personnel movement, new regulations and a good deal of moral-persuasion backed up with policing brought great pressure to bear on financial institutions to improve their corporate governance and reporting (i.e., financial information) transparency. These measures provided for more uniform treatment of financial information which, in turn, allowed for greater scrutiny and more effective regulation than before in the sector (Bhattasali, 2002; Boyreau-Debray, 2002; Cassidy, 2002; Lardy, 2002).

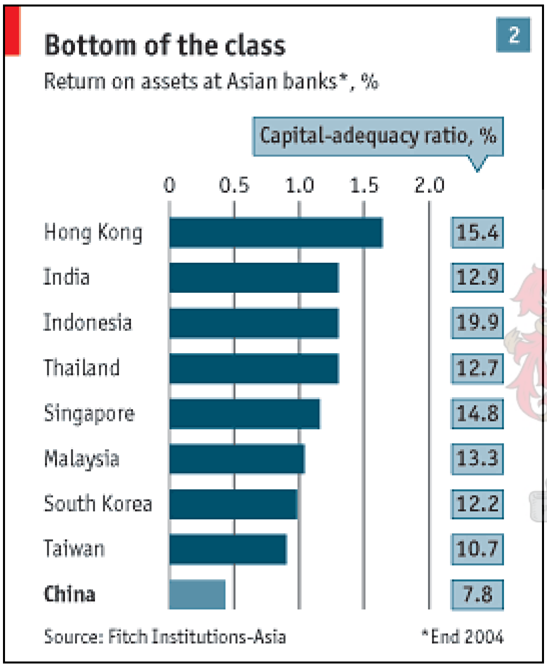
The big four state banks had never operated with a large degree of capital and the adoption of international best practice for capital adequacy ratio’s (8% is required by the BASEL accord which is an international agreement on risk management in banking) saw the government attempt to improve these ratio’s to acceptable levels. As such the Ministry of Finance issued special 30-year RMB 270 billion government bonds in August 1998 to raise funds for a capital injection into the state banks – this was the official reason for the capital injection, although global speculation also pointed to a bail-out to prevent un-marketability on the international scene owing to NPL’s (Lardy, 2002). The very mixed effects of this are shown below:

Bank	1997	1999	2002
Industrial and Commercial Bank of China	2.55	5.7	5.54
Bank of China	4.70	3.0	8.15
China Construction Bank	2.73	2.5	6.91
Agricultural Bank of China	2.14	5.1	1.44

Table 2 The Capital Adequacy Ratio of the big four state banks

Source: Annual Reports of the Industrial and Commercial Bank of China, Bank of China, China Construction Bank and Agricultural Bank of China

However, Citigroup (2002) estimated that the ratio of NPL's at the four state-owned banks at about 35% at the beginning of 2002 and the average capital adequacy ratio (CAR) – as shown above – of these four banks to be around 5%. In short, the bank recapitalization in late 1998, which had raised CAR to over 8%, could be considered a wasted effort as CAR had again deteriorated and NPL's remained at high levels. The primary reasons for this rapid deterioration in the financial health of the banks since the capital injection are that the composition of the customer base did not change. This means that state-owned enterprises (SOEs) remained the biggest borrowers, resulting in intermittent pressure on the banks since 1997 from the government to expand investment credit in order to combat deflation and to expand social stability loans to reduce firm closures – and destabilising unemployment.



Additionally, to dispose of NPL's, the government, in 1999, established four asset management companies, capitalised at RMB 10 billion each, to acquire the big four state bank's NPL's. These companies were Cinda asset management, associated with the China Construction Bank, Great Wall asset management associated with the Agricultural Bank of China, Oriental asset management associated with the Bank of China, and Huarong asset management associated with the Industrial and Commercial Bank of China. As wholly state-owned financial institutions, the asset management companies remained (and remain) under the supervision of the central, with additional guidance from the State Securities Supervisory Committee of China and the Ministry of Finance. The general mandate of the asset management companies is to collect debt, restructure, or assign NPL's; convert NPL's into equity; issue financial bonds and borrow from financial institutions (Cinda made an Asset

Backed Securities contract with Deutsche Bank, which in turn then issued bonds abroad for the company); and, recommend companies for listing (Lardy, 2002b).

Since their inception, the asset management firms have made some progress in terms of reducing total outstanding value of the NPL's through debt market trading and financial debt instruments. Approximately RMB 1.4 trillion (UD $ 0.169 trillion) of NPLs (about 15.6% of the combined total of outstanding loans) were transferred from the four state banks to the asset management companies – effecting another debt bailout (Lardy, 2002b). However, the NPL's of the state banks have continued to grow sharply. Furthermore, it has become clear that other financial institutions' NPL problems have also worsened and their capital adequacy ratios too have steadily declined. The most important challenge facing China's financial reform is how to resolve the NPL problems and how to increase capital adequacy ratios and move away from the culture of defaulting on loans (Lardy, 2002b).

According to experience in other countries, generally one Asset Management Company is established to play the role of disposing of NPL's of all financial institutions comparable to the state banks. Contrary to this practice, China took a somewhat different approach, assigning an asset management company to each bank – this was for two main reasons. Firstly, the size of loans is (and was), on average, small and the clients very widely dispersed[7]. Owing to these factors, it would prove very difficult to have one asset management company to deal with all the state banks' NPL's. Secondly, given that every loan emerged from relationship lending, it was crucial to have informal and, in many cases, unrecorded information about those loans. For this reason, many staff members of the asset management companies were seconded from the relevant state bank. Thus it was relatively important and more suitable for China to allocate an asset management company to each bank.

Unfortunately, the effectiveness of the asset management companies was hampered by the appointment of management (specifically, the managing and vice-managing directors) by the various provincial political structures. This resulted in less effective dealings with many SOE's – owing to political pressure. Generally, the process of disposing of NPL's began with the NPL's that were most easily reformed – again, partially owing to political interference; meaning that the remaining NPL's are those that are much harder to tackle.

[7] For example, China and Great Wall took over about 2 million enterprises/natural debtors, totalling about 4 million contracts, averaging US $20,000 for each debtor and US $10,000 for each contract.

In 2000, credit to SOE's with large NPL's on state banks books was halted in several inland provinces. This policy was to be adopted across China over the next few years, forcing loans from state banks to be made against collateral (something SOE's were previously not compelled to do – an almost ludicrous proposition in most banking sectors). Additionally, to shield banks from political pressure as much as possible, further laws were enacted stating that individuals and non-bank organisations may not interfere in any bank operations. Reports of the success of this endeavour have been scarce – although the subject is, admittedly, hard to gauge. Additionally, to shield banks from commercial pressure and to stop SOE's from circumventing state finance, commercial banks were also barred from lending to parties related to the process above (Lardy, 2002b; Bhattasali, 2002).

Despite the above measures, the total amount of state banks' NPL's reached RMB 2 trillion at the end of June 2003 (not counting the transfers to the asset management companies. Thus, it became necessary for the state banks to begin to dispose of NPL's quite urgently and before making any restructuring reforms. The question left was what course to take in order to dispose of a large amount of NPL's – a very important issue. Regulations that discourage banks from conducting direct disposals of NPL's have existed for a long time. For example, a regulation prohibits a bank from disposing of its NPL's at a discount – a reasonably common practice elsewhere in the world. The four state banks are also prohibited from performing informal negotiations with a debtor or cancelling part of the debt without court approval (Lardy, 2002b; Bhattasali, 2002).

To circumvent a diatribe on the various laws regulating commercial bank business, it will suffice to say that the state banks are not allowed to carry out investment banking businesses – as described above. Given the very limited number of measures to deal with NPL's by the state banks, the government obviously hoped that the asset management companies would be able to successfully dispose of the NPL's. However, the pace of NPL restructuring through these companies has not been as rapid as it would appear was envisaged. Since NPL's have increased rapidly in the interim between the asset management companies debt-takeover, the government (from 2003) began to actively encourage the state banks to directly dispose of NPL's and welcomed foreign investors to join in the market for NPL's through rapidly modified (or sometimes ignored) legislation. Further comment will be delivered on this issue when recommendations are made later in the text.

In 2004, the government launched a further bout of banking sector reform. This included NPL disposal at the big four state banks through a number of measures, including recapitalisation, broad reforms of the capital market and a marked improvement in corporate governance through adoption of further international-best practice methods. Industry analysts speculated that this was chiefly (and, in retrospect, quite rightly) to prepare the state banks for public listings by way of IPO's (Initial Purchase Offers – a standard means of listing unlisted firms). Additionally, the government injected another RMB 372 billion (US $ 45 billion at the market value at the time) into the Bank of China and China Construction Bank, short-listing these as the two prime candidates for initial offerings. As a result of the cash injection, the two bank's capital adequacy ratios exceeded 15% each. Given that China has ample foreign reserves, utilizing foreign exchange reserves to inject capital to banks is one measure to resolve the problems of capital inadequacy and could be regarded as a reasonable way of utilizing foreign exchange reserves.

It is commonly held that the injection to the above mentioned banks is just a first step in China's banking restructuring strategy; the remaining two state banks are expected to follow along the same path in the near future. However, the government has not decided whether cash injections should be made to them given that their performance is much poorer relatively, implying that it will take a longer time for the other two big state banks to be eligible for public listing. The Agricultural Bank of China has the largest NPL's (in relative terms) while the Industrial and Commercial Bank of China's assets are the largest in absolute terms (Laurenceson, 2004).

China's state-owned commercial banks and joint shareholding commercial banks also adopted the internationally accepted five-category loan classification system that grades loans as being either Pass, Special-mention, Substandard, Doubtful and Loss in 2004. Additionally, legislation and rules were enacted to attempt to force banks to lend on commercial criteria only – although, as mentioned above, political pressure in local government areas meant that this was not always possible (People's Daily, 2003a; People's Daily, 2003c).

Finally, further clarification of the roles of the China Insurance Regulatory Commission (CIRC) and the China Securities Regulatory Commission (CSRC) went a long way toward strengthening banking sector oversight. Additionally, further diversification of financial instruments to meet the emerging needs of savers and not just those of the banks (e.g., mortgage loans or automobile finance to accompany the anticipated growth of newly created housing markets and the anticipated increase in automobile purchases after accession to the WTO) provided additional liquidity which was, thanks to a number of the above reforms, not being channelled to non-performing SOE's but rather through less risky capital loan approval procedures. Furthermore, licensing for WTO entry (providing license early enough for WTO entry to allow operation by the firms who were seeking licenses) began as early as 1998 with certain firms and institutions, although limited in number, anticipating further reforms and seeking new business within China (Lardy, 2000; Lardy, 2002; Mathieson & Roldos, 2001).

Liberalisation of Capital Controls

As well as the reforms above, China's Open Door Policy signalled a willingness on the by the government to use foreign capital to fund domestic investment – however, capital controls at the time made it very difficult for foreign capital to enter China. During the 1980s the majority of capital entering China for investment came in the form of foreign loans, and official donors such as foreign governments and international organizations (e.g., IMF and the World Bank) featured prominently. These loan inflows were relatively small and only averaged around one percent of GDP at the time, peaking at 1.68% in 1990. Foreign direct investment (FDI) was significant and increasing during the 1980s but never exceeded 1% of GDP (Laurenceson and Chai, 2003). National stock markets were not established until 1991, thus there was no foreign portfolio investment possible.

The funding roles were reversed in the following decade as, while FDI trailed foreign loan inflows during the 1980's, the polices that liberalized FDI in the early 1990's contributed to FDI inflows averaging around 4% of GDP during the 1990's (and it is important to remember that these figures represent considerable absolute growth, as China's economy – and thus GDP – were growing consistently) with a peak in 1994 of 6.22%[8]. Aside from FDI, the formation of national stock markets, as mentioned above, in 1991 made it possible for foreigners to undertake portfolio investment in China. Nevertheless, foreigners were only permitted to purchase equity in Chinese companies listed on the B-share market. The A-share market, which contained a greater number of listed companies, was reserved solely for Chinese individuals and companies until after WTO accession. Controls over other types of capital flows, such as foreign loans and

[8] It should be noted however that a significant proportion of this FDI could in fact be capital of Chinese origin seeking to take advantage of concessions extended to FDI. Lardy (1995) reports that the World Bank in 1992 guessed that round-trip capital might comprise as much as 25 percent of gross investment inflows into China.

Chinese investment abroad, remained largely in place in terms of capital controls preventing capital from leaving China (see Yu, 2000 and IMF, 2003).

However, in 2002, 2003 and 2004, China absorbed more FDI than any other country in the world, including the United States – thanks largely to the policy reforms in terms of incoming capital controls (People's Daily, 2003a; People's Daily, 2003e). These policy liberalisation reforms included moving decision making power away from central government, over time, and toward local and regional government with respect to the screening and approval of FDI (ACFERT 1985; ACFERT 1997/8).

Additionally, rules and restrictions governing joint-venture requirements for starting businesses in China were relaxed, leading to a dramatically increasing level of FDI directed toward wholly-owned foreign enterprises in China. This saw wholly owned foreign enterprises move from accounting for less than 5% of FDI in the early 1980's to over 36% by 1997 (ACFERT 1997/1998).

Further moves from the command economy, such as greater managerial control over SOE inputs, outputs, core financial decisions and pricing saw reductions in inefficiency and saw a large number of these firms privatised – mainly through FDI. This was made possibly, to a large extent, through sectoral controls being relaxed and the Chinese services sector being globalised (Chai, 1998).

Finally, various tax breaks and incentives were provided (such as offering concessions on customs duties, industrial and commercial taxes, income taxes and taxes on profit remittances as well as reduced fees for land use, labour services and other public utilities) While these incentives were initially confined to FDI located in Special Economic Zones (SEZ's), over time – and because of greater autonomy in decision making for regions, as indicated above – they become more widely available, particularly to those cities and provinces located in the coastal regions, which were more able to direct their own matters owing to the influence they had gained through previous positive economic performance (ACFERT 1985; Chai, 1998; Lardy, 1995).

The considerable growth in FDI has taken place in the environment of the above reforms and initiatives to promote FDI but capital controls still exist. Lardy (1995) argues that Chinese capital controls have become porous over time and that this has also contributed to effective capital movement into – and out of – China. Ironically, a large body of work, including Gunter (1996), Wu & Tang (2000), Chai (1994) and Lardy (1995) have shown by way of empirical evidence that capital controls designed to prevent Chinese capital from moving abroad have met with very limited success. Chai (1994) would appear to be the first author to point out that for much of the reform period China would appear to have been a net capital exporter[9].

Exchange Rate reform

In 1979, the RMB was not easily tradable or convertible into more global currencies and was pegged at a massively overvalued RMB 1.5 to the US Dollar. In an attempt to bring in line the exchange rate, China adopted a 'shadow' exchange rate in 1981, known as the International Settlement Rate (this was calculated from the average cost of purchasing a dollar via *exports* – as opposed to on the currency market – and a rate was set at RMB 2.8 to the dollar). This rate was used in international trade and foreign currency dealings (Chai, 1998).

Elementary mathematics shows that the above rate setting at RMB 2.8 to the dollar was an effective devaluation of the RMB by almost 50% of its previous trading (pegged) value. Further systematic devaluations took place. 1985 saw the 'official' exchange rate aligned with the International Settlement Rate (RMB 3.71 to the dollar at the time) – thus moving all currency operations to the devalued rate (Chai, 1998).

Additionally, the exchange rate was forced down through selling pressure from the introduction of swap markets (as part of reforms mentioned above in diversifying financial instruments – a good indication of the relevance of currency to financial institutions, especially banks, who can diversify their risk in the currency market) where firms – and eventually, in the early 1990's, individuals – could sell surplus foreign currency at rates determined by market (demand and supply) forces. Estimates have the portion of currency traded at market rates through the currency swap markets at approximately 80% as early as 1992 (Chai, 1998).

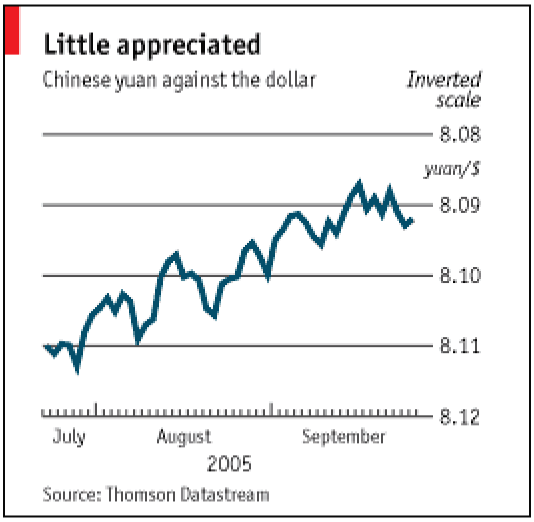
[9] McKibbon & Tang (2000), quoting World Bank data, argue that in 1995, China was already the eighth largest capital supplier in the world and the largest one among developing countries through such capital flight.

1994 saw the official (i.e., unified in 1985) exchange rate abolished and the currency market unified with the swap market's exchange rate. The RMB (also referred to as the yuan) traded at overvalued levels during this timeframe, hurting trade to a very limited degree, according to Chou and Smith (1998). However, The RMB had largely begun to reflect its equilibrium value by the 1990s.

From the mid-90's the RMB was traded via a managed float system, whereby market forces determine the interbank forex rate daily. Economists would, however, label China's exchange regime a 'dirty float' owing to the extensive manipulation of the rate by the Chinese central bank, effectively pegging the currency against the dollar with a very narrow trading bank of 0.3% daily variance being allowed. This band maintenance was achieved through buying and selling RMB and dollars on the international market and manipulating the market or floating price of the yuan (IMF, 2003).

In 1996, the yuan became convertible for current account transactions – i.e., could be used by the government in international balance of payments transactions. This watershed was reached far earlier than original expectations - officials and commentators in 1993 predicted a ten-year time frame at the least. In 1997, following on from the earlier than expected achievement of current account convertibility, China's leaders announced the goal of achieving capital account convertibility by year 2000. The events of the Asian financial crisis, however, scuppered this plan (Groombridge, 2001).

Nonetheless, Hu (2001) argues that the achievement of current account convertibility and WTO accession amounts to significant de-facto capital account convertibility. For example, one of the most popular methods for Chinese companies (and, indeed, their European Union counterparts) to illegally move capital abroad has been through the misinvoicing of trade (the over-invoicing of imports and under-invoicing of exports). The achievement of currency convertibility for current account transactions, and WTO-mandated trade and investment liberalisation more generally, has only served to make this process easier. The most significant official move towards full convertibility since WTO entry has been the introduction of the Qualified Foreign Institutional Investor (QFII) scheme. This gives approved foreign institutional investors limited access to the A-share market. A QFII can apply for a foreign exchange quota to be used for securities investment ranging from US $50million to US $800 million. As of October 2003, nine QFII licenses had been issued and in aggregate these foreign institutional investors received an investment quota of US $975 million to buy A shares, bonds and mutual funds (China Daily, 2003; Groombridge, 2001).



Finally, on July 21st 2005, China moved to an exchange rate based, not solely on the US Dollar (critics called the dollar-band management an effective currency peg) but a managed-floating regime pegged against a basket of currencies, including the Euro – which will be allowed to fluctuate by 3% per day (This probably implies, as the Economist (2005c) points out, more management than floating). As part of this change in exchange rate regime, the yuan was allowed to appreciate moderately against the dollar (see graph on the right – source: Economist, 2005b) from US $ 8.28 to US $ 8.11 (rounded to the nearest figure) – not a massive amount of change (Economist, 2005a).

However, the change in regime brought a great deal of raise for China's actions as it took the currency somewhat closer (although, in truth, only very marginally) to a free-floating currency after 11 years pegged to the dollar only. However, the dollar-trade band (the dollar being the target currency for the yaun's tracking) is still in place at 0.3% daily variation – but it is worth noting that the absolute rate shifted by 2.1% - as indicated above through the move from 8.28 to 8.11 (Economist, 2005c).

At September 2005, however, the US was still insisting further appreciation of the yuan – many US politicians blamed the relatively undervalued yuan (even after the small revaluation) for the poor balance of payments and large trade-deficit with China. The US claimed that Chinese efforts to depress the value of the yuan were providing an unfair cost advantage to Chinese exporters. At the time of writing, Chinese monetary authorities show no sign of further devaluing the currency (Economist, 2005a).

Two alternative hypotheses are provided by Lardy (2002) and the Federal Reserve Bank of San Francisco (FRBSF, 2002). One of these is that China has long regarded the maintenance of the peg to the dollar as an important anchor for its domestic monetary policy and still regards it as such (official statements notwithstanding and despite the recent development of a currency basket – the dollar is still the most narrowly traded) – not to mention the benefits for export of preventing the RMB (or yuan) from appreciating against the dollar, making exports cheaper and thus more attractive to export markets. Thus, owing to the regard of the dollar as important to monetary policy and because the US is China's largest trading partner, the RMB was allowed to follow the dollar up against other currencies when the dollar was appreciating during the 1994–early 2002 period, and it has followed the dollar down since then.

The second hypothesis is that China earlier regarded its peg to the dollar as essential to its domestic financial stability but has lately grown increasingly uncomfortable with it (e.g., because the domestic credit crisis of 2003 and the first half of 2004 demonstrated the costs of not having a more independent monetary policy). It would like to move to a more "flexible" regime in the future (the first steps having been taken with the recent move to a currency basket for the peg) but doesn't regard present conditions as right for an "exit" from its peg (second best strategy – more on this below) both because a revaluation or appreciation would reward the speculators and, potentially more important from a political economy point of view for the government, because it would be seen as giving in to foreign pressure. Thus, China will continue with the newly reformed regime until such time as the authorities view "exit conditions" as more favourable.

Chapter 5: China's WTO Commitments: Financial Services

Upon accession in 2001, China undertook a wide array of commitments to liberalise, deregulate and open various markets and industries. A full examination of these undertakings is, owing to the scope of this text as well as brevity concerns, not possible here. However, what follows is a summation of the commitments undertaken by China, first in broad terms and then specific to financial services and, later, the banking sector.

General undertakings and commitments

China's undertakings for the 2001 WTO accession were possibly the most far-reaching and dramatic undertakings of any country joining either the WTO or the history of the Uruguay Round of trade negotiations. China undertook a number of very strict and – some would argue – disadvantageous commitments to secure WTO membership in 2001 (the subject of Chinese WTO membership was, at the time, a fiercely debated and much opposed issue).

Transparency

China has undertaken to improve transparency in trade related policies and related issues. This comprises improving the openness (i.e. visibility to external parties) and predictability of the legal framework governing China's internal and external trade regimes as well as transparency in the functioning of these regimes. This process includes making available all regulations and legislation in place with regard trade[10] available to all WTO members; notifying the Chinese public and the international trading community of amendments to or the introduction of new laws governing trade or aspects of trade as well as reasonable opportunity to comment on such amendments or introductions; translation of legislation and policies into one of the official WTO languages (English; French or Spanish) within 90 days of implementation of said legislation or policy; and establishing procedures and institutions for addressing questions of WTO members, companies or individuals with regard trade and relation issues and legislation (USTR Report, 2002; World Trade Organisation, 2001).

[10] Trade is used to understand trade in goods, services, trade related investment measures, trade related aspects of intellectual property rights and control of foreign exchange, in line with the US Trade Representative to Congress and the understanding of the phrase used in the WTO document governing the accession of China to the organisation (USTR Report, 2002; World Trade Organisation, 2001).

Non-discrimination

In accordance with the guiding principles of the WTO, China has undertaken to practice non-discrimination through extension of the Most-Favoured Nation (MFN[11]) principle and the National Treatment[12] principle as well as undertaking to repeal or amend all legislation and policies not in accordance with the general WTO rules and the specific undertakings China agreed to in the accession protocol (USTR Report, 2002; World Trade Organisation, 2001).

Independent Review

China has agreed to establish review courts or tribunals in order to review administrative and legislative decisions with regard trade policy. Such tribunals are to be independent of the state and government in all aspects with regard to their decision making and investigation processes. Review processes set up in this regard are also to include the right to appeal the decision of the review tribunal (USTR Report, 2002; World Trade Organisation, 2001).

Uniformity in application

Lastly, China has undertaken to ensure uniformity in the application of trade agreements and WTO stipulations throughout China and all regions of the country, including special economic zones (SEZ's). This comprises ensuring that compliance is assured at national, provincial and local government levels to ensure that all WTO stipulations are met as required. As an enforcement tool, the establishment of an internal review process is required to investigate and address inconsistencies in application of WTO agreements or regulations (USTR Report, 2002; World Trade Organisation, 2001).

As with the above, the Chinese commitments on the banking sector were far-reaching and quite radical in terms of the effect that these could have on the domestic banking sector within the country. After briefly outlining the broad scope of the commitments in financial services and banking, attention will be given to the possible motivation for commitment to such a fundamental liberalisation of the sector.

Financial Services: undertakings and commitments

The undertakings specific to securities and fund management will be reviewed first in order to create a view of commitments for the financial sector as a whole and, specifically, because most

[11] This principle requires that all WTO members receive the best trading privileges that are granted to any other member (World Trade Organisation, 2001).

[12] Imported goods are treated no differently from domestic goods (World Trade Organisation, 2001).

foreign banks that would entertain the concept of investing in the Chinese banking sector would have some form of involvement in this area – this ties in with the explanation earlier in the text that the lines between the banking sector within the financial services sector and the rest of said sector are, from time to time, somewhat blurred distinctions (Bhattasali, 2002; Fang, 2001; Lardy, 2000; Pomerleano & Vojta, 2001).

Securities

In terms of securities, foreign securities firms would be allowed to engage directly in "B share" business (reserved for foreign investors – so not a massive concession) in China immediately. Additionally, foreign investment banks would be permitted to establish joint ventures by 2004 (with foreign ownership not exceeding 33%), to engage (without a Chinese intermediary – i.e., directly) in underwriting domestic shares (A shares) and underwriting and trading in foreign currency denominated securities (B and A class shares, government bonds and corporate debts). Representative offices of foreign securities companies were also permitted, immediately upon accession, to become special members of Chinese stock exchanges – the implications of which were that information from these exchanges was, in some instances for the first time, available to foreign securities analysts and investment management firms (Bhattasali, 2002; Bonin & Huang, 2001; Cheng, 1999; Lardy, 2000; Mathieson & Roldos, 2001).

Fund-Management

In terms of fund management, specifically, it became immediately possible to establish joint venture fund management companies (as with securities, foreign ownership limited to 33%) to conduct fund management business – allowance was also made to increase foreign ownership to 49% after three years[13]. Fund management differs from securities trading firms in that the underlying securities are often purchased and held for longer terms than trading houses (as above) would generally hold them for. The difference in important as pension funds (China, by virtue of it's massive population) traditionally use fund managers as opposed to trading houses to manage their investments (Bhattasali, 2002; Fang, 2001; Lardy, 2000; Wong & Wong, 2001).

Banking Sector: undertakings and commitments

This section details the specific undertakings in the banking sector under the WTO agreement.

[13] The reading of the agreement would seem to indicate that this is *not* an across the board liberalisation from 2004 onwards but rather a concession to firms that have operated as fund managers in the Chinese industry for at least three years.

Geographic

Specific to banking, China undertook at accession to the WTO, in terms of geographical matters, to immediately remove the geographical restrictions previously imposed on banks dealing in foreign currency operations – the implication of this was that, broadly, the large portion of foreign banks in China were now free to locate anywhere within the country and were not subject to restrictions as they were in the past. Additionally, and far more importantly, the government undertook to phase out geographical restrictions on local currency business for foreign banks – thus opening up the massive Chinese domestic commercial and core retail banking markets to international competition – previously only the foreign banks taking part in the Shanghai and Shenzehn pilot programme could perform these services. By the end of October 2003, 84 foreign banks held local currency (RMB) licenses in China (People's Daily, 2003b; People's Daily, 2003d). It was agreed that said phasing out of operations would take place over five years, resulting in full-deregulation (in terms of geographical location) by 2006. This phasing out would take the form of four cities at a time – four at inception and four for each phased movement from there on in – table 1, above, lists the major cities that opened on a year by year basis (Lardy, 2000; Lardy, 2002).

Products

China furthermore committed itself on banking products. Foreign banks were to be allowed to provide local currency services to Chinese enterprises by 2003 and to all Chinese individuals by 2006 (the latter provision goes a long way toward explaining the mass of interest in purchasing interests in Chinese banks in 2005). The implication of this undertaking was essentially to throw the market open to international competition. Domestic banks would no longer be shielded from international competition in the domestic market and significant pressure would be brought to bear in terms of rationalising NPL's and assuring proper business models in future. For a summary of these measures, see Table 1, above (Lardy, 2000; Lardy, 2002).

RMB dealing

One of the most significant events since WTO entry occurred in late 2003 when foreign banks that held an RMB license were also permitted to apply to handle RMB business with Chinese enterprises, in the 13 cities that had been declared financially opened by this time (People's Daily, 2003c). This marked the first time foreign banks had been permitted to provide RMB services to Chinese enterprises, in line with the WTO undertakings two years earlier. In January

2004, four foreign banks were given approval to begin such business (People's Daily, 2004a; People's Daily, 2004b).

Prudential Measures

Finally, China committed to eliminating all non-prudential measures (or protectionist restrictions) regarding bank ownership, operation, branch rules and licensing of banks by 2006. Additionally, rules regarding the establishment of foreign banks would be revised to, similarly, remove any non-prudential rules and bring the legislation regarding these matters into line with international best practice (i.e., in terms of WTO rules, assuring national treatment[14] of all foreign banks within China) (Lardy, 2000; Lardy, 2002).

Motivation for WTO concessions

When China was negotiating WTO entry in 2001, much had been said and written about the effects of foreign entry into developing countries' financial markets. Concerns over the survival prospects of domestic banks and other financial institutions as well as the more threatening prospects of massive macroeconomic risks were balanced against previous, favourable experienced of financial market liberalisation and the benefits this had brought (examples abounded in South-East Asia, even after the currency crisis of 1997 / 1998).

Bhattasali (2002) argues that the Chinese decision to join the WTO was an attempt to 'benchmark' Chinese economic activities against international standards. Lardy (2000) goes further in pointing out that WTO membership would offer lucrative benefits to Chinese economic growth and would open markets to China that had previously been inaccessible – further providing impetus for the continued trend of strong economic growth. On the basis of these arguments, it would seem, in terms of the financial sector, that concerns over foreign entry were found less compelling arguments than the arguments supporting financial markets efficiency and improvement as a result of foreign entry. Specifically, when considering the importance of a sound financial sector to provide domestic capital for growth, the decision to radically liberalise the Chinese banking sector seems the only logical choice, especially when one considers the pitiful state of the financial sector and the seemingly never-ending cyclical bad debt inherent in the sector.

[14] National treatment, simply stated, means making no differentiation between foreign and domestic firms in whatever sector they trade (i.e. no discrimination against foreign entities).

As such, it would seem that the core motivation for liberalisation of the financial sector not as a vehicle to provide further growth through mobilisation of a greater volume of financial savings (China's savings rate was already very high) or promoting higher investment levels but rather as a lasting, if initially difficult, means to increase the efficiency of the banking sector and assure a permanent basis for providing for future economic growth (Wong & Wong, 2001).

At first glace, the two motivations above may appear to be similar. However, when seeking to liberalise financial markets for increased capital availability, the focus tends to fall on facilitation of greater savings and, more often than not, provision of liberal credit policies and so-called 'easy money' to potential investors. This usually has the effect of providing a short term 'boost' to economic growth but can have unhappy side effects, as it did in the case of a number of Asian tiger economies in the 1997 / 1998 currency crisis (Fang, 2001; Lardy, 2002;).

However, when the goal is systemic change to provide for greater efficiency, as in China's case, there is less of a focus on mobilising capital for investment and greater emphasis on prudence and safe-guarding regulation of the sector. This was obviously possible for China only because of the happy situation the country found itself in with regard to a much higher than average domestic savings rate. As such, and contrary to the traditional Asian tiger model – in terms of the financial sector specifically – Chinese reform saw a slowing of credit and less 'easy-money' in the economy and available for investment. This could be done as there was minimal threat to growth. Major growth drivers like a mass of world-relative cheap labour and high technological rates of innovation (and, one may argue, more importantly, imitation) provided for growth in the absence of cheap credit and easily available capital. Bhattasali (2002) and Lardy (2000) argue that this leads to a more secure basis for future economic growth when other growth drivers have been eroded (e.g., higher wages being demanded by an increasingly well-off and sophisticated population) or limited by other means (Cassidy, 2002; Lardy, 2000).

Additionally, concern among Chinese policy makers regarding efficient resource allocation throughout the economy as well as concerns over pricing, competition and fiscal reforms all pointed toward radical reform of the financial sector – as opposed to the alternative, further protectionism and much later international market entry – because inefficient operation of the financial sector skews all of the above, making it very difficult to implement reform in other sectors over the long term (e.g., inefficient financing increases costs, making it difficult to allocate resources on a purely economic basis owing to pricing being uncertain (because pricing is affected by financing of resources) (Li & Jun, 2001; Lardy 2000).

Finally, given the size of the state banks in the domestic market and the pervasiveness of information gaps, control problems (which lead to ineffective management) and the problems, politically and socially, linked to severing SOE’s easy credit financing and NPL history, there was a strong need to introduce competition rapidly – again, something that China, thanks to high savings rates and a growing economy, could *afford* to do (Li & Jun, 2001; Lardy 2000).

Chapter 6: WTO entry and beyond: problems remain

Despite nearly 23 years of systematic, if somewhat sluggish, reform, China's banking sector was far from ready for increased foreign competition before the 2001 accession to the WTO. A profile of the industry immediately prior to accession is as follows: The size of the industry was – and remains – remarkable by any global standards, thanks in part to the massive population of the country as well as to the relatively high propensity to save on the part of the Chinese (total bank deposits reached the very high level of 150% of total GDP in 2001 – far higher than US or European savings levels at any time in the last 20 years) Given China's failure to develop healthy stock and bond markets, bank assets have ballooned to almost 30 trillion yuan (US $3.7 trillion) in 2004, or 210% of gross domestic product (GDP). That is the highest of any big economy, according Nicholas Lardy of the Institute for International Economics in Washington: India is at 170%, Brazil 160% and Mexico 100% (Bhattasali, 2002; Cheng, 1999; Lardy, 2003; Li & Jun, 2001; Economist, 2005b).

At this time China had the second largest securities market in Asia (1,189 listed companies, approximately 60 million brokerage accounts, and a sector market capitalization (shares issued multiplied by share value) approaching 45 percent of GDP – which, for the layperson, is exceptionally large in value and in number of participants for a developed country – to say nothing of a developing state like China, despite the population. The four largest state banks that had been transformed into universal (or capitalised – i.e., shares issued and not purely state owned in theory) banks and constituted the core of the financial system, accounting for approximately 86 percent of total deposit bank assets and 56 percent of total financial assets (latter market includes derivative financial instruments, amongst others) (Almanac of China's Finance and Banking, 2002; Lardy, 1998; Lardy, 2000).

Nearly 77% of the annual financial savings by households were deposited in the banking system during 1998-2001. As such, state banks handled the largest portion of finance available to enterprises and the government. The share of the most dynamic segment of the Chinese economy at the time, small and medium non-state enterprises, utilised only a fraction of the total of said finance – this, to the casual observer may not have seemed odd in China but is indicative of the fact that, despite massive improvements in China's financial system, the largest majority of new deposits were still finding their way to SOE's and other potentially non-performing loans through the banking sector. In addition to this, the rural finance system was malfunctioning with the Agricultural Development Bank of China, Agricultural Bank of China and rural credit cooperatives facing the severest loan repayment problems in the banking sector (Almanac of China's Finance and Banking, 2002; Bhattasali, 2002; Claessens, et al 1998; People's Bank of China, 2002).

Bank loans expanded by RMB0.69 trillion in 2001, while new equity issues and corporate bond issues were only a small fraction of this amount – this implies that new business and capital acquisition was still being funded by credit as opposed to new ownership or non-bank credit debt at this stage, further emphasising the problems of a now entrenched culture of growth on massive corporate and government credit – ironic, when one considers the entrenched culture of saving and general dislike of credit amongst the average Chinese citizen (Almanac of China's Finance and Banking, 2002; Boyreau-Debray, 2002 ;Fang, 2001; People's Bank of China, 2002).

Corporate (i.e., state enterprise) sector leverage[15] was very high in 2001; equally, a high proportion of loans taken by state enterprises was non-performing. Official government estimates (although, in China, such estimates have a habit of changing from year to year as the government vigorously restates statistics, some may say, to suit themselves) placed NPL's at the four large state banks at about 27 percent of outstanding loans – this figure excluded the NPL transferred (in 2000) to the four asset management companies (nearly 20% of loans outstanding at the four banks at that time). These figures clearly indicate the continued problem and culture of non-repayment rooted in SOE's but that have expanded, on the face of the matter, to other sectors of the economy as these have grown (largely owing to lax credit evaluation policies on the part of the loaning banks) (Boyreau-Debray, 2002; Hu & Zhou, 2001; Mathieson & Roldos, 2001).

Unofficial (Citibank) estimates of the remaining NPL's in the state banks have run as high as 40% to 50% of loans outstanding. Additionally, it is likely that other domestic banks have a larger proportion of NPL. However, neither the application of existing loan classification

[15] Leverage refers to the portion of total capital that consists of loans. If leverage is high it means that of a total value of an enterprise, a large portion of that consists of borrowed capital. High leverage finance is risky for the financing bank as well as, in most free-market instances, for the enterprise using such high leverage as massive repayments will not be met if profit is not made.

systems nor the current state of management information systems within the banks give analysts any reason to believe that the various estimates present an accurate picture of the condition of bank portfolios (Lardy, 2000) – these figures provide even more worrying a picture of the Chinese banking sector. Consensus amongst potential buyers of Chinese banks is that the real NPL figure is somewhere between the official and highest private estimates – exactly where is the type of information that a number of industry analysts would put a very high price upon (Bonin & Huang, 2001; Lardy, 2000; Wong & Wong, 2001).

The reason for this high price is that current reporting (audit and financial statements) standards and practices do not provide sufficient information for making judgments about the profitability of China's financial institutions, the adequacy of their capital bases or operational efficiency – this obviously impacts to a very large degree on valuation and, as the reporting of risk is similarly vague, assessment of risk is a very imprecise art (Lardy 1998; Cheng 2000; Bonin & Huang 2001; Fang 2001).

Additionally, despite early licensing and reform (1997 – 2001 period) in this sector leading up to and during the first months of the accession to the WTO, this sector was particularly wrought with problems. Chinese registered capital requirements (capital required for certain activities – e.g., how much capital a bank would need to offer financial services) were in most instances not realistic, in other instances not applied strictly. These desperately needed to be harmonized with international best practices (Brilliant, 2003; USCBC, 2003; USTR Report, 2004; Hom, 2003).

The internationalisation of China's banking sector has also seen China's regulatory authorities conform to international norms regarding the prudential control of financial institutions. In 2003, the China Banking Regulatory Commission (CBRC) issued new regulations on capital adequacy standards for commercial banks, based on the original 1988 version of the Basel Accord, an international convention on financial institution risk management (China Daily, 2003).

As part of this process (and as referred to above), in January 2004, two state banks (the Bank of China and China Construction Bank) received a capital bail-out (officially dubbed an 'injection') of US $45 billion as part of a program to bring their capital adequacy ratio above the eight% required by the Basel I Accord. The need for this capital injection further underlined the

NPL concerns for these banks, which underwent debt restructuring and a similar bailout in 1998 (People's Daily, 2004a).

However, an increasing number of foreign banks have also been given permission to buy stakes in Chinese banks. HSBC became the first foreign commercial bank after WTO entry to take an equity share in a domestic lender when it purchased an eight percent stake in the Bank of Shanghai in late 2001 – HSBC has since expanded it's interests in China, as is detailed below (People's Daily, 2002c).

Additionally, China's asset management companies and banks have been forming joint ventures with foreign financial institutions in an effort to sell off the large volumes of non-performing assets sitting on their balance sheets (People's Daily, 2002b; People's Daily, 2003c).

China's domestic banks have also been active in undertaking offshore expansion. At year-end 2001, domestic Chinese banks had established 452 banking institutions overseas that held total assets of US $151 billion. The bulk of this expansion was in the Hong Kong and Macao Special Autonomous Regions, which accounted for 374 of such institutions and assets of US $117 billion (ACFB 2002).

Key Problems of the sector

China's four state banks are all big – each bank has an asset size of more than $400 billion, employ over 400 000 people and have branches ranging from 15 000 to 58 000. Based on these resources, one would expect that said banks are large enough to compete successfully against foreign banks. Additionally, it would seem reasonable even when one considers the potential entry of major international players (e.g., HSBC) that have grown rapidly in recent years (Almanac of China's Finance and Banking, 2002; Bhattasali, 2002; Cassidy, 2002; Pomerleano & Vojta, 2001; People's Bank of China, 2002; Wong & Wong, 2001).

Size, however, is not the competitive factor in modern banking. The core sector-wide institutional problem for Chinese banks, particularly the big state banks is, relative to international competitors and in absolute terms, the lack of profitability and near insolvency – largely caused by the endemic NPL culture in the Chinese sector – as stated earlier, the legacy of poor credit control and state direction of funds in earlier decades. This unhappy legacy has the potential to undermine and effectively cripple any advantage and benefits that could result from the size, reach and infrastructures of the big banks (Bhattasali, 2002).

Commercial lending

A core problem, however, is that fact that despite improvements in recent years, the banks still do not have the final word on making lending decisions. Government still directs lending – although to a much lesser degree than earlier – and banks capacity to make decisions based purely on the appraisal of repayment ability and credit risk. Additionally, narrow interest rate spreads (differences in rates from which commercial banks can profit) between deposits and loans are administered by the central bank – reducing profitability further and removing incentives to supply credit to the more dynamic (and smaller, privately owned) sectors of the economy (owing to smaller margins to be made, given the relative cost-repayment abilities) (Bonin & Huang, 2001; Lardy, 2002).

Non-Performing Loans (NPL's)

The clearest problem for China's banking system, however, is obviously the prevalence of NPL's – especially the state-financing legacy these form at the four state banks. These banks, with their majority market share, are most threatened by NPL's and, concomitantly, the entire sector is at threat if these banks were to slip further in terms of performance of loans or earnings potential. The non-performing loans to the SOE's at the state-owned banks can be roughly classified into three categories: loans to traditional old-line industrial enterprises, loans to enterprises established during the mid-1980s in lieu of a founding equity and loans contracted during the overheated period in the early 1990s. On top of these three categories of loans, there were also the rollovers (appropriately disguised) of these non-performing loans since 1994 – partially owing to regional and national political pressure but also through lax management (Bonin & Huang, 2001; Bonin & Huang, 2002).

Bank vulnerability is accentuated by pressures on NPL's to increase. SOE's cannot very easily reduce their costs (e.g., due to impediments to reducing worker numbers), which limits their competitiveness and profitability, as well as their ability to service their debts. At the same time, because of their continuing importance (and the fact that they employ millions of workers), it is very difficult to cut off SOE's from financing completely (despite measures to limit their credit). The state banks thus face pressures to roll over SOE loans, even when SOE's have defaulted on their debts, which reduces funding for more worthwhile investment projects and ultimately limits growth.

In terms of annual flows, the non-performing loans amount to between 2% and 3% of GDP, comparable to the government budget deficits in many other countries. In terms of cumulative stocks (i.e., built up over time), they amount to approximately US $200 billion. With a GDP of approximately US $960 billion in 1998, this implies a non-performing loan to GDP ratio of slightly over 20%, which is quite consistent with estimates of 20% by the People's Bank of China and 25% by international credit rating agencies. However, the amount remains enormous in absolute – as well as relative – terms and a massive problem for the banking sector. These amounts have essentially been state subsidies via the state banks to SOE's – one could argue that if the fiscal condition of the Chinese government had been better, these subsidies could have come directly from the budget rather than indirectly through the state-owned commercial banks as loans. (Bonin & Huang, 2001; Lardy, 2002; Bhattasali, 2002).

Fiscal Constraints

A large area of concern in terms of restructuring of the banking sector is the massive fiscal constraints that China will be operating under in order to reform NPL creating SOE's. Government debt was approximately 13% of GDP in 2000 but could be much higher if implicit or explicit government liabilities are counted (e.g., the massive NPL's that are – in effect – state subsidies and thus liabilities owed to the state banks by the government). Additionally, expenditure has risen to absorb NPL's through bail-outs, to expand the social security system (necessitated by closing SOE's or privatising these – actions which invariably lead to unemployment in the short term). At the same time, government revenue (as a share of GDP and thus relative to growth and inflation) has fallen, from 35% of GDP in 1978 to 11% in 1995, in part because liberalization and a shift to a tax system has eroded revenues traditionally obtained directly from SOE revenues. As a result of recent tax reforms and collection efficiency improvements, the revenue share rose to 15% in 2000. As such, a key challenge is reforming SOE's without creating greater cost than NPL's would cause.

Size matters

Additionally, the state banks are further hamstrung by their relative inability to implement efficiency reforms (cutting staff or closing inefficient branches) – a legacy of their gargantuan size and state employment and servicing policies. These policies are, however, changing slowly and the banks are in a better position than in 2001. Further disadvantages when compared to international competitors include a relative lack of international practice, management and technology as well as a slow comparative rate of innovation and product customisation – a key element in international competitors (Bhattasali, 2002).

Reporting standards & supervision

The lack of quality and reliable information in regard to state banks is mirrored and in most instances magnified by other sections of the banking industry – the published data is habitually reviewed and restated and very little systemic research of any substance has been done. Bhattasali (2002) argues that the reliable information that does exist points toward an insolvent and illiquid trend in urban and rural co-operatives (a massive source of financing in lesser-developed areas of the country since the Agricultural Bank of China withdrew from sub-country level banking in 1996).

Additionally, Bhattasali (2002) points out how periodic reports of failures amongst these co-operatives do not engender much confidence in any real reform in the area up to his point of writing. This, worryingly, has been attributed to continued poor management on a massive scale as well as a lack of adoption of sound banking practices – something the WTO required in all parts of the banking sector to some degree (detailed below), as well as poor reporting standards by international comparison. The poor performance of such co-operatives is thought to be a massive stumbling block for the rural economy, cyclically contributing and being affected by the relative stagnation in the area since the mid-1990's (Bhattasali, 2002; Bonin & Huang, 2001; Li & Jun, 2001).

Additionally, for financial supervision and regulation to be effective (on the part of the central bank), the management of commercial banks must be made responsible for their banks' performance, implying that there must be hierarchical and business until control within the commercial banks – again, much as is common in most countries. To enforce financial discipline, weak banks and non-bank financial institutions must be allowed to fail or become bankrupt (or forced to consolidate and merge if necessary, as is the more recent trend). To a certain extent, the Chinese government has already implemented such a policy by allowing the closure of non-bank financial institutions such as Guangdong International Trust and Investment Corporation (GITIC) (Economist, 1999; Xinhua News, 2003).

Implicit guarantee

In addition to the above, other issues facing the banking sector include factors like the fact that, in the current environment, the central government or the central bank must be prepared to guarantee the security of deposits of all individuals (perhaps up to a ceiling amount). In other words, the government must provide universal implicit deposit insurance to all commercial banks (mentioned above), and the central bank must act as the lender of last resort when necessary – as is conventionally the case. The four major Chinese state-owned commercial banks are certainly "too big to fail" by popular consensus – implying that this guarantee is assumed. Implicit deposit insurance does, however, have the potential to lead to moral hazard on the part of the depositors as well as the banks – thus the international consensus regarding such issues that a ceiling amount on the insurance may be desirable (Lardy, 2002b).

The GITIC bankruptcy has significance for the banking sector (beyond the GITIC episode itself). It set a good precedent and sent a strong signal that non-sovereign (i.e. state) guaranteed debt is just that and that lenders, both domestic and foreign, should beware as, like anywhere in the world, Chinese financial businesses can fail. Thus, in one fell swoop, by not bailing out the creditors of GITIC, both domestic and foreign, and otherwise not interfering in the workout process, moral hazard on the part of both potential lenders and borrowers was reduced. The GITIC bankruptcy provided for equal treatment for all creditors in accordance with the priority established by law. It lead directly to the downgrading of the credit ratings of the Chinese state-owned banks and investment companies – Standard and Poor's assigned a "junk" rating to China International Trust and Investment Company (CITIC), the Bank of China, China Construction Bank and the Industrial and Commercial Bank of China, but there was a strengthening in the sovereign credit rating of China. This was accomplished through conventional international practice but extra-ordinary practice for China.

Moral hazard

Moral hazard can further be reduced through a reduction of excess leverage – high borrowings relative to capital (Asset price bubbles are frequently caused by over-leveraging – and these are notoriously dangerous, as a number of securities exchange collapses bear witness to). The damage from the bursting of an asset bubble can be minimised if the degree of leverage is controlled and sane – this is commented on in the recommendations below.

Political interference

Political interference with banking and monetary policy decisions is a problem in China. The institution of a US Fed-like system of district central banks in China is a first step to insulate the banking system from political influence at the provincial and local levels. Nine district branches of the People's Bank of China, each overseeing two or more autonomous regions, have been established (Tianjin, Shenyang, Shanghai, Nanjing, Jinan,Wuhan, Guangzhou, Chengdu and Xian). In addition, the original provincial-level branches have all been abolished – this is referred to above in terms of central bank reform. Eventually, perhaps even the central bank itself can become more independent of the executive branch of the government.

Human capital

A further issue is that there needs to be more investment in human capital in the banking sector. More education, training and institution building are required. Efforts should be made to develop and nurture a modern bank "culture" with emphasis on credit analysis, risk control and efficient provision of banking services to customers. It should be noted, however, that this lack of human capital is more of a generalised problem amongst developing nation's financial institutions than a specific trait of China's banking sector. Furthermore, one would rationally expect that, given the economic value in China, international interest should soon drive human capital up to more acceptable levels through technology and expertise transfer.

Covariant risk

A further structural weakness was created in the run-up to the WTO accession when the three policy banks in China (Agricultural Development Bank, China Development Bank, and China Export and Import Bank) has a significant portion of direct lending transferred to these banks and away from the four big state banks. These policy banks fund their operations through issuing long-term local currency bonds[16] (possible through the expansion of China's financial markets and instrument diversification), which are mostly purchased by the state banks. This creates a massive structural problem in that failure or significant underperformance by these three banks could have significant knock-on effects for the state banks (either directly or to current or future international owners) if such bonds cannot be repaid – this is known as covariant risk and it existed at the time among the major players in the Chinese banking system (Bhattasali, 2002; Hu & Zhou, 2001; Wong & Wong, 2001).

[16] Together these policy banks accounted for 11 percent of assets, 13 percent of loans, and less than one percent of deposits in 2002 (Bhattasali, 2002).

Taxation concerns

Taxation policies also pose a significant challenge to the Chinese authorities – on the one hand, a demonstrable need for government revenue exists and, other the other, tax must be tempered to foster growth, particularly in the banking sector – a sector which desperately needs to attract more foreign players. Business tax in China has, in the last few years, steadily declined from 8% to 5% - however, tax policies on banks are particularly unfavourable and continue to affect the prudent operations and profitability of banks. Presently, commercial banks are subject to two main forms of taxation: Business tax (as mentioned above), which is revenue based and income tax, which is profit based and is currently set at 33% for domestic commercial banks.

The level of corporate income tax levied on commercial banks is, compared to international standards, very high and this makes it difficult for commercial banks to achieve profits which, in a more conventional tax environment, would be possible. Furthermore, the high tax rate compares unfavourably with the tax rate for foreign banks in China. In terms of foreign currency operations, foreign banks are subject to a tax rate of only 15% (with a full tax break for the first year of operation and a 50% tax break for the second year (the 15% is applied from the third year onwards) – this meets the need to foster new foreign interest in the market but leaves the domestic banks (and, specific to this text, the state banks) at a disadvantage.

The level of revenue tax erodes profitability – China is one the very few countries in the world that impose a business tax on gross income for banks (Lardy (2002b) argues that this is necessitated by the urgent need for government revenue). Until 2001, the business tax rate was 8 percent (3 percent collected by the central government, 5 percent by the local government). Since then this rate has been reduced by 1 percent a year until January 2003, and to date it is 5 percent. Such revenue tax makes it difficult for banks to generate and retain earnings and thus to strengthen their capital bases. By way of example, ironically, in 1998 (at the time of the capital injections for the state banks), when the business tax was at 8%, the big four state-owned banks alone paid RMB 11.6 billion in business tax and generated a total profit of only RMB 4.1 billion. Furthermore, a significant tax-based disincentive still needs to be removed in order to encourage banks to increase their provisioning levels as, at present, the tax authorities impose a cap on the tax deductibility of specific loan-loss provisions at 1%. This severely discourages commercial banks to make adequate provisions that are urgently needed to accelerate loan write-offs and comply with supervisory rules. In short, banks in China have to pay higher taxes than their operations and profits could support, resulting in de-capitalization – precisely the opposite of what is needed at present to strengthen the banking sector.

Non-state bank growth – glimmers of hope

Despite the above weaknesses and problems, other segments of the banking market showed potential for growth and innovation immediately prior to WTO accession. Deposit growth at the state banks continues to be strong – increasing by almost 26% from 1999 to 2001 – other commercial banks (with a significantly smaller reach in terms of branch networks, capital availability and infrastructure) have made rapid gains – contrary to the expectation that increased deposits with the big state banks would be a drain on new business for such smaller, commercial banks (Almanac of China’s Finance and Banking, 2002; Boyreau-Debray, 2002; Lardy, 2002); People’s Bank of China, 2002).

The implication of the above is that, despite the implicit guarantee that state banks enjoy (the state will not allow the banks to fail is the implied guarantee) and despite the belief among analysts (Citibank and others) that a solvency crisis would see deposit flight to the large state banks, these non-state banks had increases of over 77% during the same 1999 – 2001 period. Again, this large percentage increase is partly owing to the relatively small base number that these banks began with but the continued growth is evident of some confidence in these banks by business interests within China. This impression is given further credence when examining the new loans information. These non-state banks accounted for 42% of the new loans in the 1999 to 2001 period, compared to only 21% for the state banks – this clearly comparable figure does show that the non-state banks, who are able to lend capital on a purely risk assessed basis, were growing rapidly immediately prior to the WTO accession. A large portion of this growth is owing to the highly successful exploitation of the non-SOE part of the corporate market in China (Almanac of China’s Finance and Banking, 2002; Bhattasali, 2002; Mathieson & Roldos, 2001; People’s Bank of China, 2002).

The continuation of the above trend into 2004 (USTR, 2004) falls in line with earlier expert opinions of a smaller market share for the state banks by 2006, when all of China’s existing WTO commitments on banking liberalization are expected to come into force (these commitments are explored below). This is consistent with the fact that the non-SOE portion of the market required, in 2001, and now requires more financing than the SOE portion – consistent with the large private-sector economic growth within the country, particularly since large-scale non-banking liberalisations under the WTO agreement in 2001 (USTR, 2004; Lardy, 2002).

At the eve of the WTO accession, 191 foreign banks operated in China. Most of these operated almost as "off-shore" banks[17]. The number of foreign banks – or the foreign bank penetration rate – if measured by the number of banks or branches seemed high at 52 percent of the number of banks and 14 percent of the number of branches of the total in the Chinese banking. However, these accounted for under one 1% of deposits, under 3% of assets (by market-capitalisation) and less than 2% of loans – clearly indicating that the domestic (and state) banks were still heavily dominant at the time (Almanac of China's Finance and Banking, 2002; Wong & Wong, 2001).

Most foreign banks, however, were able to register a profitable return within two years of entering the Chinese market. The activity of these banks was limited – pre WTO – mainly to foreign currency (or forex) business, small market share foreign currency loans and an impressive 45% of trade in international settlements (payments facilitating international trade). These international banks had, increasingly, located along (or co-located) with their international settlement clients (e.g., large export manufacturing concerns), mostly along with coastal belt of China where a number of foreign-domestic joint-ventures[18] were located for ease of export (Almanac of China's Finance and Banking, 2002; Bhattasali, 2002; People's Bank of China, 2002).

Foreign bank problems

However, the situation was not entirely rose-coloured for these international banks. Very few of these banks (the exceptions being mainly Hong Kong based) had, by 2001, developed broader market aspirations or penetration strategies and were, to a very large degree, waiting upon the liberalisation undertakings on the part of the Chinese government to dictate their next moves within the Chinese banking sector. At this point, these banks operated in an environment that was radically different from that of the domestic banks. Onerous restrictions upon location, product offering and investments, together with a vastly different supervisory and tax regime were severely limiting factors to these banks and few linkages existed between foreign and domestic banks. This implied limited technological spill-over and very little direct competition

[17] Of these 92% were foreign bank branches. The remaining 8% were locally registered with full foreign ownership or were joint ventures within China. In addition to these operating offices, a further 263 non-operational, representative-only offices of foreign banks existed in 2001 (Almanac of China's Finance and Banking, 2002).

[18] Joint ventures were a requirement to operate in China before liberalizations encapsulated in the WTO agreement (USTR, 2003)

(effectively, legislation pre-WTO was protectionist in nature, shielding domestic banking from international competition) in the domestic banking industry (Bhattasali, 2002; Bonin & Huang, 2001; Fang, 2001; Hu & Zhou, 2001).

Additional problems exist, such as the fact that the asset share of foreign banks is still not increasingly sufficiently to offset the structural concerns in the big four banks. At end-October, 2003 the total assets of foreign banks in China were US $46.6 billion, which only accounted for 1.4 percent of the total banking assets in China (Liu, 2003).

Rationale for investing in China's banks

A number of assertions have been put offered to explain the reluctance of foreign banks to become significant players in China's domestic financial sector. Two key concerns are highlighted below, their selection owing to their rational and substantial explanations, as opposed to some of the more fanciful theories abounding in 2005.

The first concern for foreign banks is that during the five-year phase in period after WTO accession, many foreign bank activities remain subject to restrictions, as does their geographical location – obviously, as 2006 draws nearer, this is less of a concern but it is submitted that a key factor in the relative rush to buy into China's banking sector in 2005 can be explained by this factor. Through 2004, foreign banks still could not provide RMB services to either foreign or domestic entities in most cities in China. This meant that they remained segmented from the 1.3 billion people, RMB1200 billion local-currency savings market – a market which now draws nearer and has attracted HSBC, Standard Chartered and a number of other big international names (The Banker, 2003; The Economist, 2005b).

The second factor is the approval process for foreign banks. To expand their operations in China is extremely slow as foreign banks have to wait 12 months after a branch license has been issued before they can apply to open another branch. Additionally, to undertake RMB business, a branch (not the bank as a whole) must have shown a consistent profit for at least two years. This is especially difficult given the limited business available to branches unable to real in RMB – resulting in a catch-22 situation. This has meant that even the largest foreign bank in China, Hong Kong and Shanghai Banking Corporation (HSBC), has a network consisting of only nine branches in 2003. This is in contrast to the Industrial and Commercial Bank of China, the largest domestic bank in China, which has 8800 branches – this further contributes to the consensus among observers that Chinese banking sector access must be come about through buying into the existing sector players (The Banker, 2003).

Chapter 7: Implications of Internationalisation

This portion of the text will examine the impact of foreign entry on China's banking sector and related policy issues.

The relatively young nature of the process of internationalisation (or globalisation) taking place in China's banking sector, the consequences of some policy choices, particularly those implemented later after WTO entry, are not yet entirely clear, owing to the time required for such policy to create material effects. As such, it is still too early to discuss the consequences that removing restrictions on foreign banks will have on the efficiency and stability of the domestic financial sector (A comparison between China and emerging economies in Eastern Europe is undertaken by Bonin & Huang (2002) in terms of these effects). What follows therefore is a broad overview of some of the major and identifiable consequences of China's policies to date, as well as indications as to where possible lessons for other countries and China can be learnt in terms of undertaking the transition to a globalised financial sector.

Seigniorage

A clearly identifiable consequence of the increase in financial depth has been that the Chinese government has earned considerable seigniorage revenue (Kime, 1998). This is important in the context of a transitional economy, which tends to lose it traditional tax base in the move to a market economy (McKinnon, 1991) and China is no exception (Wong, et al., 1995). The collection of seigniorage revenue further reduced China's need to borrow from abroad – to some extent this goes a very long way toward explaining some of the NPL problems in China (but also toward the stellar growth of the last decades).

Alternative funding route & capital controls

China, through internal financing and effective capital retention, was able to finance NPL's from SOE's (and other sources – as is common during rapid economic change) through domestic capital and credit policies. This has, to a large extent, allowed Chinese industry and the economy not to 'hiccup' or lose momentum but rather to grow – to a large extent paid for through NPL's – without interruption. The downside, as is now obvious, is the institutionalisation of NPL's and the massive debt burden that China's big banks now face.

A further consequence of internationalisation has been the improved stability of foreign capital inflows into China. This has come about through the removal of controls on FDI, while maintaining relatively tight controls on foreign borrowing and portfolio investment. FDI involves a long-term commitment to the host country through a physical presence. FDI also implies technology transfer (broadly defined) – something foreign loans and portfolio investment (which are solely financial in nature) do not. The development benefit to China from FDI has been well established and is thoroughly examined by Kueh (1992).

China's policy of discriminating in favour of FDI could well offer lessons for other countries. The stability of capital inflows is important, particularly if it is accepted that highly liquid capital flows are vulnerable to market failure such as herding behaviour and contagion effects. It is also the poor who are disproportionately affected by rapid capital outflows and exchange rate depreciation if a large proportion of basic necessities are imported – this was displayed very well in the Asian financial crisis of the late 1990's.

Capital controls – the graduation approach

Retaining controls over purely financial flows, like foreign loans and portfolio investment – which can take flight, is a specific example of China's overall approach to banking sector globalisation of gradual change. A wealth of literature on financial sector liberalisation and reform exists regarding the relative merits of a gradual approach like China's and the converse – what Tsang (1997) called a "big bang" approach (Tsang, 1997). China's experience lends credence to the benefits of a measured and gradual approach. It is hard to conceive that China could possibly have grown even faster had it pursued a more "big bang" approach – infact the dangers for the heavily indebted big banks and the fragile agricultural sector in the latter approach are enormous.

Additionally, IMF data shows that, on an inflation basis, the "big bang" approach to financial sector reform, as taken by transitional economies in Eastern Europe during the 1990s produced far higher and less favourable outcomes with inflation in China averaging 9.5 percent annually during the decade, compared with 130 percent in the transitional economies of eastern Europe. This alone could provide a sound argument for gradual change – add China's subsequent superior economic performance and the argument becomes rather one-sided, especially if one considers that massive quantities of aid went into eastern Europe in a far shorter time-frame than anything comparable in China. It would be irresponsible to claim that financial sector approach to internationalisation is the only cause for this disparity but it is acceptable to submit that the paced change in the Chinese model provided a solid basis for growth – something China was well placed to do owing to her large population and strong culture of saving (Gorton and Winton 1998).

The average growth rate of real GDP over the same period was 10.8% in China compared with – 2.0% in the other emerging economies. Gorton and Winton (1998) also note that financial sector reform in most emerging economies has been accompanied by increased bout of instability and almost all such countries have experienced some form of banking crisis. China has so far avoided a financial crisis.

The benefits of gradualism are theoretically grounded in the notion of second-best (i.e., while radical and complete liberalisation is optimal in a world of perfect markets, perfect institutions and perfect information; if any of these factors is missing it is rationale for intervention – and, more importantly, the use of a policy set that stresses prudence and is more able, through greater institutional capability – if less freedom – to manage imperfect conditions[19].

This prudent approach, however, would appear to have harmed China's wider financial sector – and, concomitantly, the banking sector. The policies that favour FDI over financial flows (financial rather than physical investment) come at a cost. Gregory & Tenev (2001) argue that control over foreign portfolio investment has, most likely, come at the expense of a more active and vibrant investment capital market for China's emerging private sector – this harms the direct banking sector as banks diversify their risk and profit out of such secondary markets. Additionally, the private sector has often had difficulty, additionally, in accessing financing owing to the restrictions that China imposed on foreign loans (and because the state banking system channelled the bulk of household savings towards SOE's (Gregory and Tenev, 2001).

Financial depth

Another consequence of the opening of the financial sector is that the existing combination of capital controls and the lack of full RMB convertibility contributed to a rapid increase in domestic financial depth and reduced China's reliance on foreign capital. During the reform

[19] Purely financial capital flows are a good example: because these flows are vulnerable to panic and market failure (Asian financial crisis), for a fragile economy to use them must be on the assumption of a policy framework that would limit their damage whilst maintaining openness. In the absence of such a framework, a second-best option is capital controls.

period China has been able to match investment rates ranging from 30% to 40% of GDP with domestic savings rates of the same magnitude. In 2001 the average external debt stock relative to gross national income ratio amongst developing countries was 118.5%. In China the comparative figure was just 15% (World Bank, 2003).

This assertion does, however, need to be qualified as other, and possibly more important factors, have also been responsible for increases in financial depth. These include the maintenance of positive real interest rates and increasing financial institution density (Laurenceson and Chai, 1998). Furthermore, as noted above, controls over Chinese capital moving abroad appear to have become less effective over time.

It is not possible to come to definitive conclusions regarding the outright value of policies that have reduced China's initial reliance on foreign capital. Public policies that have promoted high domestic savings rates (although it must be noted that China has an established culture of saving) have been identified by some commentators as contributing to the rapid rates of capital accumulation and economic growth (World Bank, 1993). It may be argued that such policies have helped China avoid a "foreign debt trap" of the type experienced by other developing countries (McKinnon and Pill, 1996).

Geographical skewing

Furthermore, the liberalisation of many coastal cities (referred to above as 'open cities' in the pilot programme for RMB business) has resulted in skewing of FDI and banking sector development toward the coastal regions – consistent with the developmental trend in China. Whilst this is an expected result in a globalising export economy owing to the coastal provinces strategic location for trade and investment, the policies that have first liberalised coastal cities have exaggerated this effect greatly – leaving the western area and interior of China in an underdeveloped state, particularly in regard to the banking sector as only state banks serve the interior – as foreign banks have had no incentive and, in most instances, no rights to serve these areas.

This has important implications because an empirical link between globalisation (of trade and finance) and growing regional income inequality in China has been found by several recent studies (Jones, et al., 2003; Zhang and Zhang, 2003). This is not to say that globalisation has contributed to absolute income declines in the central and western regions but rather that it has contributed to coastal cities growing relatively fast. Thus, opening up the coastal regions first has further worsened regional income inequalities. The lesson for other large countries in this respect is self-evident. In the interests of promoting sustainable growth, governments need to better manage the distributional consequences of globalisation, not exaggerate them.

Challenges from internationalisation

Additionally, the increase openness of the banking sector has resulted in many factors, traditionally considered to have allowed relatively uncomplicated financial and macroeconomic management – despite the challenges in China (e.g., inadequate economic information, weak accountability of institutions and distortions in market signals), have become pressure points in the transition period for financial markets. These factors include control over major interest rates, financial capital flows, and the level of the exchange rate (although the latter is pegged to the dollar, massive effort is required by the central bank to keep the currency from appreciating – if the peg were abandoned by the central bank, the domestic banking sector would face a massive liquidity crisis in the time it takes the currency to adjust) (Economist, 2005c; Cassidy, 2002).

Additionally, owing to the above indicated ineffectiveness of capital controls – especially in a more liberalised banking sector, the ability to capture and retain, within the banking system, a large proportion of household savings (as has historically been done), to channel said funds to SOE's and government (directly or indirectly) to support fiscal policy through the financial system, is highly likely to be affected. This is as a result of the reforms toward international best practice which are beginning to affect the government's ability to direct funds in the financial system owing to a move toward more credit-risk based lending, as well as external pressures (Bhattasali, 2002).

Effect on state banks

Finally, obviously a central issue to the banking sector and the future of said sector, from all of the above, is the fate of the big state banks. The development of the non-bank financial market is, despite the profit potential in this field for the banks through non-retail activities, a threat. This is because funds directed toward said market diminishes the ability of these banks to capture household savings and continue lending – this decreases liquidity in the banking sector of the financial sector. This risk is, to a large degree, mitigated by the potential returns from allowing participation in the equity and investment fund markets but the portfolio problems of these state banks limit their ability to participate and compete with international competitors in a more open non-bank financials market masses of NPL's, resulting in losses, as well as technical disadvantage mean that international players are better positioned to take advantage of liberalisations in the capital and financials markets. The draining effect of these NPL's cannot be ignored, nor easily removed – owing to internal political economy pressures, particularly at regional and thus branch level (Bhattasali, 2002).

Bhattasali (2002) models a series of projections for the state banks to continue as they were in 2002 and in all of the models the banks, combined, run into negative capital within a decade. Thus, the only viable option seems to be international buy-in to the IPO's for these banks – both because the funds required are massive and because this mitigates experience in financial markets through technology and expertise transfer from these international banks.

Chapter 8: Current situation

The Economist (2005b) says it’s a staggering thought that communist China now has a bank more valuable than Barclays, American Express or Deutsche Bank – the banks that, possibly more than anything else, portray Western capitalism. China Construction bank was put up for IPO on 27 October 2005 and its market capitalisation following this exercise is US $ 66 billion – larger than any of the banks mentioned above. The listing raised US $8 billion alone from foreign investors for 8% of the bank’s shares – the biggest global flotation since 2001. Another 14.1% of the shares raised US $ 4 billion through pre-listing sales to Bank of America and Temasek investment agency in Singapore. The same article is at pains to point out that this is the same bank with a terrible capital adequacy ratio and is, despite the foreign holdings, still a state agency, plagued by bad debts and corruption (the article goes on to mention that the corruption is so endemic that in May that bank’s then chairman was arrested for bribery)

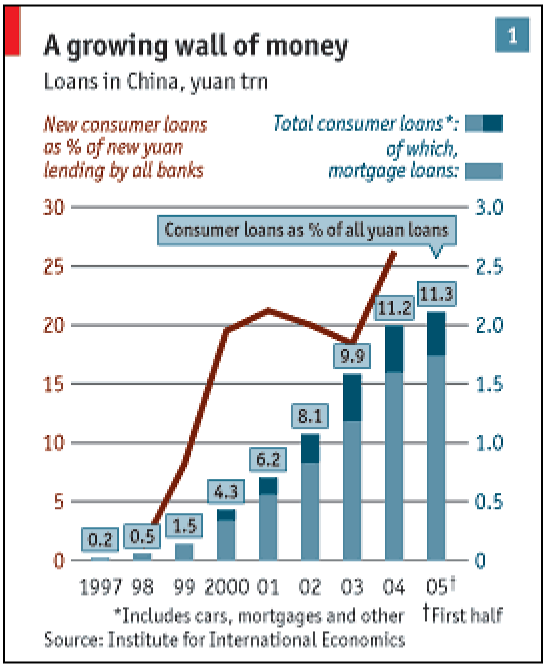
Chinese ambition doesn’t end there, however – despite the fact that international observers are still marveling at the amounts banks have been willing to pay to enter the Chinese domestic market in this manner. Bank of China, the second of the state banks, with some existing foreign investors, is planning a $5 billion foreign IPO in early 2006. Industrial and Commercial Bank of China, the biggest of the state banks by asset value, has appointed advisers for a $10 billion flotation in 2006 or, more likely, 2007 (Economist, 2005b).

Naturally, the Chinese government is happy to encourage this high level of interest in the Chinese banks as the IPO’s and the huge sums raised from them are the most fundamental step in reforming the economy since 1979. China's political leaders have shown that they possess an iron commitment to bank reform, backed with cash. As indicated above, since 1998, Beijing has injected more than $260 billion into its banks via injections and by allowing the state banks to shift NPL’s into separate asset management companies. This is almost twice what South Korea spent to restructure its banks after the 1997-98 Asian crisis and about what America needed to bail out its savings & loans industry in the 1980’s. The Economist (2005b) argues that China is mindful of the long paralysis of Japan's indebted financial system, and, as such, is pumping in funds before a financial meltdown. The article quotes Weijian Shan, a director at Newbridge Capital, a private-equity firm which owns a controlling 18% stake in Shenzhen Development Bank (SDB), is impressed: “the government is taking the pain before it is too late, showing it understands that China's economic development depends on a healthy banking system" (Economist, 2005b).

Improved supervision and standards

Additionally, as indicated above, since 1998 China has raised accounting, prudential and regulatory standards – a specific example worth mentioning is that, before such reforms, banks could book interest income for up to three years even if it was not being received; now this can only be done for only 90 days, as per the international standard. In 2002, archaic system whereby banks provisioned just 1% of their loans regardless of risk, was replaced by a five-tier classification tying the size of the provision to loan quality – again, as per the international standard and according to the Basel I Accord. Meanwhile, the central bank's decision in October 2004 effectively to lift the ceiling on commercial loan rates should, in theory, allow banks to charge more to riskier borrowers – a key concern highlighted earlier in the text, i.e., commercial basis for loans (Lardy, 2002; Economist, 2005b).

The most important recent development, however, has been the creation of an industry regulator, the China Banking Regulatory Commission (CBRC), which was formed from the supervision department of the central bank in 2003. The regulator is trying to shift the banks' focus from loan and deposit growth (the traditional Chinese model of churning money through the banking system – as depicted to the right) to preserving adequate capital and generating decent returns on it through more innovating and internationally utilised means. Furthermore, banks that do not meet a capital adequacy ratio of 8% of risk-weighted assets (again, as decreed by Basel I, a global standard) by 2007 face sanctions, including – importantly for China – the removal of senior management. With 20,000 staff the regulator is working markedly at ensuring compliance (Economist, 2005b).



Strong growth

All the restructuring – recent and for the last decade – has been helped by a very favourable economic environment. China saw loan growth of nearly 16% since 2001 and deposit growth of 18% a year for the same period. Consumers lending, which started only in 1997 has increasing 123 times to more than 2 trillion yuan ($250 billion) in seven years, according to Merrill Lynch investment bank (Economist, 2005b). Corporate loans still dominate but private lending now makes up 11% of the total loans and 26% of new loans, according to Lardy, 2003).

Additionally, strong revenue growth and offloading bad debts on to the government has inflated bank profitability. In 2004, China's biggest banks made net profits of 90 billion yuan ($11 billion) and a good return on equity of almost 11%, says Fitch, the credit-ratings agency. Over half of this return came from China Construction Bank, what the Economist calls “the sector's poster child, which expects net profits of 42 billion yuan ($5.2 billion) for 2005” (Economist, 2005b). China Construction Bank has achieved this good return, despite being third in line according to asset size, through aggressive management and leadership in private lending and services – ultimately achieving a sector leading return of over 25%. Further positive developments include the news that the headline NPL ratio (as reported by the regulator) fell to 8.8% of total loans by June 2005 – a reduction of half since the end of 2003. China Construction bank – in keeping with it’s poster child status – is much better in this regard than the industry, with a ratio of just 3.91% and stronger reserves, with loan-loss provisions of 64% of its bad loans compared with 15% average for the other state banks (it should be born in mind that headline NPL is different from accrued or total NPL which is, for the industry, still somewhere in the region of 25%, depending on whose statistics you use). Finally, the IPO prospectus claimed that loans to customers acquired since 2000 are one-third as likely to fail older clients (SOE’s) loans – which may be largely the shop talking itself up, in a manner of speaking but does imply that regulations enforcing commercially viable lending is working, given the bank’s confidence in their new loans. Given all of the above, one may start to think that the banking industry in China has, in the last year or two, improved remarkable and is, possibly, even comparable to most other countries banking sectors (Economist, 2005b).

Problems still remain

This section examines the most important problems at the time of writing.

NPL’s

Unfortunately, this is very much not the case – despite the rose-tinted picture that the facts above paint. Independent estimates put total bad debts at 20% to 25% (as indicated above), far exceeding official state figures. The regulator itself has acknowledge this – at least internally, as a internal report leaked to Shenzhen's Securities Times, reported that sector-wide, bad loans actually rose this year, if a loan disposal (it is unclear if this is a write-off or a transfer to an asset management company) from Industrial and Commercial Bank of China was excluded from official figures (more evidence of variable Chinese statistics). Furthermore, the regulator expects at least 30 billion yuan in new bad loans in 2005 – evidence that the SOE's, though reformed[20], commercialised or privatised to a large degree, are still a millstone around the banking sector's collective neck (Economist, 2005b).

The news that bad loans are rising, not falling (Fitch estimates by 8% in the first half of 2005 once government-funded write-offs are excluded) is not all that surprising, given the massive flurry of lending that China's banks embarked on in 2003 and 2004 – partly a throwback to old, bad habits and attempting to "grow out of" their bad loan problem through new business and partly as a result of an economy that was, to some extent, overheating (growing at an unsustainable pace). As a result of the measures put in place to 'cool' the economy (slow the rate to something more sustainable), many loans could turn into NPL's. Thus, if economic growth slows sufficiently, there is a danger of a new series of NPL's. Additionally, banks carry alarmingly high levels of "special mention" loans – essentially SOE loans that were performing and are still ranked as performing even though the borrower's circumstances have worsened. Even at CCB, these are 14% of the total (Economist, 2005b).

Boom dependency and non-compliance

The Economists argues that Chinese banks do not have sufficient earnings to absorb another surge in NPL's, owing to poor profitability (in relative, not absolute value terms as quoted above and in IPO prospectuses). The state banks' average net interest margin is less than 2.36% (which looks good compared with the 1.5% to 2.5% in developed markets) which, according to David Marshall, head of Asian financial institutions at Fitch, is insufficient, in China, to cover the risks typical of an emerging economy[21]. Additionally, low cost margins contribute to Chinese banks

[20] Most large and medium-sized SOE's had achieved the goal of establishing a modern corporate system. Specifically, since 2000, 442 large state-owned enterprises were listed on a stock exchange. A variety of measures, including debt equity swaps, were adopted to reduce their debt burdens and a large number of insolvent state-owned enterprises were closed down. Going forward, the government plans to empower the state asset management agency to manage the state assets in the capacity of shareholder and press ahead with the reform of some monopolistic sectors, such as telecommunication, power supply and airline industry – the success of the regulators and the asset management companies is something for future investigation.

[21] Indonesian banks show a 5% net interest margin and Indian banks 3.45%. The Economist (2005b) also argues that Chinese banks income is too loan dependent. Commission and credit card fees form only 13% of revenue, half that of India and a third of Thailand's figure. Furthermore

profit margins, coming in low at 45% of revenues. This, however, reflects poor human capital investment and IT, as opposed to better efficiency – and will thus drop in future (Economist, 2005b).

To make matters worse, the regulator recently (October 14^{th}) concluded that it is common practice for banks to ignore regulations, fail to monitor loans and that bad-loan levels are "not accurately revealed" owing to poor accounting (which means that, in some instances, the banks themselves are unsure of the value of NPL's) after inspecting banks. Lai Xiaomin, head of the regulaotr's Beijing office, admits that "when our banks disclose information, they don't always do so in a totally honest manner" – this non-compliance is exceptionally worrying as further reform depends on new regulations being observed in many banking areas (Economist, 2005b).

Effect of the remaining problems

All of the above negatives mean that, once analysed, China's banks provide a return on assets worth less than 0.5% last year - easily is the worst in Asia. Return on equity is better but even the brilliant 25% return on equity for China Construction Bank is actually 17% when you discount the massive tax-break the bank received in 2004. The capital adequacy ratio continues to be a massive problem and this means that the banks aren't protected against unforeseen risk – like another rise in NPL's. Carrying sufficient capital, Marshall of Fitch argues, would see return on equity at around 5% or below, something he argues is a better reflection of the real profitability in the sector (Economist, 2005b).

The above points to two alarming facts – these being that any downturn in the banking sector is likely to almost completely wipe out the new, much vaunted earnings at the state banks. The second is that the banks cannot generate enough internal capital to support their current levels of loan growth - even if the economy remains good. Standard & Poor's estimate that a return on assets of over 2.1% is needed to avoid further expensive capital injections from the state. Once again, the root of the problem comes down to lending on a strictly commercial basis and ensuring that risks are well secured – something that is obviously not possible yet, most probably owing to a combination of SOE requirements (and the political and social problems associated with denying these) as well as poor operation by the banks, bourne out of a history of similar dealings. This problem will be further frustrated in something were to affect China's booming economic growth.

As indicated above, political and regional influences are still a problem for banks in China. A core cause of the current state of the banking sector is that branches, especially state bank branches – with their history of government appointments, where rules are not enforced regarding commercial basis only lending and prudence. Reforms have taken root at most head offices but are hard to enforce at branch level[22]. The text above has highlighted the problems in affecting change in the big state banks – with massive workforces and numerous branches (as well as the decentralisation of the branches and their relative autonomy[23] – a legacy of the past) (Economist, 2005b).

Foreign solutions

China's current strategy, consistent with their gradual approach, sees foreign investors as the solution to a lot of these problems as they bring skills in risk management and advanced financial products – as well as massive amounts of money. China's high growth and huge population has triggered an astonishing stampede in a variety of markets and, as recent acquisitions and activity on the part of foreign investors into the sector is proving, banking is no different. China's banking sector has attracted over US $18 billion in FDI in 2005 alone. The rush was triggered by HSBC's US $1.7 billion 19.9% stake in Bank of Communications, the fifth-largest lender by asset value. This was followed by the China Construction bank IPO, detailed above, and a consortium (led by the Royal Bank of Scotland) purchasing a stake to the value of $3.1 billion into the Bank of China – which has further received another US, $3.1 billion from Temasek and US $500m from Switzerland's UBS. Additionally, Goldman Sachs and Germany's Allianz are investing in the Industrial and Commercial Bank of China. The Economist (2005b) reports that only Agricultural Bank of China – the state bank with the most serious debt problems has so far failed to attract a Western investor.

[22] The China Construction Bank's new chairman, Guo Shuqing, has been quoted as saying that "more than 90% of the bank's managers are unqualified" (Economist, 2005b).

[23] "Wu Jinglian, China's most respected economist, notes that, until a decade ago, provincial branches of the state banks borrowed funds directly from provincial offices of the central bank and lent them to local customers. These banks enjoyed "legal person status" and needed no authorisation from head office. Even today, big branches of Industrial and Commercial Bank of China have their own English-language websites—emphasising their independence. "Branch managers are kings in China," concurs Frank Newman, an American who took over as chairman of SDB on behalf of Newbridge earlier this year" (Economist, 2005b).

This investment rush is largely explained by the fact that Western banks are getting access to the world’s biggest financial market by participants (and a major player by value) and a massive branch network and private client base the envy of every other bank, for a massive discount. Bank of America only paid 1.15 times book value for its investment in China Construction Bank. These shares have now more than doubled in value. Each investment to date has been accompanied by a joint-venture (as required by Chinese law) in savings and insurance products and credit cards – a massive market waiting to be tapped (McKinsey predicts exponential growth from this segment with profits of $1.6 billion by 2013 – however, in the same breath the firm warns banks to expect losses on credit card operations for at least the first four years). In light of the above, the only real way for investors to make decent returns in the short term is from large increases in post-IPO share prices – all other income is based purely on future expectations.

Limited ownership rules mean that foreign investing banks only have a modest influence on strategy or operations at their Chinese partners – not an ideal situation given the need for technical and human capital transfer. HSBC's vastly greater size compared with Bank of Communications means that it may prove to be the exception to the rule here. The remainder of the purchases in 2005 have seen ownership rights restricted a few board members and little or no influence on the appointment of senior management – this still remaining within the ambit of the government.

Chapter 9: Recommendations

This section makes recommendations as to potential solutions or betterments to some of the problems and challenges for the banking sector as listed above. S

State recognition of NPL's

A logical place to begin is with the NPL's of SOE's. These ultimately unrecoverable and non-performing loans have been estimated to be in the order of between one-third (by Chinese bank officials) and one-half (by rating agencies) of all outstanding non-performing loans in China – a massive amount both in relative and absolute terms. It is submitted as referred to above, that these loans (which will not be repaid) should, as a result of there being no possibility of repayment, thus be regarded as indirect loans by the state-owned banks to the state itself.

Therefore these loans should properly be included as part of the Chinese public debt (as indicated earlier is a possibility). Official Chinese public debt outstanding was approximately 10% of GDP as of 2003. Adding in the estimated net new debts issued in the past two years well as the entire stock of outstanding non-performing loans, the public debt to GDP ratio will be somewhere between 35% and 40% (Lardy, 2003), still considerably lower than those of many other countries – transferring the responsibility from the banking sector, which the government is trying so desperately to reform and make internationally marketable to the rightful holder of the responsibility – the central government.

Tax treatment

In addition to the above, mention was made of the tax treatment of commercial banks in China at present as a core challenge for China. The current tax treatment of provisions for NPL's tends to lead to overstatement of profits (owing to insufficient provision being made for NPL's), which are then subject to taxes, as explained above. These specific provisions should be made tax deductible, as is internationally the case for banks. This should see financial institutions much more willing to classify loans according to their true prospects for collection (a requirement under the 5-tier classification for Basel I), rather than making recourse to sequential rescheduling (rolling over of loans) to avoid falling foul regulatory norms on provisioning.

Ownership rules

Ownership was mentioned above, specifically that restrictions still remain in this area in so far as foreign investors are concerned. It is submitted that, in order to reform its banks properly, China must allow full foreign takeovers – with the concomitant provision that the banks must be allowed to merge and fail according to market conditions and performance, as well as making loans on this basis – a subject discussed below.

At present the regulator expects the government to raise foreign ownership allowances above 25% next year – even if this happens, the state will still retain ultimate control over these big state banks (raising the further concern of SOE pressures being balanced off against banking sector reform on the balance sheets of the banks). The sector regulator does not seem to be pushing hard enough to get this foreign ownership allowance increased, with an official quoted as saying the wisdom of increasing foreign ownership is doubtful “if we don't get something in return” (Economist, 2005b). Evidence from delayed foreign ownership in Eastern Europe (Poland, for example) points toward this causing delays in bank reform and more costly bail-outs.

Marketing NPL’s: Asset Management Companies

With regard to NPL’s, at present, foreign investors are not allowed to directly acquire NPL’s from the state banks – this must be done through the establishing of joint venture entities, a large disincentive for many investors who may otherwise have been interested in purchasing Chinese debt. These debt purchase transactions are, currently, structured through forming a strategic relationship between state banks and foreign investors(e.g., the Industrial and Commercial Bank of China and the China Construction Bank established venture entities with Morgan Stanley and Goldman Sachs, respectively, to dispose of their NPL’s. These banks have begun to deal directly with foreign investors regarding their NPL portfolios and are considering auctions, as well as private placements, despite the current regulatory restrictions). The regulatory hurdle facing China's domestic banks in doing private deals with foreign investors is found in Article 43 of the Commercial Banking Law, which prohibits commercial banks from investing in non-banking financial institutions – it is, however, expected that the article will be overlooked in the near future – as it has been by the banks mentioned in the above example (Xiaochuann, 2004)..

With the change in policy that appears to have taken place regarding NPL's being disposed of by the state banks, as opposed to asset management companies, the general consensus is that the government was not satisfied with the work done by the asset management companies. It must be remembered, however, that since their inception, these Asset Management Companies have acquired experience and skills in how to resolve NPL's. Thus, the role of the Asset Management Companies should not be ignored when the government designs an institutional mechanism aimed at disposing of NPL's – something that at present is sorely needed on a sector-wide basis. The China Banking Regulatory Commission (the regulator) has emphasized the role of the Asset Management Companies in its campaign to reduce bad loans. This would appear to have been recognised by the regulator which has, publicly, indicated that the Asset Management Companies role has not yet been disregarded.

Making investment banks – just add legislation

The hope is that the government will allow the Asset Management Companies to expand their businesses to become more commercially-oriented. In the future, it is believed that Asset Management Companies should develop into a comprehensive Asset Management Companies that will focus on NPL resolution as its main business whilst maintaining the function of asset management and an investment bank – thus the inclusion of this discussion to begin with in this text. The scope of the business area to be granted to the Asset Management Companies should include the following aspects: Firstly, Asset Management Companies will be authorized to use their capital to invest in some NPL's that have the potential to increase their value. This approach differs from the previously used (1998) debt-equity swaps, since the former is related to investment decisions made in the discretion of the Asset Management Companies, whereas the latter is an investment determined by the government (a similar problem to the banking sector, ironically). In general, the profits for the former are greater than those arising from the latter, since some firms not selected for debt-equity swaps by the government are viable from a debt trading point of view, so that their swaps could generate higher returns.

Secondly, Asset Management Companies should be allowed to dispose of NPL's of the state banks and other financial institutions as well as dispose of their assets on a purely commercial basis. Third, Asset Management Companies should be allowed to operate as investment banks, performing such functions such as underwriting, giving financial advice and NPL securitization – incidentally, a potentially revolutionary solution to debt management in China (but sadly far too complex an idea to explore in this text). Given that there are no investment banks in China, it is not unreasonable to argue that the Asset Management Companies can be transformed into investment banks after their completion of NPL disposal. Fourth, Asset Management Companies should, theoretically, be able to participate in the inter-bank repurchase asset market. The government has not expressed a view with regard to this matter yet but it would be consistent with allowing these companies to operate like investment banks. In short, it is possible that the government dissolve the Asset Management Companies by 2008 – the original timeframe for execution of the NPL's was 10 years – thisis becoming increasingly unlikely for two reasons, firstly their total employment has already reached 11 million and it is logical – and pragmatic – to allow these organisations to evolve into investment banks (Xiaochuann, 2004).

SOE reform

Whether the commercial banks can prevent large amounts of new NPL's from occurring will hinge on the success of enterprise reforms – SOE's specifically. Only when these enterprises improve their operation and profitability, can they strengthen their ability to repay debts, which will lead to lower loan default rates and low NPL ratios. Some SOE's have taken advantage of complicated, non-transparent company organizational structure unknown to the banks and a complicated controlling structure to conduct connected borrowing through varied channels of financing they controlled or through obtaining shares at a number of financial institutions or quasi-financial institutions. From a legal perspective, using false information to defraud financial facilities from banks or other non-bank financial institutions is illegal in China; however, the challenge is to change this culture. Laws and regulations that can discipline and punish such acts should be put into place – the effects of these are, obviously debatable.

The second aspect of SOE reform should be to quicken the steps of reform to build up SOE's capital. Generally, SOE's with inadequate capital pose a serious problem. Even though the situation has improved compared to that in the early half of the 1990s, the enterprises' own capital still remains at a low level in regard to the rules of market economy. In a society where indirect financing has been dominant, the first problem caused by low capital level is the required high leverage ratio, which implies relatively low risks for borrowing enterprises and high risks for banks. In this regard, good risk management requires the banks to find out the appropriate leverage ratios for different enterprises under different circumstances, based on commercial risk decisions.

Enforcing commercial lending

Furthermore, the nature of banking business is to take deposits, issue loans and make profits out of interest spreads. Not all loans issued can be recovered, however. There will always be a percentage of loans that result in losses and need to be absorbed by higher interest rate income. Thus, it is crucial for banks to be able to decide on the prices charged to different clients so that they can prevent large amount of NPLs from forming or be able to dispose of them – a consistent argument throughout this text. If a one-size-fit-all interest rate is charged to different types of enterprises (as has been the case), the loss of some risky loans would not be covered. If accumulated, even losses on a small scale could evolve into large amount of NPLs – again, as has been the case previously. As such, banks should charge market-based interest rates (i.e., the market for loans, in terms of what firms with various risk profiles are prepared to pay in interest). Market-based interest rate should not only be reflected in pricing of loan products and other assets, but also be extended to pricing of all kinds of services and deposits. In absence of good customers, the commercial banks could adjust their business strategy in two directions: one is to reduce activities on the asset side and expand business on intermediate service, which surely involves pricing of services; the other is to cut business on both the liability side and the asset side. Active management of the liabilities, either expansion or reduction, would surely require commercial banks to exercise discretion in pricing products on the liability side of the balance sheet, including deposits. In this regard, deposit interest rates shall remain flexible too to remain consistent – and as per international norms.

Cycle-smoothing policy

Additionally, In order to effectively prevent large amount of NPL's from being accumulated at the state banks, actions should be taken to smooth out business cycles. Indeed, the biggest concern for banks is the ups and downs of the macro economy – given that it has been submitted that even small economic changes could play havoc with the banking sector at present. When the economy is in boom, it is apparent that banks are in good conditions with handsome profits and better asset quality – as is the case currently. However, once the economy experiences variances, especially during recession, the encouraging trend should reverse and it is likely that large amount of NPL's may emerge – as indicated earlier. Similar situations occurred before and after the Asian financial crisis as reflected in the NPL data of Thailand, Korea and Singapore, where when the economies plunged into recession, the ratios of NPL rose sharply. In this regard, the state banks need economic expertise, like other big, international banks, which can help make good judgments about the coming shifts in the business cycle so that proactive measures can be taken to guard against potential risks – essentially a human capital issue.

Additionally, to prevent the economy from experiencing stop-and-go cycles, in addition to deploying the appropriate monetary policy tools at appropriate time, the regulator and the government should especially stress the importance of avoiding asset bubbles. Once large bubbles have formed, it is very difficult to make adjustments and deflate these without a massive economic crisis.

Moral hazard

With regard to moral hazard concerns (in order to prevent the bursting of potential asset bubbles), rules and regulations that reduce or limit leverage (e.g. by asset classification) on the part of bank borrowers (enterprises and individuals) should be enacted – and these should cover loans collateralised by stocks and residential and non-residential properties as well. The swap of debt for equity by enterprises should also help to reduce leverage. Higher capital requirements on the banks (Basel I Accord) also help to reduce the leverage of the lenders and hence their moral hazard – forcing them to provide more capital in order to take more risk, without the implicit guarantee of a bail-out. Economics dictates that overall credit quality of bank loans can be expected to improve with a reduction of moral hazard on the part of both lenders and borrowers.

Role of the regulator

Additionally, efforts should be made to promote competition and leverage off the role of foreign banks. No evidence, anywhere in the world, suggests that foreign banks could destabilize the local banking market – if the entry is rationally controlled. The regulator seems to share the view of most analysts in that the most important question is not who provides banking services but who can provide them more efficiently. Indeed, as pointed out above, the role of foreign banks has become increasingly important for China's banking sector since the late 80's. They have brought in some competition and helped unfold many changes in the banking sector. As the country continues to honor the WTO commitments and eventually remove all the geographical and customer restrictions on foreign banks, the policy towards foreign banks has become more and more supportive – this is reflected, in a sense, in the massive rush to purchase a stake in Chinese banks in 2005.

The regulator emphasises the fact that banks are run by banks' management and not by the regulator. However, the regulator has the duty to promote best practices for risk management and encourage the improvement of banks' risk management. The regulator has aggressively introduced the new supervisory concepts and approaches as embodied in the New Capital Accord, also known as Basel II. The draft capital rules state that banks should improve their risk management beyond the narrow compliance with a minimum capital requirement. In light of the nature and size of their operations domestically and overseas, large banks should build a robust internal credit risk rating system benchmarked to Basel II and small banks should introduce, the best they can, elements of best practices for managing credit risk. All banks should start collecting the necessary data for both borrower and facility, which serve the very basis for a more quantitative approach to measuring and managing credit risk. Over time the regulator will consider the use of an internal ratings-based approach for capital regulation when banks are ready and provide incentives for banks to improve their sophistication in risk management accordingly. It has been encouraging to observe that at the support of the supervisor, big banks in China have fully embraced Basel II in the interest of better risk management.

Core challenge: Political will

Finally, in a sense in summation, the most important aspect as far as recommendations are concerned is difficult to implement. The government needs to generate the political will to, as indicated above, allow ownership of the state banks to be vested somewhere other than with the Chinese government. The challenges in this instance are revenue issues, concern over SOE sustainability and social issues like employment. However, it is evident from international experience in Eastern Europe and elsewhere in Asia that a solid foundation needs to be laid in terms of the financial sector of a county in order for long-term growth to be safe from crisis and collapse. As such, it is submitted that a hard-line approach to SOE's – a pragmatic approach – is needed. The de-facto subsidy of these enterprises needs to be stopped – not only because it violates WTO rules but, more importantly, because subsidising the least competitive and least profitable part of the Chinese economy is reducing the capital available for other investment and allowing inefficiencies which, if not so already, risk becoming as institutionalised as the culture of NPL's in China. That said, it is also acknowledged that a mass of problems arise from the cutting off of SOE's from non-commercial bank finance.

Chapter 10: Conclusion

China's policy approach to financial sector globalisation has differed from both its neighbours in Asia and other transitional economies in Europe. Whereas China's neighbours underwent comprehensive financial sector globalisation during the 1980s and 1990s, China continues to retain many capital controls. While other transition economies adopted a "big bang" approach to financial sector globalisation, China has adopted a more gradual approach. Throughout the reform process, the government has endeavoured to strike a proper balance between the rehabilitation of the banking system and the imperative to maintain stability and sustain the economic reform and support the SOE's. The changes brought by WTO entry have further heightened interest in the topic of China's banking sector globalisation.

Large problems, especially in terms of NPL's exist in the banking section and China's banking sector is unlikely to be able to allocate resources more efficiently and contribute to sustained economic growth unless the balance sheets of the existing financial institutions are rehabilitated and a commercial credit culture takes hold.

Banking reform is, arguably, one of the last and most fundamental aspects in China's macroeconomic reform. Having achieved significant progress in restructuring the real sector, the government has moved decisively to address the difficulties in the banking sector – although a number of problems have been more difficult to solve in this area than in others. The creation of a new banking supervisory agency is, however, a testimony to the government's renewed commitment to achieve major breakthroughs in the banking sector reform. Reward for this reform – as well as pure commercial good sense – has seen large interest in China's state banks with the regulations in China forcing foreign buy-in as opposed to start-ups.

The overall direction of the banking reform has been clearly identified in attracting foreign investment, as indicated above. The newly created banking supervisor is well positioned to take the challenges in reforming the banking system but faces a number of human-capital and experience based challenges.

Problems as well as potential solutions have been identified and examined in details above – this will not be repeated here in the interests of brevity. However, it is important to highlight the fact that the single most important challenge facing reformers in the sector is the issue of non-performing loans. This causes any international investors to risk massive losses in value owing to the structural problems in the Chinese economy. These NPL's are caused by two factors, namely an institutionalised culture of debt default and, more importantly, the massive burden of SOE's in the Chinese economy. The constraints and challenges to reforming SOE's has been examined above and the problems cutting off loan financing for these institutions have been explained.

Finally, however, it must be mentioned that the interest in China is no freak occurrence or investment fad. International banks have identified the largest market in the world from a retail banking point of view and potentially the largest market from a commercial point of view in years to come. The Chinese banking sector, purely by virtue of the size of the population represents an enormous opportunity for considerable profit from banking. Additionally, the continued economic growth throughout the country presents further opportunities to provide investment capital and financing to the growing Chinese economy.

In conclusion, it is the view of the author that the Chinese banking sector will continue to be a fascinating and ever-expanding field of enquiry in the years to come, particularly as capital markets open up and the government, through WTO commitments and market forces, is forced to remove restrictions on the sector. Expectations of a strong foreign ownership trend and more conventional responses to risk are not unreasonable and are an almost certain recipe for success and prosperity in the banking sector – if the Chinese government are able to find the political will to make the important decisions for reform in the years and months to come.

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