Banking Reform in China:
Catalyzing the Nation's Financial Future

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Abstract:

In 2003 China posted its highest economic growth rate in seven years, a robust 9.1 percent. Today the nation's gross domestic product (GDP) dwarfs by more than eight fold its level of 1978, the year China began taking its first tentative steps away from a centrally-planned communist economy towards a mixed socialist-market system. According to the World Bank, market reforms in China and the growth they have stimulated helped lift more than 250 million people from poverty (roughly equivalent to positively transforming the lives of the combined populations of England, France, Germany, and Italy). In 2003 China's per capita GDP surpassed the $1,000 mark for the first time in history. The greatest and most fundamental undertaking for China's financial reform over the coming years undeniably will occur in the banking sector. As with the situation throughout East Asia, businesses in China typically obtain external financing from banks rather than through the issuance of securities. Yet banking in China represents a glaringly fragile component in its economy. Poor lending policies of the past have produced a massive deadweight of nonperforming loans (NPLs). This article argues that investors and policy makers, while right to be concerned, would be patently wrong to ignore the tremendous upsides that should accompany China's banking reforms. Although now a soft spot in the Chinese economy, we contend that China's banking sector has the momentum and potential not only to be restored to health, but to play a catalytic role as a stimulant to further and sustained growth.

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To call growth in the Chinese economy "impressive" is something of an understatement. Despite what for other developing economies would have been a devastating setback from last year's SARS epidemic, in 2003 China posted its highest economic growth rate in seven years, a robust 9.1 percent. Even though some predict this rapid growth will taper off, no major estimate puts growth for 2004 at below 7 percent and the more optimistic estimates have growth as high as 9.5 percent. Today the nation's gross domestic product (GDP) dwarfs by more than eight fold its level of 1978, the year China began taking its first tentative steps away from a centrally-planned communist economy towards a mixed socialist-market system. From being off the global economic map only a quarter century ago, today the People's Republic of China boasts the sixth largest GDP on the planet. Adjusted for purchasing power parity (which allows for a more balanced comparison) its GDP is actually second only to the United States and nearly double the size of third-ranked Japan. Measures such as these point to an economy that could, within a generation, emerge as the world's largest.

An encouraging sign amidst such high-charged growth comes from the way China has shed its former economic isolation and gradually embraced the principles of global trade. Unlike Japan, which modernized its economy largely through policies of self-sufficiency and a unilateralist conceptualization of trade relations, China has adopted a more inclusive strategy. Today China is the manufacturing breadbasket of the world, a status achieved largely through subsidiary and cooperative production arrangements with foreign multinationals. China is also the world's top destination for foreign direct investment, with $53 billion in investment inflows in 2002. The People's Republic of China also now lays claim to being the world's fifth largest trading economy, with more than six times the share of global trade that it had in 1978. On the basis of purchasing power parity, China contributed 1.1 percent—more than one-third—of the world's 3.2 percent growth last year. (This compares with 0.7 percent contributed by the U.S. and 0.2 percent each contributed by Europe and Japan.)

The net result of such developments for the Chinese people has, on balance, been overwhelmingly positive. According to the World Bank, market reforms in China and the growth they have stimulated helped lift more than 250 million people from poverty

(roughly equivalent to positively transforming the lives of the combined populations of England, France, Germany, and Italy). In 2003 China's per capita GDP surpassed the $1,000 mark for the first time in history. China's vast population is now enjoying more goods, services, and general economic freedom than ever before. Rising affluence has resulted in a new cadre of worldly, cosmopolitan consumers. In many parts of the world visitors from China have already replaced the position long held by tourists from Japan as Asia's most visible globe trotters. The swelling national enthusiasm for the Beijing 2008 Olympics, though suffused with an abundance of national pride, nevertheless is reinforcing the trend towards an increasingly modern and sophisticated world-view; one that breaks from the traditionally self-centered and isolated national identity of China as the world's "Middle Kingdom."

From the standpoint of the mechanics of global trade, the most significant development has occurred with China's accession to the World Trade Organization (WTO) in 2001. Among other obligations, with WTO membership China's leadership committed to opening up the country's entire financial services industry to foreign competition by December 2006. Openness will entail greater equality, with those restrictions that remain exclusively for foreign financial institutions （but not their domestic counterparts）to be removed. China's financial marketplace accordingly will be exposed to the challenges and opportunities posed by global competition.

The greatest and most fundamental undertaking for China's financial reform over the coming years undeniably will occur in the banking sector. As with the situation throughout East Asia, businesses in China typically obtain external financing from banks rather than through the issuance of securities. (This contrasts with the U.S. and many other Western nations in which capital markets play a more central role in financing investment projects.) Yet banking in China represents a glaringly fragile component in its economy. Poor lending policies of the past have produced a massive deadweight of nonperforming loans (NPLs). There are those who contend that China's NPL problem will corrosively eat away at the gains that are being made and drag down the country's overall economic performance.

We contend that investors and policy makers, while right to be concerned, would be patently wrong to ignore the tremendous upsides that we believe will accompany

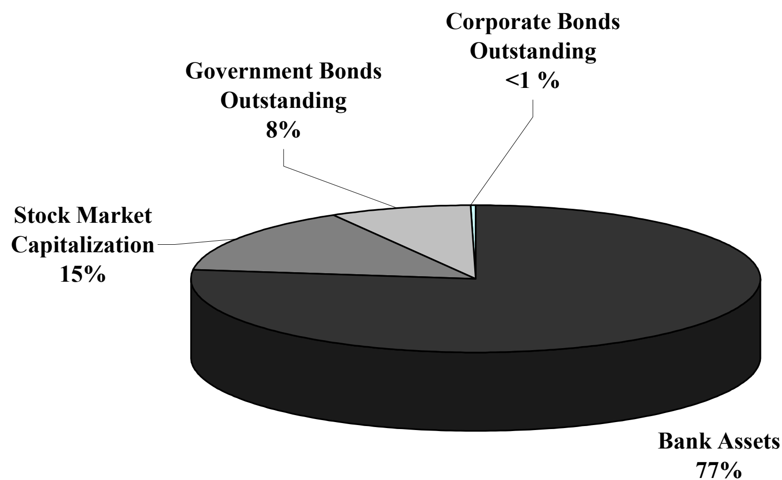
China's banking reforms. Although now a soft spot in the Chinese economy, China's banking sector has the momentum and potential not only to be restored to health, but to play a catalytic role as a stimulant to further and sustained growth.

China's Financial System

China operates what is clearly a bank-centric financial system. Banking assets comprise nearly 80 percent of the nation's entire financial asset pie. Based on the market capitalization of equities listed on China's Shanghai and Shenzhen stock exchanges (the only two in the country), stocks rank a distant second to the value of bank assets, accounting for only 15 percent of all financial assets. About two-thirds of China's listed shares, moreover, are government-owned and thus not tradable. Bonds, in terms of their value outstanding, rank last at a mere nine percent. The percentage of external funds raised by firms through the issuance of bonds, moreover, is even more minute: less than one percent.

Size and Composition of China's Financial System – 2002

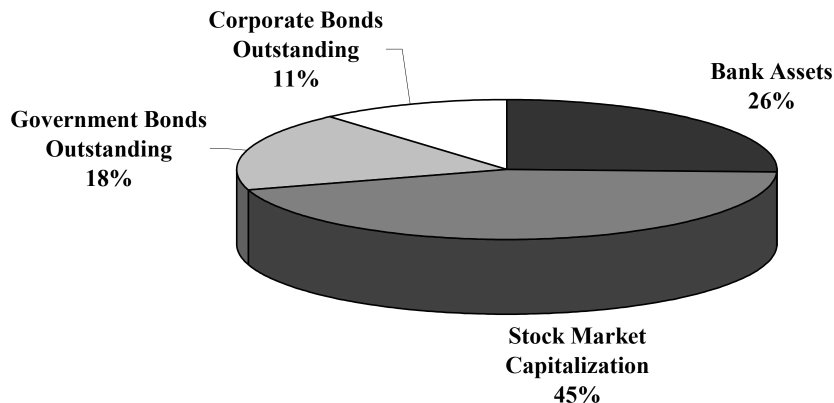
Total = $3.1 Trillion



An interesting point of comparison is that the proportional size of China's financial system is actually about the same as that of the United States. Expressed as a percentage of each nation's GDP, China's financial asset base is equivalent to 244 percent of GDP; in the U.S. the figure is 236 percent. Yet the composition of two nations' financial systems differs strikingly. America's financial infrastructure is dominated by capital markets. Firms have a smorgasbord of choices and, with little structural impediments, are able to raise funds externally by issuing either stocks or bonds and can borrow from banks as an alternate source of funding. The simple beauty of a diversified system like the U.S.' is that if banks get into trouble the rest of the nation's financial architecture can better avoid getting dragged down as well. In the face of a banking crisis, firms can still obtain investment funds through the capital markets. Stock and bond holders, moreover, provide not only capital but a valuable source of discipline. Their investment decisions help ensure that only firms with productive investment projects receive funding and use the invested funds as intended.

Size and Composition of United States' Financial System – 2002

Total = $24.7 Trillion



The Chinese government recognizes the importance of a more balanced financial system. The first major step taken in this regard occurred when it established the nation's two (and so far only) stock exchanges in December 1990 in Shanghai and in July 1991 in

Shenzhen. The exchanges provide for a more multifaceted financial infrastructure and act as the central mechanisms for converting state-owned enterprises (SOEs) into stockholding companies. The public listing of privatized SOEs in turn enables firms to mobilize capital necessary for restructuring. Trading in company shares also provides the impetus for improved corporate transparency and governance.

Later reforms have brought added enhancements to China's financial infrastructure and greater means for capital access. Among the recent notable initiatives is the Qualified Foreign Institutional Investor (QFII) program introduced in late 2002. Under the QFII scheme, foreign institutions receive a foreign-exchange quota to be applied to securities investments ranging from $50 million to $800 million. As of December 2003, the China Securities Regulatory Commission (CSRC) approved 12 QFII applications. By January 2004, the State Administration of Foreign Exchange granted ten of them a foreign exchange quota, totaling $1.7 billion. This is a small beginning, to be sure, but at least six additional overseas institutions have applied for new QFII licenses and several existing license holders are applying for quota increases. (UBS, for example, has already exhausted its $300 million limit and has obtained the permission for increasing its limit to $600 million.) The QFII's success has already spurred discussion in policy circles for the launch of a Qualified Domestic Institutional Investor (QDII) program, which would allow China's own institutions to invest in overseas capital markets, thereby broadening the country's global financial interlinkages.

China's fledgling bond market is also receiving attention, especially the area of corporate bonds. The country is emerging from something of a corporate bond moratorium that followed a spate of SOE bond defaults during the late 1980s. Concerned about the ensuing economic and social ramifications these could cause, the central government took actions to restrict corporate bond issuance. By 1999, with the drive for financial liberalization gaining steam, the harsher elements of these actions were suspended and the market for new corporate debt has since been revived. Although the market remains extremely small, it has the potential to grow much larger once some of the impediments still in effect are lifted. For example, currently the rate of interest on Chinese corporate debt is capped irrespective of the issuer's credit quality. According to the Securities Law, moreover, issuance of corporate bonds must be approved by

government departments authorized by the State Council (the top executive organ in China). For example, under the Measures for Administration of Securities Company Bonds, issuance of bonds by a securities firm is subject to the approval of CSRC. Additional reforms that will be more favorable to the development of the corporate bond market are anticipated.

Size that Matters: China's "Big Four"

Though it still has far to go, China obviously has been making progress in developing a more balanced financial system. Yet the dominance of banks over capital markets in China's is well entrenched and will remain so for the foreseeable future. Accordingly, overall financial reform in China will depend first on the nature and timing of the reforms being enacted in the banking sector.

The dominance of a "banking sector" does not tell the whole story. There are 36,611 banking institutions in China. The vast majority (98 percent) operate as mutual institutions known as rural credit cooperatives (RCCs) that are located throughout China's approximately 25,000 townships. Despite their numbers, the RCCs account for only 10 percent of all banking assets. The real money is in China's "SOBs": the government's four enormous state-owned banks. These banks, the "Big Four," represent a 59 percent share of the banking asset pie and operate a vast nation-wide branch network. Given the dominance of banking assets in the financial system as a whole, this means that the Big Four SOBs account for about half of the financial assets of the entire nation. China thus does not merely have a financial infrastructure that is "banking system" dominated but one that is in fact Big Four "bank" dominated.

The background to how the Big Four have established their pre-eminence in China's financial system is important to understanding the extent of contemporary changes to the system and the direction in which reforms are heading. The SOBs were incrementally born from China's first stage of reforms orchestrated by Vice Premier Deng Xiaoping in 1979. From 30 years prior to that, in the aftermath of the 1949 Revolution, the new Communist government had incrementally closed down China's patchwork of commercial banks and replaced them with a single People's Bank of China

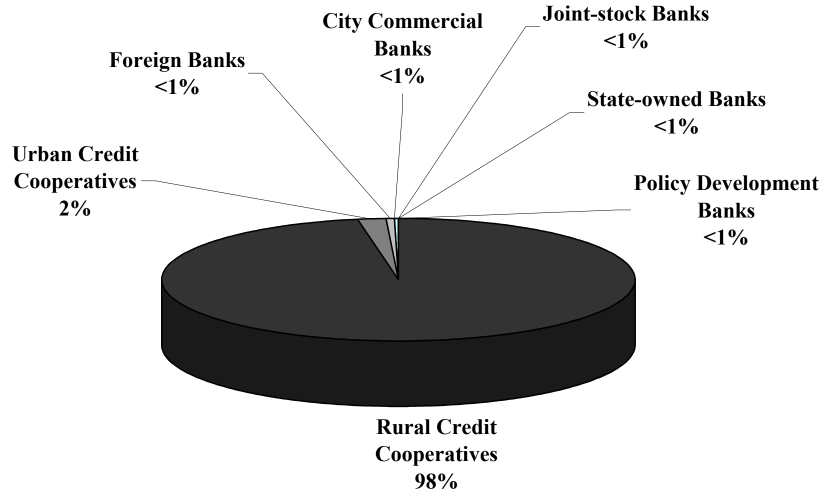
(PBOC). From then on the PBOC played the dual role of both a central and commercial bank. It wielded monopoly power over the banking system, disbursing investment and operating funds to SOEs according to government fiat.

Deng's reforms brought the first break in the PBOC monopoly with the creation of two spinoff entities: the Agricultural Bank of China and the Bank of China. For the Agricultural Bank its 1979 spinoff was more of a rebirth as it previously had operated independently but had been merged with the PBOC in 1957. The Bank of China was then created by carving out the PBOC's foreign exchange division. Within a matter of years the State Council firmly decided to reconstitute the PBOC to serve solely as the nation's central bank and launched a process of gradual reorganization. Its first major initiative along these lines was to transfer the bank's remaining commercial banking functions and certain banking functions from the Ministry of Finance to two special purpose banks: the China Construction Bank (formed in 1983) and the Industrial and Commercial Bank of China (formed in 1984). Thus was the PBOC directed down the road to functioning as a true central bank and China's two state-owned commercial banks turned into four.

The immense size and domineering presence of the Big Four in the financial system can easily give the impression that they represent a monolithic force, an anachronistic holdover from the days of China's centrally planned economy. In actuality they represent the first major effort to restructure and redirect towards market principles what was previously a completely monopolistic and self-contained banking system. The fundamental problem left unsolved has been that the SOBs continued lending to inefficient and frequently unprofitable SOEs. This situation has impeded the development of a sense for that all-so-important "credit culture"—an appreciation for necessary balance of risk and return considerations—in reaching lending decisions.

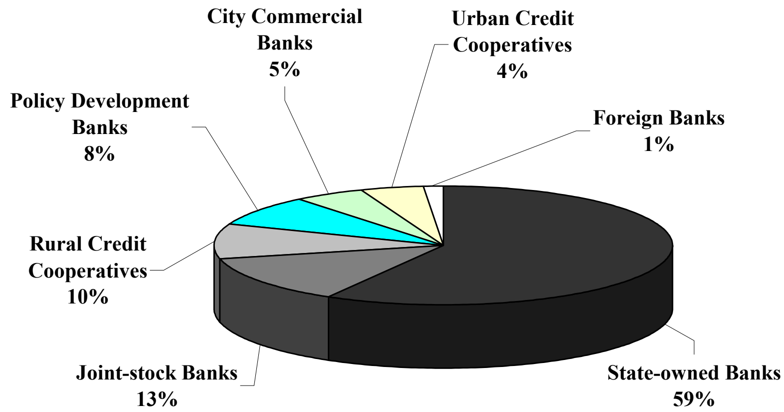
Number and Type of Banking Institutions in China - 2002

Total = 36,611 Banks



Total and Composition of Bank Assets in China - 2002

Total = $2.7 Trillion



To further liberalize the banking system the authorities have pushed ahead with further efforts at reform. In 1994, the Big Four were recast as commercial banks and three new policy development banks were established: the China Agricultural Development Bank, China Development Bank, and China Import and Export Bank. The three new banks were created specifically to unburden the SOBs from responsibility for policy lending, enabling them to act more like real "commercial" banks. Moreover, it should be noted, though the policy banks issue financial bonds ($109 billion outstanding as of year-end 2002) to fund their lending, most of these bonds are purchased by banks, particularly the Big Four.

The year 1995 witnessed another major reform in banking with the passage of two pieces of legislation by the National People's Congress: the Law of the People's Bank of China and the Commercial Banking Law of China. The former solidified the PBOC's status as China's central bank and made it the chief supervisor and regulator of the banking system. The latter further enabled the Big Four to operate more as true commercial banking enterprises by giving them greater autonomy. It also introduced prudential standards and regulations for the banking industry. The greatest contribution of this round of reform legislation was to promote a more market-driven banking system and generally advance the rule of law, both crucial components for effectively liberalizing China's economy.

In the aftermath of the 1997 Asian financial crisis and fears that the contagion might spread to China, the central authorities made further reform of the banking system a strategic priority. Originally the PBOC had been responsible for banking, securities, and insurance. In 1998 all organizations engaged in securities trading supervised by the PBOC were put under the CSRC. (Although established in October 1992, the CSRC did not become a fully operating regulatory body until the government's action six years later.) The China Insurance Regulatory Commission (CIRC) also was established in 1998 to supervise the insurance market.

Coinciding with these moves, the central government publicly owed up to the precarious banking situation and injected $33 billion of capital into the Big Four. Within

a year it took the added step of establishing four asset management companies, one for each of the banks. The companies then absorbed $169 billion in nonperforming loans from them. By the end of 2003, the four companies had disposed of $61.5 billion in NPLs and recovered cash of $12 billion cumulatively (a recovery rate of only 20 percent). This was a significant effort towards bolstering the nation's fragile banking system, to be sure, but only the beginning of what will need to be a continuing effort to clear out the banking sectors' NPLs. Even after this unloading of bad debt, the Big Four were still left with an official NPL ratio of 21.4 percent. This translates into a nonperforming loan amount of $253 billion. Unofficial estimates have put the ratio as high as 40 percent, equivalent to $470 billion. If one assumes a recovery rate of 30 percent for the disposal of these assets, the depth of the problem at the Big Four thus would range from $177 to $329 billion: 15 to 27 percent of national GDP. The alarmingly large scale of China's NPL problem (which is even larger if other types of banking institutions are included) encapsulates why the banking system simultaneously represents China's greatest financial asset base and also the Achilles heel of its booming economy.

The Ongoing Pace of Reform

Only last year the government created the China Banking Regulatory Commission (CBRC), part of a pattern of incremental moves that have narrowed the focus of the PBOC so that it can better serve the role of a central bank. The creation of the CBRC finalizes the transfer of the PBOC's formerly all-encompassing regulatory powers over the financial services industry, reflecting the functional approach China is taking towards financial services regulation. Significantly the PBOC is now structured to focus more of its attention on monetary policy and similar central bank responsibilities, avoiding being potentially compromised by its earlier responsibilities for the general state of the banking industry.

At the end of 2003 the government injected additional capital into the Big Four, placing $45 billion that went in equal portions to China Construction Bank and the Bank of China. These are the two of the major lenders least burdened by NPLs and the State Council has selected them to test the viability of transforming the SOBs into

internationally competitive joint-stock holding banks. Both are expected to IPO by 2005 and already have important alliances and partnerships with foreign banks in place. The money the capital infusion has come from China's huge foreign exchange reserves (which even after the cash injection stand at $403 billion—a reminder of the increasing importance of foreign trade for the nation). Notably, rather than transferring bad loans to the Big Four's asset management companies in exchange for bonds, as was done previously, the latest round of capital infusions has come as a pure cash transfer. This has increased the banks' capital-to-asset ratios, incentivizing them to make more presumably prudent loans, which in turn should help reduce their NPL ratios. Also encouraging are the indications that $40 billion has been earmarked for the Industrial & Commercial Bank of China and $35 billion into the Agricultural Bank of China, the Big Four's more troubled SOBs.

In addition to the capital injections, the National People's Congress recently passed three new banking laws that took effect in February 2004. One solidifies the position of the PBOC as legally responsible for determining and executing monetary policy, guarding against financial risk, ensuring financial stability, and combating money laundering (official confirmation that it is relieved of many previous duties for direct regulation and supervision of financial institutions).

A second law, the Law on the Supervision of the Banking Industry, complements the first by mandating the CBRC's responsibility for regulating and supervising all banks and other depository institutions. This law also introduces some of the Basel Core Principles for Effective Banking Supervision, international norms or standards for banking supervision. Adoption of these principles is designed to steer banks towards better control of risk. A third law removes from the Big Four previous obligations to grant loans for projects approved by the State Council. It additionally allows banks to participate in many of the dimensions of banking taken for granted in advanced economies: the purchase and sale of government and financial bonds, engaging in foreign exchange, and offering bank card services. Although banks are prohibited from *investing* in nonbanking financial institutions, the laws leave room for *expanding* into nonbanking businesses, such as in the fields of securities and insurance. This expansion of business

activities holds out the promise for increased profitability and greater risk diversification at the banks.

The Challenges Ahead

Even with the pattern and momentum of reform that suggests China is indeed making progress at getting its financial house in order, criticisms of the banking reform process still are heard. These typically boil down to claims that deregulation and efforts at addressing the NPL problem as insufficient for dealing with the sheer magnitude of China's infrastructural issues. For example, the recapitalization program recently begun for the Big Four is derided as counterproductive, helping only to sustain their legacy of poor lending practices, not set them on the road to recovery. In addition, the use of funds from the nation's swelling pool of foreign reserves is characterized to be as much for the purpose of delaying genuine reform at the banks as it is to ease pressure for China to appreciate its Renminbi currency. Moreover, with some estimating that the economy's actual growth rate in 2003 at higher than the official rate of 9.1 percent, loans that have been directed to especially frothy sectors like real estate could, once this spike in China's growth cycle turns downward, further burden an already troubled banking sector.

Although these arguments have their merits, there are further considerations that mitigate against putting too much faith in the bleaker portrayals of China's ongoing banking reforms. The value of the latest round of recapitalization is indeed dwarfed by the magnitude of the entire NPL situation. Yet the Big Four hold the key to restructuring China's financial system overall. Apart from the mounting evidence of authorities' commitment to banking reform, the looming prospects for the Big Four to have to compete with foreign entrants presents a tangible incentive for these banks to put their capital infusions towards improving performance. As for the use of foreign reserves, currency considerations may well have exerted influence. Yet given the crucial importance of banking reform, drawing from the nation's foreign reserves hardly can be deemed unwarranted. Arguments that the capital infusions serve merely as a tactic against Renminbi appreciation are unconvincing.

The more legitimate concern regards examples of potential overheating in the economy. Rapid growth in the money supply and credit may have stoked overinvestment

and subsequent excess capacity in certain sectors of the economy. Both credit and money grew by more than 20 percent in the first half of 2003, the most rapid rise since 1998. Such trends could without doubt serve to debilitate an already fragile banking system. Here again, however, the government has taken what appears to be appropriate measures, which include a new requirement, issued in September 2003, that increased the percentage of deposits banks must hold on reserve from six to seven percent. As a consequence, bank loans increased by $9.9 billion from October to November, a dramatic drop from the average monthly increase of $33.2 billion during the first three quarters of 2003. Nevertheless, if growth in money and credit is not checked continuously to prevent overheating in the economy, it will only add to the precariousness of China's troubled banking sector.

Final Thoughts

During the past twenty-five years China has taken major steps to convert a centrally planned economy into a market-oriented one. This has included spinning off the commercial banking operations of the PBOC into separate commercial banks, improving financial supervisory authority, generally strengthening the rule of law in the financial system, and taking related actions to foster a modern credit culture. Although derided by some, the combined total of nearly $250 billion that has already been pumped into the Big Four is a demonstrable sign that China's authorities are doing more than just talking about banking problems. The momentum and trajectory of China's banking reforms, though by no means guaranteed to continue on course, nevertheless does indeed suggest that NPL ratios eventually will decrease to manageable levels.

Furthermore, China's increasing integration within the global financial system is accentuating a sense of urgency for resolving the nation's NPL problems. As of late 2003, there were 62 foreign banks from 19 countries with 191 operational entities and 211 representative offices in the People's Republic. Currently these banks account for a mere 1.4 percent of total banking assets. Once China's banking industry is accessible to foreign and domestic banks on more equal terms, the proportion of assets held by foreign institutions surely will increase. China has a national saving rate of around 40 percent of

GDP. Most of this savings is deposited in banks, with banks holding $1.25 trillion in household deposits at year-end 2003 (75 percent being held by the Big Four). The depth of this asset pool combined with the opportunities implied by China's economic mass, continued growth, and rising personal income levels, means that leading foreign financial institutions will continue to make China a major target for their future growth. The new competition in the banking sector should eventually see Chinese households and businesses benefit from better interest rates on loans and deposits and a wider range of financial products and services, all of which should provide additional stimulus to the economy. Since January 1, moreover, the PBOC has allowed banks greater leeway to raise their lending rates to reflect better the risk profiles of clients. Needless to say, the impending greater foreign bank participation is already stimulating various initiatives to boost the performance of China's own banking institutions.

A balanced review of the evidence suggests that whatever the banking sector's present difficulties and inherent weaknesses, the pace and direction of ongoing reforms should provide an abundance of opportunities for those with the insight and wherewithal to navigate the unfolding dynamics of China's evolving financial system. To be sure, China must continue to pursue reforms: vigorously and with attention to addressing problems at their root causes. In addition, although the banking sector represents the backbone of Chinese finance, its strengthening implies that other components of China's financial system must be reformed and reach a level of global competitiveness as well. Yet with these caveats in mind, what so far has been the weakest link in the world's hottest economy has legitimate prospects to become one of the stronger links in an economy that before long may well be the world's largest.

Key Events in the Development of China's Banking System

1948:	People's Bank of China (PBOC) established.
1951:	Renminbi issued as new currency.
1978:	Vice Premier Deng Xiaoping begins the process of transforming China from a centrally planned to a socialist market economy.
1979:	The PBOCs banking monopoly ends with the formation of the first two SOBs of the Big Four: the Agricultural Bank of China and the Bank of China.
1980:	China resumes its membership in the World Bank and returns to the International Monetary Fund.
1983-4:	The second two of the SOBs of the Big Four are created: the China Construction Bank and the Industrial and Commercial Bank of China.
1985:	China approves establishment of first foreign branch bank office in China since 1949.
1990:	Shanghai Securities Exchange established.
1991:	Shenzhen Securities Exchange established.
1992:	China Securities Regulatory Commission (CSRC) established.
1994:	The Big Four are recast as commercial banks; three new policy development banks are established: the China Agricultural Development Bank, China Development Bank, and China Import and Export Bank.
1995:	National People's Congress passes the Law of the People's Bank of China legalizing the PBOC as China's central bank.
	National People's Congress passes the Commercial Banking Law enabling the Big Four to become genuine commercial banks; the law also segregates the business operations of banks, securities firms, and insurance companies.
1996:	China Minshen Banking Corp., the nation's first publicly traded private bank, established.
1998:	China Insurance Regulatory Commission established to take over regulation of the insurance industry from the PBOC; CSRC takes over supervisory responsibility of securities market regulation from the PBOC.
	Big Four infused with $33 billion of capital.
1999:	China's first bankruptcy of a major financial institution: CITIC.

Four asset management companies established to offload $169 billion in nonperforming loans from the Big Four: China Xinda, China Oriental, China Great Wall, and China Huarong.

2001: China becomes a member of the World Trade Organization; commits to opening up its financial services industry on equal terms to foreign banks by 2006.

HSBC Holdings becomes the first foreign bank to buy a stake in a mainland Chinese bank.

2003: Law of the People's Bank of China and the Commercial Banking Law of China amended; Law on the Supervision of the Banking Industry passed: the China Banking Regulatory Commission legalized and the PBOC further empowered as the nation's central bank.

State Council approves Reform Measures for Rural Credit Cooperatives thereby promulgating reforms on supervision, ownership, policies, and operations.

$45 billion injected into the China Construction Bank and the Bank of China, two of the Big Four considered to be the least burdened by NPLs.

Measures for the Administration of Equity Investment Made by Overseas Financial Institutions in Chinese-funded Financial Institutions take force on December 31. The amount of equity investment allowed to be made by foreign financial institutions in Chinese financial institutions is increased to a maximum of 20%.

2004: Three major new financial laws implemented: Law of the People's Bank of China (Amended), Administrative Measures on the Supervision of the Banking Industry, and Commercial Banking Law of China (Amended).