Current Issues of China´s Economic Policies
and Related International Experiences
- The Wuhan Conference 2002 -

Hansjörg Herr, Jan Priewe (eds.)[*]

Paper No. 16, February 2003

Part II - Further Monetary Issues

8. On the Interest Rate Policy in China after the Asian Crisis
Meng Qingping 88

9. Barriers in Transmission Mechanism of China Monetary Policy
Qu Yang 95

10. Why the Financing of Private Enterprises is Difficult in China: Towards an Institutional Transition Analysis
Sun Li 100

11. Why China should not liberalise The capital Account
Hansjörg Herr and Jan Priewe 106

12. On FDI in China's Financial Sector
Xiao Fengjuan 111

13. Security Concerns in China's Banking and Financial Systems after Its Accession to the WTO
Wang Peizhi, Liu Xinying 117

[*] Members of the Acedemic Board of „Macroeconomic Policy Studies“

8. On the Interest Rate Policy in China after the Asian Crisis

Meng Qingping [*]

1. Chinas Response to the Asian Crisis

The Asian crisis of 1997 which rampaged through the economies of Southeast Asia like an invading army was halted on the Chinese border because the central government had adopted two main macro-polices (Tyers 2001): The first one was to announce and defend the fixed nominal parity of the Renminbi with the US dollar, therefore the People's Bank of China took measures to stabilize the yuan-dollar exchange rate at around 8.3 yuan per dollar. The second is to carry out a policy of fiscal expansion. In the two years before the crisis government spending had been below 12% but raised it now to 13% of GDP in 1998 (IMF 1999). However, we also can see some changes in China due to the speculative attacks: On the one hand, the crisis had meant the redistribution of investment around the world: China faced a big capital outflow and a rise in the risk premium on investment in China (see table 1). It is estimated that this risk premium rose by a considerable amount; on the other hand, an autonomous substitution of private saving for private consumption led to a consecutive decline of domestic prices (see graph 1).

Table 1: The Capital Account and Unsanctioned Outflows, US $ billion

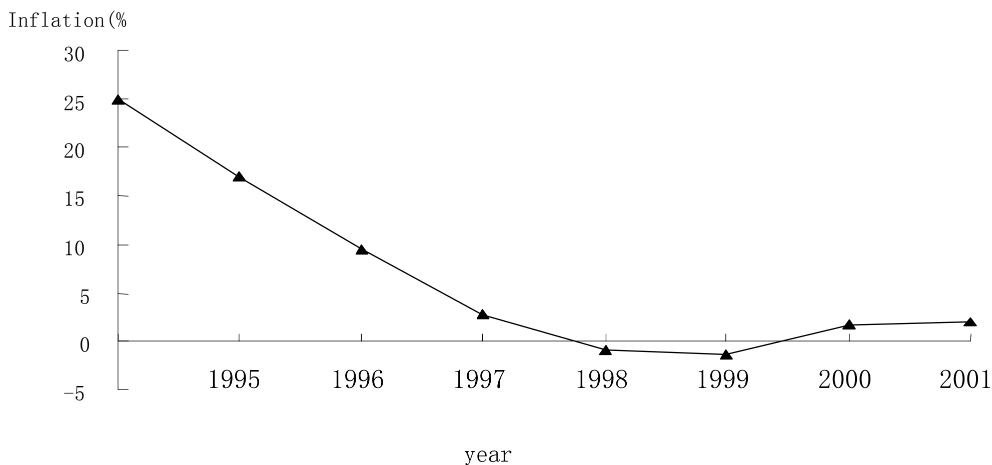
	1994	1995	1996	1997	1998
capital inflow	40.9	41.0	46.2	53.4	50.4
- sanctioned capital outflow	5.7	-7.8	6.2	19.0	14.8
- unsanctioned capital outflow	8.4	18.3	11.1	31.6	62.9
= net foreign saving in China	25.8	30.5	28.9	2.8	-27.3
- change in reserves	30.5	22.5	31.7	35.7	5.1
= capital account	-3.7	8.0	-2.8	-32.9	-32.4

Source: Tyers 2001

In order to counteract deflationary trends and maintain high economic growth, the Central Bank of China continued to reduce interest rates. The government wanted to encourage the households to consume rather than to save under the weak aggregate demand. And in the meantime they hoped to trigger higher investment by low interest rate (see graph 2). The Prime Minister Zhu Rongji claimed that the economic growth in China would be kept at 7% at least in the next five years (see China Times, 2001, 6 June). And then in the 71st annual meeting of the Bank of International Settlement (BIS), Dai Xianglong, head of People's Bank of China, said that China will continue to increase the internal demand to push the economic growth (China Times, 2001, 13 June). Consequently, in March 2002 the central bank of China cut the deposit and lending rate again. Cutting interest rate seems to become the main monetary policy of the central government. But can the government realize these targets by focusing on the low interest rate policy? In other words, will low interest rates result in continuous economic growth and strong domestic demand? The purpose of this paper is to analyse some restrictions to the impact of interest rate policy on the whole economic system and to suggest some policy recommendations.

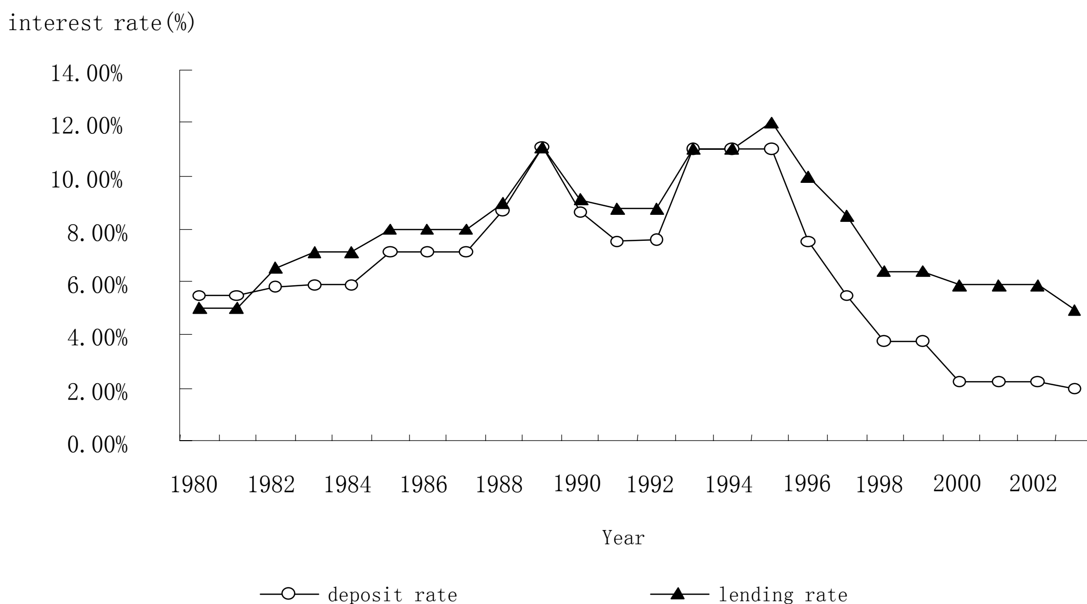
[*] Shandong Institute of Finance, Shandong

Graph 1: Domestic Price Change from 1995 to 2001



Source: The World Bank Group: www.worldbank.org/data/

Graph 2: Deposit and Lending Rate from 1979 to 2002



Source: IMF: 1997 International Financial Statistic; Quarterly Statistical Report of People's Bank of China 1999

2. Restrictions to the Impact of Interest Rate Policy

When lending is concerned, the existence of a "credit plan" and the nationalisation of most commercial banks mean that state banks cannot adopt more market-oriented lending behaviour. At present, China has four main commercial banks, i.e. the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China (ABC), the Bank of China (BOC), and the Construction Bank of China (CBC), all of them owned by the state government. Until now, the loans from the four main commercial banks account for approximately 75 percent in the total loans extended in China. Under the "credit plan", these commercial banks became the external fund suppliers and service sectors of SOEs. In 1998, the "mandatory credit plan" was turned into an "indicative credit plan" and state commercial banks can enjoy a higher degree of decision-making authority.

Many policy loans, such as loans for infrastructure investment, agricultural procurement and for individual projects or enterprises, were shifted to the three development banks, including the State Development Bank, the Import-Export Bank, and the Agricultural Development Bank. But the central bank still issues an overall lending limit and local governments also exert some pressure on local branches of state commercial banks to influence their loan decisions in order to favour the enterprises owned by them. Table 3 states that from 1978 to 1998 SOEs have been the biggest borrowers of the state banks and that the SOE-share in total lending decreased to 82.8 percent in 1998 from 91.1 percent in 1978, only by 8.3 percentage points.

With the restructuring of SOEs, more and more enterprises have been in loss or gone bankrupt (see table 4). For the SOEs in losses, especially some middle and large enterprises, the government wants them to survive so they need more investment in technology and equipment. Even if they did not repay the old loans, they can get under these conditions new loans from the state banks. For the SOEs declaring bankruptcy, the machines, equipment and real estate are sold and the net finance was paid to employees because most SOEs in bankruptcy owed their employees wages and benefits; and some funds even flowed into the individual pockets of some managers. Enterprises and banks are all owned by the government, there is no difference for the money in the "left hand" or in the "right hand", so declaring bankruptcy became a method for SOEs to evade repaying loans. "According to a nationwide survey of 145 of 1,520 enterprises that were declared bankrupt between 1993 and 1995, the average loan repayment rate of the 101 enterprises that had completed bankruptcy procedures by the survey date was only 9.2 percent."(Almanac of China's Finance and Banking 1997, p.285). As the overall amount of "bad debt" is concerned, a quote of the central bank governor Dai Xianglong in Ming Bao (22 April 1998) suggests "unhealthy loans": overdue loans, non-performing loans, and loan losses account for about 20 percent of total loans in the four state commercial banks in 1998. And it was estimated by Standard & Poor in 1998 that the amount of "bad debt" is 2,000 billion yuan, equal to about 22 percent of total lending by all financial institutions in China (Xinbao, 5 August 1998, and People's Bank of China Quarterly Statistical Bulletin 1998-3, p. 14).

Table 2: Gross Domestic Investment (percentage of GDP) in China

1994	1995	1996	1997	1998	1999	2000	2001
41.2	40.8	39.6	38.1	37.8	37.8	37.8	37.3

Source: Asian Development Outlook 2000, p. 249, Table A8

The question to be addressed here is how the interest rate policy can come into effect in the absence of decision-making autonomy in the banking sector and market-oriented lending behaviour of state banks. Table 2 shows that the domestic investment has been kept at a stable level since 1997. As mentioned above it was mainly not the interest rate but the SOE credit plan that prevented a severe reduction in investment.

Table 3: State Bank Lending

	1978	1980	1985	1990	1995	1996	1997	1998
total loans (billion yuan)	185.0	241.4	620.6	1516.7	3939.4	4743.5	5931.8	6844.2
growth over previous year(%)					21.4	20.4	25.0	15.4
lending to (billion yuan)								
state-owned enterprises	168.5	215.6	528.8	1289.8	3307.7	4004.7	4907.7	5666.8
agriculture	11.6	17.6	41.7	103.8	192.2	236.8	306.3	353.7
urban collectively-owned enterprises	5.0	7.8	31.1	81.6	106.6	120.0	...	...
individually-owned industry and commerce	0.0	0.0	1.1	1.6	3.4	5.4	16.1	20.8
foreign-funded enterprises	...	...	...	...	90.0	121.7	171.6	222.7
others	0.0	0.4	18.0	39.9	239.5	254.9	530.0	59.2
Share in total lending (in %)								
state-owned enterprises	91.1	89.3	80.9	85.0	84.0	84.4	82.7	82.8
agriculture	6.2	7.3	6.7	6.8	4.9	5.0	5.2	5.2
urban collectively-owned enterprises	2.7	3.2	5.0	5.4	2.7	2.5	...	...
individually-owned industry and commerce	0.0	0.0	0.2	0.1	0.1	0.1	0.3	0.3
foreign-funded enterprises	...	...	...	...	2.3	2.6	2.9	3.2
others	0.0	0.2	2.9	2.6	6.1	5.4	8.9	0.9
total loans by all financial institutions (billion yuan)	...	...	...	1768.1	5053.8	6115.3	7491.4	8652.4
shares of state banks in total lending (%)				85.8	78.0	77.6	79.2	79.1

... data not available

Note: State banks include the four main commercial banks, three development banks, Bank of Communication and CITIC Industrial Bank.

Sources: Almanac of China's Finance and Banking (1997, p. 464, 471; 1998, p. 508f; 1999, p.384f)

Table 4: Financial Performance of State-Owned Industrial Enterprises (in 100 million yuan)

	Fixed assets	profits	losses	taxes paid	ratio of pre-tax profits to fixed assets
1978	3193	508.8	42.1	281.9	0.25
1980	3730	585.4	34.3	321.7	0.24
1985	5956	738.2	32.4	595.9	0.22
1990	11610	388.1	348.8	1115.0	0.13
1995	30936	665.6	639.6	2208.6	0.09
1996	34765	412.6	790.7	2324.5	0.08
1997	38351	427.8	831.0	2479.4	0.08
1998	38734	525.1	1023.3	2845.9	0.09
1999	...	997.9	851.4	3081.2	...

... data not available

Sources: China Statistical Yearbook 1998, p.461, 1999, p.435, 2000, p.417; China Statistical Abstract (various years)

3. Policy Recommendations

Interest rates are an important target of monetary policy under the conditions of free capital markets. But at present in China, the manipulation of interest rates alone may no longer be enough to address the main problems. In fact the state banks and SOEs constitute two sides of the same state-owned sector, and the bad credit of state banks together with the losses of the SOEs are produced by the mutual relationship that exists between them. In order to make monetary policy such as interest rate changes more effective, the critical step is to deepen the reform of financial institutions and SOEs, especially the banking sector, because good banking practice will exert pressure on the SOEs to improve their productivity and raise their standards of management.

In 1999, the four main state commercial banks set up their own asset management companies (AMCs) with the support of the government. The main purpose of these AMCs is to take over the bad credits from their own commercial banks. The government provided the initial capital, which allows these AMCs to issue government-guaranteed bonds that in turn enable them to raise finance. With this finance, they bought the bad credits of selected SOEs from their own commercial banks at face value and then converted them into equity. Finally they have to decide how to deal with these equities. The total number of selected SOEs was 601, most of them being middle or large-scale enterprises. By mid-2000, the AMCs had taken over more than 1.3 trillion yuan of bad debt, which accounted for about 20 percent of all state bank loans (see Xinbao, 28 July 2000, and People's Bank of China Quarterly Statistical Bulletin 2000-2, p.24). This means that most bad debts had been transferred from state commercial banks to government-owned AMCs. It is very doubtful that a large amount of these bad debts will prove recoverable. Even if the bad debts acquired by the AMCs are shifted into SOE stocks, the return on these will probably be lower than the interest that the AMCs must pay on the bonds they have issued. Eventually, the central government will have to repay the bonds issued by the AMCs, which probably implies a larger budget deficit in the future. These measures, however, have not substantially altered the character or the *modus operandi* of the state commercial banks, which are still in the hands of the government. Fresh cases of bad debt will arise if the banks continue to extend loans to uncom-petitive SOEs. Within five years after China's entry into the World Trade Organization (WTO), foreign banks will be granted full access to the domestic bank sector. Foreign investors will be allowed to own a 49 percent share of security and fund management companies within 3 years of China's accession to the WTO. This development will have the effect of pushing the liberali-zation of the domestic financial and insurance markets, and will also mean that Chinese banks and insurance companies will be faced with stiffer competition. The government should take substantial measures to extend the reform of financial institutions, enabling the latter to adapt more effectively to the new situation.

State-run commercial banks should, in the first place, be allowed a greater autonomy in decision-making and lending behaviour. Table 3 showed the absolute figures for loans made by state banks in 1998. As was shown above, loans given to state-owned enterprises account for 82.8 percent of the total. Tables 4 showed that the ratio of pre-tax profit to fixed assets in state-owned enterprises was only 0.09 percent, whereas in table 5 can be seen that the output of SOEs amounted to merely 26.5 percent of total GDP in 1998. If the banks are permitted a greater say in decision-making, they will extend loans to more profitable non-state-owned enterprises rather than to loss-making SOEs.

In the annual session of the National People's Congress, in March 1999, the constitution was amended to enhance the formal status of the private sector and provide it with greater political protection (Asian Economic Statistics, "People's Republic of China", pp. 61-65). According to this new measure, the private sector should be given the same opportunity to acquire bank loans. The extension of more loans to the private sector, based on sound lending criteria and supported by an independent decision making process, should lower the incidence of bad debt. Moreover, improved bank supervision may drive companies to raise and improve their productivity.

Table 5: The Structure of Output According to Types of Ownership

year	state-owned enterprises	collectively-owned enterprises	individually-owned industry and commerce	others
1978	77.6	22.4	0	0
1980	76	23.5	0	0.5
1985	64.9	32.1	1.9	1.2
1990	54.6	35.6	5.4	4.4
1995	34	36.6	12.9	16.6
1996	33.7	36.5	14.4	15.4
1997	29.8	35.9	16.9	17.4
1998	26.5	36	16	21.5

Source: China Statistical Yearbook 1999, Table 13-3

Raising the standards of management in banking is an urgent task at present. A recent report that Wang Xuebing embezzled more than 10 billion yuan from a local bank as well as other examples of corruption reported in Chinese newspapers reveal the extent of serious corruption and cronyism in the state banking sphere. This, together with the bad debt issue mentioned above, suggest the extent of the financial crisis that is crippling the domestic financial sectors. If China's economy is to continue to catch up with the level of the industrially developed world, then the government must institute wide-ranging reforms in both the political and financial systems.

Last but not least, the government should carry out more reform measures to establish a functioning social welfare system and a social insurance scheme for those in employment. This would provide the basis for all kinds of further reforms and lessen the threat to social stability.

Following the Asian crisis, the Chinese government has cut the interest rate five times in order to stimulate domestic demand. In fact, a relatively high degree of government intervention, as well as a lack of market-oriented lending behaviour have prevented low deposit and lending rates from coming into effect. To improve the efficiency of the monetary policy it is of urgent necessity to pursue the reform of the SOEs and the banking sector with much more vigour. Rigorous and wide-ranging changes need to be implemented, particularly in the banking sector.

References:

Almanac of China's Finance and Banking (Zhongguo Jinrong Nianjian), various years. Beijing: China Statistical Press.

Asian Development Outlook 2000, Oxford University Press, Manila, Philippines

Chen, Y.M., et al.(1997): The Imperfections of the Bankruptcy System Hinders the Progress of Reform (in Chinese).In: Financial Research Report, 17 June, P. 1-2

China Statistical Yearbook, various years. China Statistical Press. Beijing

Holz, C., Tian Zhu (2000): Banking and Enterprise Reform in the People's Republic of China after the Asian Financial Crisis: An Appraisal. In: Asian Development Review, Vol. 18 No. 1, P.73-91.

IMF (1997): International Financial Statistics, Washington D.C.

People's Bank of China (1999): Quarterly Statistical Bulletin, Vol. XIII, No.1

Tyers, R. (2001): China After the Crisis: The Elemental Macroeconomics. In: Asian Economic Journal Volume 15, No. 2, P.173-197

Zuo Min, Shi Hongxiu and Shi Zhongyu (2000): Research on Social Security Systems Reform (in Chinese). In: A Research Subject supported by the Ministry of Finance of PRC. Beijing

9. Barriers in Transmission Mechanism of China Monetary Policy

Qu Yang[*]

In recent years, China has implemented a 'stable' monetary policy to prevent deeper deflation. Although there have been efforts made to lower interest rates, to abandon the strict limits imposed on the credit and loan scales of the commercial banks, and to develop the private enterprise, there has been little attempt to co-ordinate these separate initiatives into a broad plan to overhaul the economy as a whole. It is generally accepted that the Central Bank has made all the right moves in responding both to deflation and the deficiency of effective demand. The results however, cannot be said to have met with initial expectations. The reason is not only that the money supply itself is insufficient, but also that monetary policy cannot be transmitted smoothly, i.e., the transmission mechanism is blocked by certain impediments. In short, the effectiveness of monetary policy has been inhibited from the start by the problems inherent in the transmission mechanism.

1. Problems with the current transmission mechanism of China's monetary policy

Certain entities and markets, such as the Central Bank, the commercial banks, private enterprise, households and the money market are instrumental to the functioning of the transmission process of monetary policy.

1.1 The Central Bank

a) The Central Bank's lack of autonomy.

In the interests of attaining a high degree of efficiency, the Central Bank should be free to formulate and implement monetary policy. In China however, the Central Bank belongs to the State Council, and it this body rather than the Central Bank controls monetary policy. In addition, the views and concerns of local governments are passed on for the consideration of central government, further influencing the decision making of the Central Bank and diminishing its capacity to act independently and impartially. The subordination of the Central Bank to the government will eventually disrupt the continuity and, therewith, the effectiveness of monetary policy.

In addition to its subjection to government control, the Central Bank also has close ties to the state owned commercial banks, and is required to shore up the loss-making activities of these institutions. This kind of situation is also responsible for weakening the ability of the Central Bank to control macro policy.

b) The intermediary targets of monetary policy

Theoretically speaking, the intermediary targets should be controllable, measurable, and relevant. With regard to the situation in China, there are obvious shortcomings in the methods used to determine intermediary targets. Firstly, the assessment of targets is limited to the consideration of M1 and M2 as the intermediary targets. The present means of calculating M2, neglects at least two key factors: (A) the foreign currency deposits of domestic financial institutions, and (B) the deposits of foreign invested banks.

[*] Central University of Finance and Economics, Beijing, PR Chína.

The transactions (measured in assets) of A and B constitute 14% of total domestic financial dealings, which means that the contributions made to the control of current intermediary targets by A and B are not included in the reckoning of M2.
Secondly, following China's entry to the WTO, foreign banks will become more popular in China, and money demand will change as financial institutions begin to proliferate. This represents another factor that will influence the accuracy of calculations.
Finally, with the development of the money market and the capital market, the ratio of monetary wealth to gross domestic product will increase, affecting the relationship between the money supply and price levels.

c) *The marketization of interest rates*
China has carried out reforms on interest rate setting in recent years. Controlled interest rates however, still play an essential role in the credit activities that take place between financial institutions and their customers. The mechanism of regulating money flows (from or to businesses, banks, households, the government and markets abroad) through the interest rate is comparatively undeveloped. Controlled interest rates do not actually reflect credit supply and demand, and are powerless to influence the behaviour of borrowers and lenders. The main factors the Central Bank takes into account in its determination of interest rates are: 1) the bailing out of debt-ridden state-owned enterprises (SOEs), the restructuring of the industrial apparatus, and price fluctuations, all of which weaken the effectiveness of the interest rate as a market regulator. To make matters worse, the credit and loan risks for middle and small sized enterprises are relatively high in China. According to the rule of risk-and-revenue balancing, banks should offer loans to middle and small enterprises at somewhat higher rates of interest. In reality, however, fixed interest rates discourage the banks from giving loans to these enterprises.

1.2 Commercial banks

Due to the huge amount of bad loans (the total figure for the four commercial banks is as high as 1396 billion yuan), most commercial banks have had to restrict their lending in the interests of protecting themselves from incurring more bad debts. This has also weakened the transmission function of monetary policy. Under current conditions, many commercial banks adhere to a policy of 'zero risk' and abjure the practice of accepting 'lifelong responsibility for loans' [1].As a result, the commercial banks fail to create derivative deposits, shrinking the money base , and leading to a decrease in the money supply.
At the same time, many commercial banks are unskilled at motivating management and staff, and hence employees lack the incentive, initiative and commitment to make the necessary changes to their work practices. For example, the member of staff or manager who sanctions a loan is personally responsible for that loan and the fate of the repayments his whole life long. However, rates of pay are in no way commensurate to this heavy responsibility, with the result that no one is willing to take the considerable risks involved in issuing loans. This is another further factor hampering the expediency with which monetary policy can be effected.

[1] Most enterprises esp. SOEs, have a tendency to delay or even refuse to repay loans and interest to the banks. The personnel responsible for the issuing of loans are also held accountable for clients defaulting, and are penalised by being compelled to take cuts in salary.

1.3 Enterprises

Fluctuating interest rates have little effect on levels on investment in either the state run or private business sectors. Concerning the government-supported SOEs, lower interest rates do not produce investment demand, as the banks are unwilling to lend to debt burdened concerns whom they already know are almost certain to default. Smaller enterprises that have a strong desire to acquire investment funds, and which moreover have a keen appreciation of the costs of borrowing, would ordinarily be very responsive to interest rate levels, if it weren't for the fact that they cannot obtain loans on anything like the favourable terms offered to the big SOEs. These businesses cannot procure loans as easily as the SOEs since the government actively pursues a policy of rescuing the latter from financial difficulties through the provision of generous levels of funding.

1.4 Households

The ordinary people's lack of financial awareness causes them to react slowly to the opportunities made available through the government's monetary policy. People hold their financial assets mainly in banks and security markets, and as the asset structure is quite straightforward, efforts to change the structure of assets have little effect.

With the reform of medical care, housing, unemployment protection and education, households' expenditure is rising at a much higher rate than expected future levels of income resulting in a decline in current rates of consumption. This explains why the desire to save is increasing despite the fact that interest rates are in decline.

1.5 Money Markets

Commercial paper market

Most of the commercial papers in the banks' holdings are long term government bonds. There is no integral commercial paper market in China. Some entities do not follow the normal way of operation, but accumulate large quantities of commercial papers to obtain discounts from the Central Bank to gain the differential between the interest rates. This leads to the weakening of the role of the Central Bank's rediscounting policy. However, why does the Central Bank offer such discounts? The reason for this is that under the former centrally planned economic system, the Central Bank played the role of a managing institution that was responsible for making up the losses of the of the commercial banks.

Open market operation

At present in China, the interest rates between each sub-market (such as stock markets and bond markets) are not closely connected, which limits the role of the money market interest rate as a guide to the whole interest rate system. Up till now, the money market has not succeeded in reaching the point in its development whereby the Central Bank could introduce sufficiently open market operations.

2. Recommendations on How to Improve the Transmission Mechanism of China's Monetary Policy

The obstructions in the transmission mechanism of China's monetary policy have become more apparent with the abandonment of the former transmission mechanism, which was under direct governmental control, and it's replacement by one that is now only subject to its partial control. There are various means of surmounting these obstacles:

The Central Bank should maintain its independence as a policy and decision making body, while at the same time intervening in areas of the developing of financial market where its assistance, support and supervision is required. On the one hand, it should liase with the Securities Market Supervising Committee and the Insurance Market Supervising Committee to help co-ordinate and harmonise their activities, while on the other it should leave the business of implementing the monetary policy it has formulated to local government agencies. Actually since 1998, the reforms that have taken place in the provinces have embodied this spirit. Additionally, the Central Bank should be independent from the state owned commercial banks, too. Loans should be extended to these institutions mainly on a short term basis, in order to increase the power of the Central Bank, and reinforce its ability to control macro policy.

In China, money supply has been selected as the intermediary target of monetary policy. Now however, due to the trends taking place in global finance, interest rates are likely to replace money supply as the intermediary target. Interest rates, which represent the price of money, reflect demand and supply of credit and can be immediately measured by the Central Bank. The marketisation of the interest rate will smoothen out the kinks in the transmission mechanism of monetary policy, and provide better condition for open market transactions.

First of all, commercial banks should be removed from the sphere of government control to enhance their sensitivity and speed of response to monetary policy. In addition to institutional reforms, much work needs to be done in the area reorganising and restructuring the management of the commercial banks. To begin with, commercial banks should establish incentive schemes and improve the conditions governing pay and promotion to motivate their employees and foster a spirit of initiative. The commercial banks also need to be restructured in preparation for going public. The new commercial banks will be more sensitive to changes in the market and ready to meet the challenges that the marketisation of the interest rate will present. As for the large number of bad debts, multiple measures need to be developed to deal with this long-standing problem and to prevent the formation of new bad debts. It would be advisable to pursue measures such as the establishment of assets management corporations, turning bad assets into shares, and selling them to foreign financial institutions.

Enterprises, especially the SOEs, should be released from government control and granted the freedom to manage their own affairs and to assume sole responsibility for profits and losses. When such entities are forced to compete with each other to raise money, the interest rate will automatically begin to play its intended role in the regulation of investment. Businesses should be encouraged to raise the finance they require by issuing shares on the stock market, and seeking foreign investment.

A credit guarantee institution for small and middle sized enterprises should be established to allow such firms to procure the capital and finance they need to develop and expand. An institution of this kind should not be profit-oriented but seek to establish these firms on a sound commercial footing.

The commercial paper market needs development. Considering China's situation, the paper market should focus on the authenticity of the papers (i.e., papers used in concrete commercial goods transactions) and establish it as the main medium for the settlement of commodity transactions between firms.

The types of players in the money also needs to be multiplied in order to create a better micro base for money market development. In the current situation chiefly commercial banks act on the money market. The best way forward is to develop the e-bank business, and to bring the various middle or small sized commercial banks, security firms, and trust and investment corporations within the scope of the money market.

References:

Yan Qingmin, Li Muxing, (2001): 'Research in China Monetary Policy Transmission Mechanism and its Effects´. In: Southeast University of Finance and Economics Press

Dai Xianglong, (2000): 'Finance Reading Brochures for Leading Cadres'. In: China Finance Press

Xie ping, (Jan. 2001), 'Challenges of China Monetary Policy in the New Century'. In: Finance Researches

Wang Yu, (2001): 'Problems and Reforms of China's Monetary Policy Transmission Mechanism' In: China Finance Press

Wang Xun, (2001): 'Research in the Barriers of Monetary Policy Transmission Mechanism'. In: Finance Researches

Wei Gejun, (2001): 'Research in China Monetary Policy Transmission Mechanism'. China Finance Press

Huang Da, (2001): 'Economics of Money and Banking'. China Renmin University Press

10. Why the Financing of Private Enterprises is Difficult in China: Towards an Institutional Transition Analysis

Sun Li[*]

Private enterprise contribute a great deal to the Chinese economy. In recent years, much attention has been given to the difficulty of financing this sphere of the economy. Although the sphere of private enterprise has experienced high growth rates over the last decade, it depends heavily on internal financing (see table 1). The evidence world-wide, however, demonstrates that this form of financing does not prove to be a reliable, long term source of sustained growth into the future. Now, with the number of private enterprises increasing day by day, demand for external financing is on the rise. In this paper, I will present an institutional analysis as to why it is difficult in China for free market operators to procure outside capital resources. I will conclude by outlining the reasons why I believe the solution to this problem is to be found in developing the capacity of the private banking system to offer the required level of financial support to these businesses.

Table 1: Private Enterprises' Initial Capital Resources

Operate years	Internal financing	Banking credit	Financing from non-financial institutions	Others
<3 years	92.4%	2.7%	2.2%	2.7%
3~5 years	92.1%	3.5%	0	4.4%
6~10 years	89%	6.3%	1.5%	3.2%
>10 years	83.1%	5.7%	9.9%	1.3%

Source: Gregory/ Tener (2001, p. 3)

Overview: The Problems of Financing Originates with Financial Institutions

It is generally recognised that there are two patterns of transformation that characterise the development of transitional economies. The first of these is the "shock therapy" method practised in Russia, and the second is the path of evolutionary transition. The economic reforms that have been introduced in China are clearly inspired by the latter approach, which requires a stable growth in output in the traditional system (state-owned enterprises) during the initial stage of the reform. From this basis, more radical and far-reaching reforms can be implemented and allowed to gradually evolve, enabling the economy as a whole to maintain its continuity and stability as it steadily transforms itself into an increasingly market oriented system. This way of proceeding with reform has received the approval and support of a wide variety of different interest groups. However, it must also be pointed out that this mode of evolutionary change comes at the cost of the inefficient allocation of financial resources.

The banking and finance system in China has always been an integral part of the country's state-owned enterprises, existing next to but not autonomously from them in a relationship of co-dependency. In the traditional centrally planned system, the government controlled the principal allocation of funds to the state-owned enterprises.

These funds were therefore generated within and distributed through the channels of the state's industrial/financial system. With the policy of ”devolving authority and sharing profits” the government paid the anticipated benefits of reform to households ahead of schedule through the enactment of various forms of decentralisation. This meant that there was a declining share of budget revenue in relation to national income, and state-owned enterprises ended up receiving fewer funds from the government. At the same time, this reform was accompanied by the introduction of ”monetisation” of economic relations. There were two results of monetisation. One positive outcome was that the government could raise funds from currency issues without fear of raising the level of inflation. Of course this source of revenue is limited.. The second consequence of monetisation was the great increase in financial resources that were thereby made available. The government chose to use the state-owned banking system to manage and allocate the newly-generated funds for the purpose of supporting state-owned enterprises. However it maintained the restrictions on the activities of non-state financial institutions. Under these conditions, the state-owned enterprises remained completely dependent on the state-owned banking system.

Features of the State-Owned Institutions and their Policies

1. *Credit Discrimination Policy.* Until very recently, almost no institutions other than state-owned enterprises had access to credit from the state-owned banking system. There were many impediments blocking the access of private sector banks to the financial resources available to the state sector.
2. *Funds Supply System.* One the one hand, state-owned banks supplied funds to the state-owned enterprises in the form of loans, including the provision of credit for fixed and working capital. On the other hand the central bank supplied the funds required for lending to the state-owned banks.
3. *Financial Subsidy Policy.* Many kinds of financial subsidies were furnished to state-owned enterprises by the state-owned banks under the government's guidance and approval. Amongst these were subsidies in the form of low interest rate loans, the contributions of state banks that were treated as a sort of subsidy, and lastly the acceptance of a large number of non-performing loans that in essence counted as yet another form of subsidisation for the state-owned enterprises.

With the deepening of reform, the gathering evidence began to suggest that the growth potential of traditional sources of finance was being hampered by the externality of state-owned financial property rights and the lack of effective corporate governance. While the state-owned enterprises were becoming ever more burdened with debt and their performance continued to deteriorate, the scale of non-performing loans, owed almost exclusively by the state-owned enterprises, increasingly exacerbated the conflict between ”soft assets” on the one hand, and ”hard debts” on the other. These phenomena indicated that the government's control of the state-owned banks' financial resources would eventually result in a huge crisis. The reason why a full-blown banking crisis had not yet erupted can be attributed to the disproportionately high level of household saving in China. That is to say, the high level of household deposits (the saving rate in China is over 40 percent of GDP) offset the state-owned banks' asset losses. We can conclude that this huge amount of savings did not translate into commensurately high levels of investment or capital, but represented a kind of currency accumulation that made up for the state-owned enterprises' losses. The logical result of this kind of currency accumulation is a credit crisis. Under these conditions a crisis could very well be precipitated

* Miss Sun Li, Shandong Finance Institute, Jinan City, Shandong Province, P.R.China.

by a loss of domestic savers' confidence in the government's implicit guarantee of the security of their bank deposits.

Due to these circumstances, the government changed its method of controlling financial resources and introduced the practice of equity financing to alleviate the pressure of non-performing loans and reinforce the capital of state-owned enterprises. Under this institutional setting, household savings were injected into the state-owned economy as the government's preferred means of averting the looming crisis.

Features of the Equity Financing System

1. The number of shares issued is determined and managed by the government and distributed amongst the country's regions and departments.
2. Regional governments and departments recommend enterprises to be listed on the stock exchange.

By this means, the government controls financial resources and ensures that household savings are invested exclusively in state-owned enterprises in accordance with policy. This new financing method has increased government support for state-owned enterprises.

Assessment

Given the conditions, priorities and policy aims above, it is not difficult to understand why financial sector reform, a crucial area of overall economic reform, was neglected. The reform of China's financial system has primarily been carried out as a means of achieving other reform objectives. If the government relaxed its control of the financial system, then financial resources would flow to the different sectors of the economy with greater efficiency due both to the banks' striving to serve their own interests and the greater effectiveness of regional, as opposed to central, government administration, irrespective of the banks' being privately owned or state run. It can be assumed that an easing of government control would result in a fall in output in the state run sector, leading to a disruption in the smooth and steady evolution of the economy. We can conclude that the success of gradual reform up to now has taken place at the cost of the efficient allocation of financial resources.

At the same time however, a process of gradual reform is necessary to the maintenance of social stability in China, which in turn means that funds will continue to be inefficiently allocated.

When the renowned American economist, Ronald McKinnon investigated the workings of reform in Eastern Europe, he argued that there was seldom evidence of a satisfactory transition from a centralised economy to a market-oriented model because of a failure to exert sufficient financial control and pursue a policy of judicious interventionism. This though, has not been China's experience. McKinnon demonstrated that the success of China is due to the setting up of special financial arrangements to facilitate the development of the economy in its period of transition (McKinnon, 1991). He argues that the financial system has to be hardened by coercive methods in the initial stages of liberalisation. Through financial control and restraint, the government integrates the increases in savings with the process of monetarisation to provide the necessary levels of support to the state-owned enterprises.

It is Time to Change

The gradualist approach taken to reform, has led to the development of a dual track system whereby economically vulnerable groups are protected from the worst effects of change, ensuring the stability

of growth in the initial stages of transition, while the economy is being steadily steered in a free market direction.

So as provisions designed to protect the more traditional areas of the economy have been set in place and maintained, many business entities have been released from the constraints imposed upon them during the transitional phase and allowed to operate in a free and open market. This has resulted in the gradual extension of free market principles to ever wider areas of the economy. That is to say, improvements in efficiency under the conditions created through the unrestricted operation of the market mechanism have been proceeding apace on the periphery of the economy. The tremendous achievements of incremental reform can thus be attributed to the nascent free market that has emerged alongside the state-owned economy. Non-state enterprises must operate profitably in a highly competitive environment to survive, and must contend with hard budget constraints.

The growth in output theoretically depends on capital and labour (including technology). In a state monopolised banking system, financial resources are directed to the state-owned economy, and the non-state economy acquires little outside finance support. This being the case, the non-state economy in China (especially the village and township enterprises) have tended to favour labour-intensive set-ups. That is to say, labour employed by the non-state economy has come from the surplus work force in the agricultural sector, with little investment made in technological development, keeping the ratio of capital over labour constant. Any improvements in productivity have been entirely brought about through a process of ”learning by doing”, (rather than through the implementation of formal training programmes), which soon run out of steam and stagnate. The generation of higher profits requires that more attention be paid to the necessity of introducing new technologies, processes and management methods to industry. However, it is of much more pressing importance that capital investment in the economy is significantly increased, and this is a problem that can’t be solved by internal financing alone. The difficulties the non-state sector has experienced in raising finance, due to the government’s channelling of funds to the state sector, led to the establishment of a private banking system.

The non-state banking system can be defined as the total amount of financial services and related financial activities provided by non-state banks. In some senses, the non-state economy is characterised by small scale financial services needs. Due to the higher expenses incurred in the administration of a large number of small scale loans, the state-owned banks prefer to provide credit on a larger scale, typically to capital intensive enterprises and industries . So, with the rapid growth of the non-state economy, China’s economic reform process has changed the basic structure of the economic system in fundamental ways. The non-state economic sector is now producing over 50 percent of the country’s output. In the absence of a private banking sector to meet the needs of free market operators, a mismatch between real sector demand and the financial sector supply will cause a fall in investment and ultimately economic recession.

Options

Financial sector reform involves the transformation of the virtually passive banking structure of the centrally planned economy into an active financial sector that supports the development of the real sector. In my opinion, the creation of a modern, commercially oriented banking system is critical to the further development of the free market sector, and therefore the economy as a whole. The government should rethink its own role in providing financial services and be prepared to pull out if necessary. But privatisation should be carried out cautiously, with sufficiently strong capitalisation and

an appropriate regulatory environment necessary to the creation of attractive incentives for private sector managers.

In addition to the restructuring and privatisation of existing state-owned banking entities, the banking system reform strategy should focus on opening the system up to private capital. That is to say, the principle of voluntary entry and exit must be upheld.

The development of the commercial banking sector should take place from the bottom up. It has been demonstrated that some of the most significant achievements in the economic reform process so far, such as the system of contract responsibility in rural areas, and that of the village and township enterprises, have been brought about in this way. The stability and regulation of a new banking system will be produced through the free play of market forces. That is to say, the successful development of privately owned and operated financial institutions will not be achieved through strict government control and intervention, but rather through the implementation of policies designed to secure the freedom of the market to operate according to its own devices.

The Importance of a Non-State Banking System

The development of non-state owned banks will greatly ameliorate the organisational system of financial institutions and the structure of financial markets as a whole

Since reforms began, a great deal has already been accomplished in the reform of the financial system. Under the direction of the central bank, a new financial structure offering all manner of services and facilities has been put in place. Up until now however, the monopoly status of the state owned financial sector and the comparatively small scale of its private sector counterpart, has meant that the differing needs of free market enterprises have not been sufficiently accommodated. The development and expansion of non-state banks will change the structure of the state monopoly, offsetting, to some extent, the weaknesses of the traditional financial system. From the point of view of cost alone, it's clearly uneconomic for large-scale state-owned banks to serve the requirements of small and middle-sized businesses. Large-scale state-owned banks should act as wholesale banks, while small and middle-sized banks ought to assume the role of retail banks.

The development of non state-owned finance services is helps to reduce financial risk

With large amounts of financial resources flowing to inefficient state-owned enterprises, bad debts have accumulated. These represent a huge threat to the future reform of the financial system and the economy. The state-owned banks must be restructured so that their balance sheets are restored to health. This will involve the removing or writing off of worthless assets and the provision of adequate levels of capital. Moreover, the banks must stop extending credit to unviable businesses, which leads to the further accumulation of worthless assets. Some measures have already been taken, such as the issuing in August 1998 of RMB 270 billion (US$ 32.5 billion) of special government bonds to recapitalise the state-owned banks as well as the Finance Assets Management Companies primarily established to repackage and sell on the bad assets of the state-owned banks. In my opinion, we should not focus on the state-owned banks only. It's also important to stimulate the development of highly efficient non-state financial institutions. I contend that a fully-fledged commercial sector will finally become properly established after non-state financial institutions come to occupy a sufficiently large share of the market, perhaps even exceeding the share enjoyed by the state-owned banks themselves.

This development will eliminate the threat that bad debts and non performing loans currently pose to the Chinese economy.

The development of non-state financial institutions stimulates change and improves efficiency

The efficiency of a market system depends on the structure of property rights. It is, for example, essential to introduce new forms of property rights to a market dominated by the cumbersome provisions presently in existence. The efficiency with which these changes can be accomplished will be determined by the degree to which the process of offering property rights is open to competition and negotiation. If there is little or no attempt to innovate in this area and to act flexibly, no real changes will occur in the financial system. This would merely produce insufficient changes in the existing system, rather than the measured progress to genuine and effective reform that should be the aim of this process. It is therefore imperative that private enterprise is permitted the same access to financial resources and granted the same freedom to conduct business as the state sector. However the development of a financial system based entirely on free market economics will break the monopoly of the state, and exert pressure on state-owned financial institutions.

The development of standardized non-state financing will lead to greater transparency in financial dealings, strengthening the central bank's capacity to supervise control and govern the economy

The commercially owned banks will accommodate the needs of the private sector. If the entry of non-state banks were made easier, there would be no need for deals to be done "under the table". The central bank should therefore strengthen the regulatory regime for non-state banks and control the whole financial industry more efficiently. Otherwise underground financial transactions will lead to the bypassing of the proper financial channels, which is detrimental to the effectiveness of monetary policy as a means of managing the economy.

Finally, China's entry to the WTO will allow foreign banks to transact domestic currency business with greater ease, brought about by the relaxation of the geographical and other constrains that they have been working within until now. With the increased flow of foreign capital into the country, there will be no legitimate grounds on which to continue refusing access to sources of domestic capital to foreign banks.

References:

Gregory, N., Tener, S. (2001):The Financing of Private Enterprise in China. In: Finance & Development, Vol. 3

McKinnon, R.I. (1991): The Order of Economy Liberalisation, Baltimore and London

11. Why China should not liberalise The capital Account

Hansjörg Herr[*] and Jan Priewe[**]

There is, both in China and in the West, a growing number of people, from politicians to academics and business leaders, calling upon China to take the final step that would complete its move towards full integration with the world economy, following its accession to the WTO. They strongly advocate the total liberalisation and deregulation of the financial markets. The instigation of measures leading to the full convertibility of the RMB and the elimination of capital transaction controls would thereby bring about the complete opening of the foreign exchange market.

It has been argued that the unleashing of market forces in all areas of the economy would improve the allocation of factors on a domestic and international scale. Hence, market liberalisation would create a surge in China's economic growth and help the country to overcome the transitional problems it is currently experiencing. According to this thesis, China could and should benefit from the globalisation of the capital markets.

We, however, strongly call these arguments into question, as we consider them to be highly dubious both in economic and political terms. In this paper we will first discuss the expected economic benefits of market liberalisation, and then explore the general macroeconomic consequences of such a move, including the role of different types of capital flows. Finally, we will discuss some of the political issues that pertain most closely to the liberalisation of capital transactions.

Gains or Losses for China?

There are five alleged pros in favour of the liberalisation of capital transactions. *First*, Chinese owners of financial assets (individuals, companies, financial institutions) would have the freedom to invest their capital abroad and thereby benefit from the opportunities afforded by diverse and highly sophisticated foreign financial markets, and the broad range of products they have to offer. *Second*, Chinese domestic investors can take advantage of all kinds of foreign capital if conditions prove more favourable there. At the same time, there is the likelihood that substantial amounts of foreign capital – and not only foreign direct investments - will flow into the Chinese economy and boost economic growth. Domestic savings would be augmented by foreign savings which would lead to higher levels of investment. *Third*, if Chinese imports rise due to trade liberalisation (as a consequence of China's accession to the WTO), a liberalisation of capital transactions could better meet domestic demands for import-related foreign exchange. As is well known, goods' trading is commonly associated with various types of credit. *Fourth*, under the strong pressure of competition caused by the liberalisation of capital transactions, the backward Chinese banking system would be forced to considerably accelerate the pace of its reform in this critical area of the economy. *Fifth*, black or grey markets and illegal capital and currency transactions would be directed into legal channels.

[*] Professor of economics at Fachhochschule für Wirtschaft Berlin/Berlin School of Economics (e-mail: hansherr@fhw-berlin.de)
[**] Professor of economics at Fachhochschule für Technik und Wirtschaft Berlin/University of Applied Sciences (e-mail: priewe@fhw-berlin.de)

However, these apparent *microeconomic* advantages, which are supposed to translate into alleged macro benefits, face four considerable macroeconomic disadvantages and risks that could eventually lead to microeconomic drawbacks. These drawbacks are discussed below.

1. If the Chinese Central Bank loosens its monetary autonomy regarding interest rate policy, the level of short and long term interest rates would largely be determined by foreign markets. Only hegemonic countries with a key currency incorporating international reserve functions (the US Dollar, and to a lesser extent the Euro and the Yen) are capable of maintaining an autonomous monetary policy. Autonomous monetary policies are not compatible with stable, but flexible exchange rates and free capital movements. In these circumstances, the Central Bank could not use its monetary policy as an instrument of macroeconomic governance, as the People's Bank of China did in the past, if it were obliged to commit itself to the goal of stabilising the exchange rate in order to avoid the macro risks triggered by devaluation or appreciation. The current system of corporate financing and refinancing of the commercial banks in association with the Central Bank would begin to fade. This financial system was and is based on significant domestic savings which would then no longer be entirely at the disposal of domestic companies and commercial banks.

2. In a liberalised market, China would have to look for a new exchange rate regime. The stability of the external value of the RMB – hitherto an essential guarantee of China's economic growth - would prove nearly impossible to maintain. This in fact, could be achieved by pursuing a monetary policy which is primarily committed to stabilising the exchange rate, even at the cost of high interest rates. If China introduced flexible exchange rates (or like most developing countries: "managed floating"), it would probably face enormous instability risks. Foreign exchange markets are not efficient – particularly in „emerging market economies". These markets are highly volatile and not driven by fundamentals but by short-term expectations, making them a prey to speculators. Each devaluation of the RMB increases the real burden of the effective stock of foreign debt. Furthermore, a devaluation causes an importation of inflation (at China's import quota of 20 % of GDP, the importation of inflation would be substantial and could not therefore simply be ignored).

3. Removing the constraints on currency convertibility would increase foreign debt which has been very low in China until now. The low level of foreign debt is emblematic of the high growth China has thus far enjoyed. Even if the foreign deficit were zero or remained at a low level, huge amounts of capital would flow out of the country, and vice versa. Each shift in the exchange rate would change the real debt position of various asset owner groups vis à vis foreign countries. There are indications that China would face a surplus capital account and a deficit current account because of strong capital inflows (of course, this situation could just as easily be reversed). In most developing countries this constellation has led sooner or later to severe devaluations, and currency and financial crises. As a matter of fact, an exchange rate policy that aims to achieve a balance in the current account, it is hardly possible under the conditions of free convertibility and liberalised trade without protectionism.

4. The current Chinese banking system is not internationally competitive, and moreover, has no prospect of becoming so in the medium term, even though it has been (and still is) the backbone of the Chinese economy.

The system would be subjected to strong adjustment pressure involving high risks that could lead to strongly negative macro effects. In consequence, the occurrence of bank crises cannot be excluded from consideration, especially if the level of interest rates rises dramatically or saving deposits are shifted abroad.

Different types of international capital flows involving different risks

The various kinds of international capital transactions can be assessed in different ways. *Foreign direct investments* incorporate not only the advantage of a high probability of technology transfer, but offer the further advantage that the currency risks are borne by foreign investors This risk is normally assigned to the country receiving the loan. The rules of international capital transactions imply that less developed countries, which do not have strong currencies, have to use foreign currency if they want to incur debts. It is almost exclusively key currency countries such as the USA that have the privilege of “running into debt” in their own currencies.

In the case of *portfolio investments* in the form of bonds, or with regard to bank loans, China would have to bear the currency risk alone. Another disadvantage of portfolio investments such as stocks is their short time horizon. If the investor’s expectations change, stocks are quickly withdrawn. Foreign portfolio investments intensify the risk of irrational increases in asset prices with a subsequent domestic stock and real estate market collapse. Capital inflows lead to an additional demand for domestic assets and capital outflows of portfolio investments increase in the domestic supply of assets critical situations.

Bank loans are especially dangerous in cases where domestic banks or other financial intermediaries incur debts on foreign *money* markets like New York or London, since these loans are of short duration. Moreover, companies can likewise fall into debt in the same manner. There is an incentive for drawing on foreign credit in situations where foreign markets appear to be offering stable exchange rates and lower interest rates. As already mentioned, the central bank loses a large measure of its monetary autonomy in this case. For instance, in such cases inflationary pressures or lack of growth can no longer be efficiently combated by the central bank.

Particularly in the case of China, it is to be expected that the liberalisation of portfolio and bank loans would lead to substantial capital inflows. Domestic banks, investment funds and companies would have strong incentives to contract debts abroad. Due to the fact that foreign creditors expect China’s economic success story to continue, they would be more than willing to grant loans to Chinese banks and companies. Consequently banks and companies would run up high debts in foreign currencies. Such a level of debt would correspond to high trade deficits. Moreover, parts of the assets of Chinese private households would be held in foreign currencies, e.g. the US-Dollar or the Euro. Thus, high gross levels of debt in foreign currencies make countries very vulnerable. As a result, the currency will be pressurized if the capital inflows vanish for any reason.

If there is devaluation, the real burden of foreign debt will automatically increase by the percentage of the devaluation[2].

Liquidity and even solvency crises could not then be prevented. Such currency crises then become entangled with domestic banks´ and firms´ crises, causing economic chaos and resulting ultimately in high social costs. The Asian Crisis of 1997 and Argentina's crisis in 2002 are just two examples (from a long list) of financial and currency crises that have erupted because of the sudden, incautious or premature deregulation and liberalisation of capital transactions.

Controls over capital flows should remain

In the interests of preserving financial stability, China should keep her hand out of the fire of capital account liberalisation of and maintain her short and medium term controls over capital inflows. For this reason, China should continue to its policy of disallowing foreign loans and portfolio investment inflows as well as maintaining the current restrictions on the freedom of domestic agents to make independent portfolio decisions. At present there is no internal necessity for capital inflows, as China already suffers from high levels of domestic saving. Furthermore, China should keep regulating capital outflows, in order to conduct an independent monetary policy oriented to the Chinese domestic economy. Foreign direct investments are currently proving more than adequate to meet China's needs, and they therefore constitute the most appropriate form of capital inflow for China.

Many Chinese and Western economists including the World Bank acknowledge that the full convertibility of a currency (and complete liberalisation of capital transactions) should follow at a later stage of a country's economic development. On the other hand it is entirely unclear whether this phase should last for only a few years or for much longer. We advocate the latter. There are three requirements that must first be fulfilled before full international deregulation and liberalisation can be permitted to occur: First, *domestic* financial markets have to be deregulated step by step and financial institutions need to be restructured, a measure that would include the reduction of debt overloads. Secondly, China's price stability record must be allowed sufficient time to become properly established, in order to consolidate the reputation of the currency. The third requirement is the most crucial: It is essential that an international, multilateral monetary system, which can ensure the stability of exchange rates, be set up. However, no developing country, including China, is in a position to do so. High stocks of foreign reserves will not prove adequate to the task. There are two successful historical examples: the system of Bretton-Woods (1944-1971) and the European Monetary System (1979-98). But these systems of autonomous monetary policy, which are a central component of China's economic and political stability, were only feasible for the US, and within certain limits for Germany and Japan.

[2] Let us use a simple example. A country has foreign debts of 100USD. This translates, at current exchange rates, into 1,000 units of the local currency; D. Let's say the interest rate stands at 5%. This means that 5 USD, or 50D, has to be paid per annum on interest payments alone. Let's assume further that the currency undergoes a devaluation of 30%, increasing the foreign debt to 1300D. The amount to be repaid thus increases to 300D or, say, 60D p.a., assuming a repayment period of 5 years with linear repayment. Although the nominal interest rate of 5% is fixed, the annual interest burden in domestic currency now amounts to 65D, an increase of 15D. Adding the annual repayment increment to the incremental interest payment, an annual sum amounting to 75D in excess of the pre-devaluation payment, has to be transferred. If you add this amount of additional payment liability (75D) to the original interest payment of 50D, the increase reaches a figure of 125D, which can be regarded as a "real" interest rate of 12.5%, instead of the now purely nominal figure of 5%. The shorter the repayment period the heavier the burden of devaluation-induced interest rate hikes. A one-year loan would cause an incremental repayment and interest hike of 315D in addition to the normal 50D, which amounts to a "real" interest rate of 36.5%. Devaluation therefore triggers an enormous leverage effect.

Free movement of capital – new political subjection

Now we come to the political dimensions of China's integration into the world economy. After the breakdown of the Soviet Union, the United States as the world's last remaining superpower is the only country with the power to act economically, politically and military on a global scale. It seems highly unlikely that Russia, Japan or the European Union will be in a position to challenge the global dominance of the US, at any time in the foreseeable future. However, China might have the potential to become a regional superpower in the long run. According to public opinion in the United States, the victory of Mao Zedong and the formation of the People's Republic of China in the last century still represent a great failure in the history of US foreign policy. Consequently, the control of China's development is of hegemonic interest to the USA. The easiest way of exerting such control is to make China economically dependent. Now, China has already become dependent on the USA in the sphere of international trade. The deregulation of cross-border capital transactions and the high foreign deficit that this would most likely lead to, would make China not only economically vulnerable but politically susceptible as well. Were China to step out of line politically, the US could respond by withdrawing capital, and then proceeding to exploit the resulting currency and debt crisis for its own ends, whatever those might happen to be. If so, creditors and also the International Monetary Fund (IMF), which is practically dominated by the USA, could use their position of strength to exercise an unwarranted influence over China's policy. As was the case in the Asian crisis in 1997, foreign creditors supported by the IMF could try to push China to adopt an American model of "pure capitalism" which might not accord with the country's interests and values. But it is still uncertain whether it is a conscious political strategy, mainly on the part of the USA, to make China economically dependent and politically malleable by attempting to force through a hasty financial integration into the world economy for which China is not yet prepared. A more decisive argument against premature capital account liberalisation is that China would, in any case, become heavily dependent on the USA, both economically and politically, and in a totally one-sided manner, whether or not the US is deliberately pursuing a self-interested foreign policy towards her. This also holds true to a lesser degree for China's relationship with Europe and Japan.

12. On FDI in China's Financial Sector

Xiao Fengjuan[*]

Since 1990, the enormous growth of foreign direct investment (FDI) has been a noteworthy financial development in emerging markets. The impact of FDI on the financial markets of developing countries is quite clear. While FDI gives rise to technology transfers and introduces competition mechanisms to the host countries, it is a major cause of financial and economic crisis when there is a lack of strong supervisory procedures in the existing financial system. As a developing country in Asia, China has made notable progress in opening its financial markets to foreign firms since reforms began to be implemented in 1979, although foreign financial institutions' penetration in China remains far lower than in other emerging markets. On the other hand, China's control over the capital account is seen as one of the reasons why China managed to survive the 1997 Asian crisis. With the continuing evolution of financial globalisation and China's WTO entry, China should maintain its policy of caution with regard to the introduction of foreign financial direct investment, and to the question of further market liberalisation.

1. Financial Sector FDI in China Over the Last Twenty Years

Financial sector FDI refers to foreign direct investment in the banking, insurance and securities service sectors. There was a significant increase of FDI in China, following Deng Xiaoping's famous speech in the South China city of Shenzhen, from USD4.4 billion in 1991 to USD11.0 billion in 1992. In 1999 and 2000, the amount was USD40.3 billion and USD40.7 billion respectively, of which the manufacturing sector received USD22.6 billion and UD$25.8 billion while the service sector, including the financial services sphere, procured USD2.6 billion and USD2.2 billion. Evidently, FDI in China's service sector, especially in the financial sector, has lagged far behind the level of investment in manufacturing (the above data stem from *Almanac of China's Statistics 2001*).

Concerning FDI in China's financial sector, the greatest share of funds has been concentrated in the banking sphere while in the fields of insurance and securities, investment has been more limited. Foreign banks were first introduced into China in 1979 when the Import and Export Bank of Japan set up a representative office in Beijing. By the end of 1999, foreign banks had established 175 business firms in China, with a total of USD31.7 billion in assets, which represented 2.6 percent of national financial assets. At the same time, these firms' level of foreign currency credit reached USD27 billion, which comprised 25 percent of the total national foreign currency credit, with the market share of foreign banks for trade settlements standing at about 40 percent. For the insurance industry, there were 52 insurance companies at the end of 2001, among them 32 foreign insurance companies including joint ventures (19) and wholly foreign funded companies (13), and 20 were domestic insurance companies including stated-owned companies (5) and limited companies (15) (Lu Yan, 2001). By September 2001, a total of 433 foreign financial institutions (including joint ventures) had been established in China. These institutions consist of branches and offices established by foreign banks, foreign insurance corporations, foreign finance corporations and foreign trust companies.

[*] The author is affiliated with Central University of Finance and Economics, Beijing, P.R.China. E-mail:cufx2001@yahoo.com.cn

The number of foreign bank business firms reached a figure of 190, with assets totalling USD44 billion. The following table presents figures for the financial assets of foreign banks from 1991 through to 2001.

Table 1: Financial Assets of Foreign Banks in China from 1991 to 1999 (billions of US$)

Year	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001 Sept.
Financial assets	4.29	5.53	7.58	11.8	19.1	29.9	37.9	34.1	31.7	34.4	44.0

Source: Almanac of China's Finance and Banking, 1996-2001. Data from 2001 come from Statistics of People's Bank of China

Before being permitted to establish themselves, foreign financial institutions face strict entry requirements. According to the *Rules for the Management of Foreign Financial Institution of the People's Republic of China* (1994), foreign financial institutions are entitled to apply to set up banks in China only if they comply with the following directives: 1) The amount of capital for registration has to be equivalent to 300 million RMB, and the foreign currency used must be convertible. 2) Any financial institution wishing to apply, has to have had an office in China for least the previous two years. 3) The total capital of the financial institution seeking entry has to amount to no less than USD10 billion at the end of the year previous to its application. Furthermore, the "Rules" stipulate that the home country of the financial institution in question should have a sound system of financial supervision and regulation.

In addition to the above conditions, the business activities of foreign financial institutions are strictly limited. The business activities of foreign banks are restricted to 13 types, of which 10 pertain to foreign currency dealing. The "Rules" also stipulate that foreign banks are only permitted to accept the custom of foreign-funded companies, joint ventures, residents of Hong Kong SAR and Macao SAR, Taiwan and foreign nationals. The RMB business of foreign banks must first receive special approval from the People's Bank of China (PBC). In addition, the actual geographic location of foreign financial institutions is determined and approved by the State Council of China. After this system of safeguards had been put in place, China began to open its financial service sectors to foreign investors.

2. The Effects of Financial Sector FDI on the Financial System

As we know, the development of financial sector FDI is closely related to the process of financial liberalisation. The sudden or rapid occurrence of financial liberalisation in the economies of Central Europe, Latin American and the Asian region, led to significant growth in financial sector FDI. In Central Europe, the foreign bank market share rose from 8 percent in 1994 to 56 percent in 1999. The total assets of foreign banks in the Czech Republic, Hungary and Poland reached a total of USD187 billion. The specific figures for each country were the following: the Czech Republic, USD63.4 billion; Hungary, USD32.6 billion; and Poland, USD91.1 billion. In Latin American countries such as Argentina, Chile, and Venezuela, the market share of foreign banks accounted for a half or more of the total (Robert E. Litan, Paul Masson, Michael Pomerleano, 2001). Foreign bank assets in Argentina amounted to 48.6% of total national bank assets, 53.6% in Chile, and 41.9% in Venezuela.

In contrast, China, with its limited financial liberalisation, has restricted the market share of foreign banks to under 2.5 percent, with USD31.7 billion total assets in 1999.

The potential effects of financial sector FDI on these countries are both positive and negative. The positive effects are as follows. First, the introduction of foreign financial institutions results in fierce competition, which, in turn, forces local financial institutions to drastically change their modes of operation and management. This no doubt leads to better quality of financial services and lower prices. Secondly, advanced technology and the more efficient allocation of funds brought in by foreign financial institutions, assists the development of local financial services. Thirdly, according to some commentators, the introduction of foreign direct investment to the financial sphere has the effect of stabilizing to financial markets (Qiu Yanbin 2001). According to the Basel Accord, the on-and-off balance sheet activities of cross-border branches and affiliates should come under the authority of the home country's supervisory body. This places a restraint on the risk-taking activities of foreign financial institutions, which allows for the stable development of financial markets in these countries.

However, if these advantages are to be properly realized, then the precondition of establishing a fully developed and effective system of financial supervision must first be met. However, any prospective supervisory body would find it difficult to extend its jurisdiction to entities such as shell branches and organizations that have parallel ownership. Also various kinds of financial derivatives add to the difficulties of supervision. It has been argued that financial sector FDI could be a major cause of financial turmoil in the absence of a solidly grounded and effective system of financial supervision. In the opinion of Herr and Priewe a sudden, incautious or premature move to deregulate or liberalise the financial system would cause serious problems (Herr and Priewe, 2002). The Asian crisis of 1997 and the economic turmoil that engulfed Argentina in 2002 are only two examples of the potential consequences of precipitate deregulation. China's experience, however, provides an example of how such crises can be avoided through adhering to a policy of measured and gradual liberalisation.

The effects of financial sector FDI on the financial system are closely connected with the effects of financial liberalisation on macro conditions. The profound and virulent economic crises that afflicted Asia, Latin America and Eastern Europe suggest that the positive effects of rapid financial liberalisation are far outweighed by the adverse effects, where it is the case that domestic financial markets are underdeveloped and effective supervisory structures do not exist. The unfavourable effects of China's abrupt financial liberalisation can be stated in both economic and political terms. From the economic point of view, besides the greater challenges faced by the supervisory authority, the Chinese Central Bank would lose its power to determine and direct monetary policy. It would lose its control over interest rates as well as its freedom to establish foreign exchange rates. Furthermore, China would face considerable currency risks. The high level of foreign direct investment together with huge foreign debts that would result from a hasty liberalisation of the financial system would make China very vulnerable. In the case of devaluation, the real burden of foreign liabilities or debts would automatically increase by the percentage of the devaluation (cf. Herr and Priewe, 2002). From the political perspective, premature liberalisation would make China heavily dependent on the world's economic powerhouses such as the US, Europe and Japan, which would impede China's long term development.

3. Suggestions on the Introduction of FDI in China´s Financial Sector

Many policy-makers and economists have noted that financial liberalisation was not a direct cause of the economic crisis that occurred in Southeast Asia in 1997. The econometric analysis conducted by Levine on emerging markets concluded that the probability of financial crisis is inversely proportional to the presence and influence of foreign banks in such economies (Levine 1999). In fact, after the 1997 Southeast Asian crisis, many emerging market countries have proactively taken part in WTO multilateral negotiations on liberalising financial restrictions and have made additional commitments according to the Financial Services Agreement. One of the lessons to be learnt from the economic crisis, however, is the crucial importance of establishing an apparatus of financial supervision sufficiently powerful to regulate and control the changes that will take place during the process of liberalisation. At the 1997 WTO conference about opening financial markets and strengthening functions of GATS, experts concluded that financial liberalisation could worsen the problems that currently exist in the financial system, and will produce financial crises in the absence of macro-economic stability and a strong financial management and supervisory system. Accordingly, the proceedings of the GATS conference confirmed that all members are entitled to regulate their financial markets and have absolute freedom of action to protect the integrity and security of their markets.

To introduce foreign direct investment in China's financial area, it is important to recognize that, while FDI brings many benefits to Chinese financial markets, such as cutting edge technologies, the latest managerial practices, the advantages that competition brings, and methods of optimising efficiency, it also has negative effects on the financial security and stability of China's domestic banking sector. The introduction of financial sector FDI as a means of achieving high levels of efficiency must be balanced against the need to protect domestic financial and economic security. The integration of foreign institutions within the Chinese banking and finance sector must take place through a carefully controlled and well managed process of liberalisation.

The introduction of FDI is consistent with the aims of China's reform policy, and the continued inflow of these funds will unquestionably increase the momentum and pace of change. For this reason, it is certainly in China's interests to continue to allow and encourage FDI. Moreover, in addition to the immediate and short term benefits that FDI brings, the true value of this form of investment is to be found in the contribution that it will make to China's overall development in the long term. This is why China should take a clear-sighted view of the future and ensure that FDI continues to flow into the country. It should be remembered though, that due to the underdeveloped state of its economy and financial system, China should not unconditionally lift the restrictions on the entry of foreign concerns to its financial sector. For the sake of its long term development, China should continue to maintain the controls that safeguard the integrity and stability of its markets. The tail cannot wag the dog; no country should be subject to the discipline of international commitments if this proves to be in conflict with vital political objectives at home (R.A. Mundell, 2000). This principle applies to all countries, irrespective of whether their economies are advanced or still in the process of development.[3]

[3] In reviewing the policy mix under the dollar standard of the second third of the twentieth century, Mundell concluded that the United States could not be disciplined by the requirements of convertibility or any other international commitment if it is at the expense of vital political objectives at home. In 1970s, America's most important political objective was to regain economic stability. The United States protected its economy by abandoning its international commitment of converting the US dollars to gold. at the cost of its gold convertibility. See R.A. Mundell 2000.

Strategic recommendations regarding the introduction of FDI to the financial area include (1) regulating the rate of entry and (2) control of the expansion of foreign financial institutions, as well as (3) reinforcing and further developing the legal framework within which these institutions are required to operate.

(1) Controlling the pace of accession

Many countries have adopted a variety of measures to control the pace of foreign financial institutions' accession to the home market, in the interests of preserving a fair market share for domestic institutions. These measures include licensing requirements, limits on the number of foreign countries allowed to invest funds, the power to determine the geographical range of operation for these enterprises, and control over the establishment of branch offices. For example, the setting up of branches, agents, representatives or commercial credit companies in the United States must be approved not only by the Office of the Comptroller of the Currency but also by the Federal Reserve, according to the Reinforcing Foreign Bank Supervision Act of 1991.

The Federal Reserve's assessment procedure imposes strict entry standards on companies applying for admission to the American market, involving a detailed investigation into every aspect of the candidate firm's business and general standing. This includes: an examination of the state of the parent company's finances as well as it's management structures; the applicant's capacity to conduct business on an international basis; the competency of the supervisory authority in the applicant's home country to carry out thorough audits of the financial institutions under its jurisdiction; the applicant's record of abiding by American laws and regulations; the business status of the applicant in the United States as well as the degree of transparency with which the firm conducts its business operations (Cheng Yuan, 1998).

The market entry regulations that the Federal Reserve enforces are comprehensive and strict, and many foreign banks encounter great difficulties in setting up branches in America, as was the case with the Bank of China when it applied to set up a branch in San Francisco (Wang Yuan-long, 2000). Many other countries, such as Greece, South Korea, Mexico, the Philippines, Singapore, Thailand, and Turkey, also impose exacting entry requirements on banks that wish to set up branches on their soil. China needs to draw on the experience of nations such as these if it is to succeed in establishing effective entry procedures and supervisory systems in its own banking and finance sector.

(2) Controlling the expansion of foreign financial institutions

Most developed countries control the expansion of foreign banks within their territory by placing limits on their asset holdings, the scale and the scope of their operations, and so forth. For example, according to Canadian banking law, the percentage of foreign banks' total assets to Canadian national assets is not permitted to exceed 8 percent. To cite another example, the American International Banking Act stipulates that a proportion of the capital of federally chartered foreign branches or subsidiaries (not less than 5 percent of their liabilities), be held in designated depositories.

Although the primary purpose of some of these requirements may be safeguarding the overall economy, many of them actually have the effect of limiting the growth of foreign financial institutions.

In the interests of maintaining its own financial security, China must once again learn from the example of these countries who have managed to implement measures that allow their governments a very necessary degree of control over financial institutions, without at the same time impairing the latter's ability to operate successfully.

(3) Reinforcing the legal supervision of foreign financial institutions

China must take steps to formulate and set in place a body of laws that pertain specifically to the regulation of non-national financial institutions, which should include detailed provisions as to how such laws would be successfully implemented. Additionally, auditing and assessment procedures have to be established that will enable the government to accurately evaluate the capital holdings of foreign institutions, and allow it to examine the self-regulating processes of such concerns. Furthermore, there should be closer contact and coordination between the Chinese financial supervisory body and those of the countries from which the non-national banks hail. Finally the Chinese authorities must bring about great improvements in their systems of internal auditing and risk assessment, as well as making efforts to enhance the overall transparency of their policies and actions.

References:

Cheng Yuan (1998): American Bank Supervision. In: China Finance Publishing House, P. 98-102

Lu Yan (2000): The Multinational Negotiations on Financial Services and Trade after the Establishment of the WTO and Its Implications For the Opening of China's Financial Services. In: World Economic Forum, No.1

Qiu Yanbin (2001): Impacts of the Entry of Foreign Banks on Financial Industry in Emerging Market Economies. In: Studies of International Finance, No. 8

Ruan Hua-jun, Da Li, Tian Xin-ru (2000): Foreign Bank Supervisory Problems and Its Countermeasures after China Enters into the WTO. In: World Economic Forum, No. 3

Wang Yuan-long (2000): A Study of the Strategy of China's Banking Development after Entering the WTO. In: Financial Research, No. 3

Xiao Fengjuan, Zhang Xiaoyan (2001): Financial Sector FDI in China: Development and Prospects. In: China & World Economy, No. 6, 2001

Herr, H., Priewe, J. (2002): Why China Should Not Liberalise the Capital Account, Berlin

Levine, R. (1999): Foreign Bank Entry and Capital Control Liberalization. In: Effects on Growth and Stability, University of Minnesota

Litan, R. L., Masson, P., Pomerleano, M. (2001): Open Doors: Foreign Participation in Financial Systems in Developing Countries, Reference from Video Conference held by the World Bank Beijing Office, May

Mundell, R.A. (2000): A Reconsideration of the Twentieth Century. In: American Economic Review

13. Security Concerns in China's Banking and Financial Systems after Its Accession to the WTO

Wang Peizhi[*], *Liu Xinying*[**]

According to the agreement, signed between China and the U.S., the market-opening process in banking will be gradual: firstly, on its accession to the WTO, China agreed to grant foreign banks the right to conduct foreign currency dealings. Secondly, China has undertaken to remove the restrictions on RMB business in stages. Within two years foreign banks will be able to conduct local currency dealings with Chinese businesses. Within four years, China will remove the geographic restrictions on 20 cities in five steps; thirdly, China has committed itself to allowing full market access to foreign firms after a period of five years. Also within this period, foreign banks will be permitted to conduct business with Chinese customers. Foreign banks will thus possess the same rights as Chinese banks, within designated geographic areas. Throughout this period the protective measures that Chinese banks currently enjoy will be removed, leaving these institutions to face the rigors, threats and challenges of the open market.

1. Facing the Challenge

WTO membership will prompt an economic boom in China. However, in terms of banking, it remains to be seen whether WTO entry will amount to a "win-win" deal for Chinese banking. Under the competitive conditions of an open financial market free from government intervention, Chinese banking will be faced with big challenges. As foreign banks enter the Chinese market, the free play of market forces will greatly affect many areas of the banking and financial services sector.:

1.1 Competition in banking services

a) Deposit and loan services

How will things turn out following China's WTO entry? In the savings market, Chinese banks enjoy the advantage of having a complete retailing network and the loyalty of millions of customers. Concerning the high costs involved and the absence of credit in the initial phase of their entry to the market, foreign banks will be slow to broaden their networks, and to establish a credit base through savers' deposits. Furthermore, foreign banks will presumably locate their branches in large centres of population. They will not, therefore, be in a position to influence the deposit flows from rural areas. Therefore, the competition between domestic banks and foreign banks will exist mainly in wholesaling rather than in retailing.

At present, the foreign banks are very selective in their choice of customer. They are inclined to accept only customers with a good credit history. WTO accession will inevitably lead to more and more customers taking their business to foreign banks due to the wider range of services they can provide, their greater resources, and their ability to assess risks. As a result, the profit margin of Chinese banks will be greatly affected.

[*] Shandong Finance Institute, Jinan Shandong Province, PR China
[**] Shandong Finance Institute, Jinan Shandong Province, PR China

On the other hand, given their sophisticated management and broader experience, foreign banks will also show an interest in the retailing branch, as they can offer an extensive range of lending facilities. Competition will be sharp. In the area of foreign currency loans, foreign banks will probably increase their market share due to their long-standing experience in this field. It is still too early for us to predict precisely what the implications of this will be, but they are bound to have a significant effect on the way banking is organized, managed and conducted in China. China's domestic banks may lose as much as half the market for fee-based banking services to foreign competition, once foreign banks begin to handle trade financing, credit card transactions and cash management.[4]

b) Competition in the interbank services

Given the low risks, low costs and high profits to be gained in the area of interbank services, both foreign and domestic institutions are showing a lot of interest in this field. Up until now, foreign banks have exploited the considerable advantages they enjoy in this sector, and have succeeded in winning half the market share of international transactions, even though they are currently limited to non-renminbi retailing. The transaction of exports now accounts for over half the total volume of business conducted by foreign banks, while that for imports comprises forty percent. Over the coming years the continuing liberalization of the market will increase the access of foreign banks to interbank services, due to their efficiency, well developed infrastructure, and high levels of service.

c) Competition in other services

In addition to the competition in the above-mentioned services, foreign banks will not waste any opportunity to compete in other service sectors, such as trading in financial instruments and investment areas.

1.2 Efficiency

The biggest problems affecting China's banks at present, particularly the state-owned banks are: 1. their excessive scale; 2. high rates of overstaffing; 3. low levels of efficiency; and 4. poor management and organizational structures. The four state-owned banks have incredibly ungainly staffing structures and gigantic work forces that dwarf the staff numbers of even the world's biggest bank, Citibank, with a work force of just 91,000. There are 540,000 employees in the Industrial and Commercial Bank of China, 520,000 in the People's Construction Bank of China and 200,000 in the Bank of China.[5] It is therefore obvious that something must be done to deal with the problem of excessive staffing and the poor organization of personnel that goes with it, if these banks are to raise their overall levels of efficiency.

The average yearly salary in the Industrial and Commercial Bank of China is a paltry $74, whereas employees of Citibank earn $50,000 on average.

An analysis based on internet data reported by banks in various countries in 2000 (data of domestic banks dates from 1998, the data of foreign banks from1999) shows that the rate of return on assets for domestic banks is 0.14 percent, while the rate of return on equity is 0.263 percent.

[4] Craig S. Smith, New York Times, Oct. 18, 2001
[5] China Yearbook for 1998

However as regards other domestic banks such as the ICBC, the rate of return on assets and on equity stand at 0.112 percent and 1.793 percent respectively, while in the Bank of Communication these figures are –0.137 percent and –2.844 percent.[6]

Obviously the competition in efficiency between domestic banks and foreign banks will be severe. In terms of the vast head start that foreign banks enjoy over their Chinese counterparts, China really has a long way to go before it can bear the brunt of the competitive pressures that will be brought to bear by their foreign rivals. There is no way forward but to intensify the reform of the banking system.

1.3 Competition in human resources

Competition in modern banking finally boils down to the issue of human resources. Honest and hard-working candidates with the necessary training, experience, proficiency in foreign languages, knowledge of credit approval and risk controlling procedures, are the kind of people banks are seeking to employ. Competent and well-trained managers and directors are a pre-requisite to the establishment of a solid customer base. These are precisely the people who know how to avoid risks in banking, and are exactly what the modern banks require to ensure their successful operation.

However, the effects of WTO entry will, beyond doubt, encourage the "outflow" of talent from domestic banks, resulting in a weakening of their capacity to compete effectively. Foreign banks will attract leading managers and directors with higher salaries, better working conditions, and the availability of more training and self-development opportunities. Domestic banks will tend, on the contrary, to lose their best and brightest managers, particularly as the privileges they once enjoyed under the policies of the old system fall away. The question of how domestic banks can avoid serving as the training bases for foreign banks is still an open one.

2. Concern over the Fragility of China's Banking System

Where there is pressure there will always be incentives. Under the pressures brought by the foreign banks' entry to China's market, the domestic banks have spared no effort to rebuild their capacity to compete with foreign banks on as equal a footing as possible. But we cannot neglect the fact that in the process of banking reform, a condition of uncertainty and stagnation has arisen. The instability of the financial markets raise difficulties concerning the prosecution of further reform. It's true that the financial crisis in 1997 in the Southeast Asian region did not exert a "domino effect" on China's banking system. Yet this does not imply that there is a sound and stable financial system in China. In fact, China has benefited from the positive effects of prudent capital control (Krugman 1999). It is very clear to the leaders of China's banks and financial institutions that banking and finance in China are in a parlous state. The complete opening of the market to foreign-owned banks is an event that is dreaded by the Chinese banking community. State-owned banks are in greater danger than privately run ones for the following reasons:

2.1 Non-performing loans

It's a well-known fact that the quality of the loan portfolios of most Chinese financial institutions deteriorated dramatically in the 1990s.

[6] China Yearbook for 1998

Non-performing loans accounted for 30% of total loans at year's-end in 1997. Moreover, it appears that the actual proportion of non-performing loans will be at least 10% higher than has been reported, if the "extended loans" and "new loans for former debts" are taken into consideration. The People's Bank of China estimates that at the end of 1997, around 20- 25% of total bank loans, or about RMB 1,500 billion (US $180 billion) were non-performing loans - equivalent to just under 20% of GDP. Based on these figures, it can be seen that non-performing loans reached a level approaching RMB 2,100 billion by the end of 1997. Since early 1999, several Asset Management Companies such as Cinda, Greatwall, Dongfang and Huarong have been set up to take over RMB 1,400 billion in non-performing loans.

However, the problem is far from being resolved. Firstly, after these Asset Management Companies took over the non-performing loans, there were still RMB 700 billion of non-performing loans remaining in the state-owned banks. Secondly, the "takeover" of non-performing loans is not calculated according to the amount on the books. This is neither within international rules nor fair. Non-performing loans must be reckoned as losses. Thirdly, the systems, which caused the occurrence of non-performing loans to begin with, are still in place in the state-owned banks. After the Asset Management Companies took over the non-performing loans from the state-owned banks, it was reported that a great fall in non-performing loans was quickly followed by resurgence of new non-performing loans. Without establishing a sound means of dealing with this problem and of improving the standards of management, new loans will continue to fail to perform.

2.2 Capital Adequacy

Capital adequacy is one of the key issues in the Basel Accord of 1987. There, the importance of regulating and maintaining a stable ratio between capital paid in and bank assets is recognized. The standard ratio, in accordance with the Basel Accord has been set at 8% while that of paid-in capital has been fixed at 4% of assets. According to statistics provided by "British Bankers", the paid-in capital of the "Big Four" commercial banks in 1996 was 2.55%, 2.14%, 4.70% and 2.73% of their assets, respectively. That is to say that only one bank, the Bank of China, has managed to achieve the required standard. In international banking circles China's state-owned banks are regarded as being technically insolvent. In order to strengthen domestic banks to withstand risks, the government of China issued special public debts of RMB 270 billion in 1996, as a means of injected much needed new capital into the banks. Though the Asset Management Companies have taken over a total of RMB 1,400 billion of non-performing loans since 1999, it's clear that they are still quite some distance away from the norms set down in the Basel Accord.

Due to the regulations and restrictions imposed on the property rights of the state-owned banks, the capital of these institutions cannot increase in line with increases in deposits. These are problems that should have been redressed before WTO accession. Even the capital adequacy of the non-state-owned banks has failed to reach the needed 8%, although these institutions are not as hemmed in by regulations as the state-owned banks and, in addition, are profit-based.

2.3 Liquidity

High liquidity is essential to the commercial banks. Bankruptcy in financial institutions results mostly from a lack of asset liquidity, which finally results in an inability to release funds. The poor state of asset liquidity in the state-owned commercial banks does not bode well for the future. Although short term loans in all state-owned banks totalled 80%, the problem is that the short-term loans have been tied up for so long. Some branches of state-owned banks have even encountered severe liquidation problems.

3. Shaking off the Troubles

At home, the state-owned banks are suffering from troubles of their own while having to face the pressure of competition with foreign banks. In the interests of furthering their development, it's quite natural for state-owned banks to undertake strategic adjustments and restructuring. How these adjustments and restructurings should be implemented is the main issue in this field. It makes sense that financial reform should concentrate on two main areas: guarding against financial risks and improving efficiency.

The practical restructuring of the banking system should include the following steps:

Step one: to hasten reform of the administrative framework

The framework of a company should allow the owner, the manager and the supervisors to cooperate and work together as efficiently as possible. It's crucial for the company scaling up today to have a well developed and clearly understood administrative framework as a means of achieving its goals.

Market access in the banking sector will surely force domestic banks to compete on equal terms with foreign banks. Initially the framework will be tested as to whether it serves as a mechanism for efficiency. In our opinion, the administrative framework is closely linked to property rights. Reform of the framework could start in the market sector, targeted at improving the overall efficiency of the company. Domestic banking institutions, especially state-owned commercial banks could start their reforms by applying property rights.

For example, banks could diversify and socialize their equities. By changing and reforming the manner in which property rights are created and enacted, ownership could be devolved to the decision makers and operating rights to management. Finally the ownership and operating rights could be coordinated according to the economic principles of rights and responsibilities. When applied to the "Big Four" state-owned banks, it is advisable to restructure them into financial assets management companies. The branches at home and abroad could be transformed into subsidiaries of these asset management companies which will hold the major proportion of shares. Under this situation, the government can then utilize state-owned capital through the asset management companies, and strategically manage the subsidiaries as decision makers. Based on the reform and adjustment of property rights, the following results can at least be gained:
The enlargement of total capital volume. Through this and market-opening, the state-owned banks could be made to compete more effectively with foreign banks.

b) Under the conditions that the government holds the major share of equities, the banks can modernise their administrative and management structures.

c) Without raising the fiscal burden, the long-standing problems of asset management and efficiency could be removed from the operating part and temporarily placed within the remit of the asset management companies.

Step two: Reforming the management of domestic banks

Following WTO entry, state-owned banks should begin to change management practices in the following areas:

Tackling the non-performing loan problems of the state-owned banks. Since 1999 the government launched a series of policies to write off bad loans in order to revive the loss-making state-owned banks. The strategic restructuring of domestic banks should take account of the different ways and channels of writing off the non-performing loans.

b) Restoring the authenticity of financial records in the state-owned banks. At present the domestic banks are running losses. There are two main reasons for this: First, the financial controlling of domestic banks is based on the accrual accounting system. Due to the very low interest rate currently existing, the domestic banks have to render income tax at the cost of bearing a momentary loss. Secondly, the domestic banks have little internal control over their financial management. Moreover, the banks have used credit capital from their accounts to acquire fixed assets. As a result, the balance between debts and assets collapsed, thus greatly lowering efficiency. The best solution at the moment is to be found at the managerial level.

c) Implementing reforms on the allocation of personnel. It is essential to change the existing model of
government administration in the domestic banks to a more business-oriented one. It is important, for example, to introduce a system of performance related pay.

S*tep three: Overhauling the management of domestic banks.*

With regard to the above, domestic financial institutions, especially the state-owned banks, should take two major steps to improve their management.

a) In the interests of improving managerial efficiency, the domestic banks should try to rearrange their administrative structures and reduce both overstaffing as well as the problem of careless and inefficient human resource allocation. Long isolated from the outside world and sheltered by the government, domestic banks are unused to the demands and conditions of a competitive market. Owing to China's WTO entry, the supervisory policies and the evaluation of services are due to be made to conform to international standards. If domestic banks keep their heads in the sand and continue to ignore the crippling costs of poor efficiency, the prospects for them of gaining a substantial share of the market are not good.

Attempts to deal with human resources problems in the banks have so far met with little success. The big state-owned banks should rationalise their institutions and reduce the high levels of overstaffing.

This applies particularly to the less-developed regions in China, which suffer from particularly low levels of staff and institutional efficiency.
The emphasis, however, should first be shifted to banking institutions in the developed cities in order to improve their ability to compete more effectively with foreign banks. Secondly, the government should implement policies aimed at introducing the latest computer technology to banking and at reorganising staff and cutting their numbers.

b) Starting with improving the efficiency in internal administration, the domestic banks should reorganize their internal administrative structures in the light of the commercialisation of the banking institutions. The managerial systems of the state-owned banks require some of the following changes. *First,* the process of universalising the commercial banks should be accelerated. The opening up of the financial markets that WTO accession has brought, is putting pressure on the commercial banks to expand their services and operations. Restrictions on the range of services in commercial banks should be eliminated. In the interests of increasing profits and improving competitiveness, the commercial banks should be allowed to offer investment banking as well as insurance services. *Secondly,* streamline the internal structure of the banks to meet the needs of the commercialisation of the commercial banks. The banks are currently organised and function according to a state controlled system, which does not take sufficient account of market demand. Financial institutions must be merged or shut down according to the dictates of the market. It is important to create a sound balancing mechanism that coordinates internal control with the risk-guarding mechanism. *Thirdly,* the current management model should be changed to take into consideration the relationship between debts and assets, and costs and profits. The management of banking institutions should be completely reviewed and the process of reform extended and accelerated.

WTO entry has inevitably forced China’s banks into a competitive market place. After more than ten years reform, the reform of the domestic banking system has achieved great success. However owing to several long-standing problems, domestic banks are still in a precarious position. If it were not for WTO accession, domestic banks would continue to lumber along like the dinosaurs they have since become. However with WTO membership, the only choice for the domestic banks is to restructure.

References:

Huang Da (1999): Money and Banking, People’s University of China Press

Krugman,P. (1999): The Return of Depression Economics, (Chinese translation), People’s University of China Press

Liu Bin (2000): WTO and China’s Economy. In: Dalian Haishi Press

Minsky, M.L. (1998): Money and Finance, (Chinese translation), People’s University of China Press

Xie Ping (2000): The Principle and Practice of China’s Financial reform in China, the Economics Press