

BY JAMES R. BARTH, ROB KOEPP AND ZHONGFEI ZHOU

**To call China's** economic growth impressive is plainly an understatement. After brushing aside the SARS epidemic, China managed to post its highest growth rate in seven years in 2003 – a robust 9.1 percent. And while many expect this pace to taper off, no reputable estimate puts growth for 2004 below 7 percent.

China's GDP is eight times greater than it was in 1978, when the nation's leadership took the first tentative steps towards a mixed socialist-market system. Measured at current exchange rates, China is already the world's sixth-largest economy. Adjusted for purchasing power, which offers a better sense of domestic consumption levels, China's GDP is second only to the United States' and nearly double that of Japan. It is possible – even likely – that China will be the world's largest economy within a generation.

Beyond the upward trajectory implied by these figures, another reason for such optimism is the relative ease with which China has shed its former economic isolation and embraced global trade. Unlike Japan, which modernized through policies geared for one-way trade, China has adopted a more inclu-



sive strategy. Flexible relationships with foreign multinationals have made it the manufacturing center of the world. By no coincidence, China is also a magnet for foreign direct investment, absorbing \$53 billion worth in 2002.

The combination of fast growth and global trade has made the People's Republic of China the world's fifth-largest trading

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## **CHINA'S BANKING REFORM**

economy. Measured in terms of purchasing power, China accounted for one-third of the world's 3.2 percent growth last year. In 2003, China's per capita GDP surpassed the \$1,000 mark for the first time in history. And according to the World Bank, China's more than two decades of market reforms have helped some 250 million of the nation's population rise out of poverty.

The country's growing embrace of global trade is epitomized by its surprisingly rapid accession to the World Trade Organization. With China's WTO membership in 2001, the national leadership embraced a variety of challenges – among them opening the country's financial-services industry to foreigners by Dec. 2006. The deadline means a lot of change, quickly. The most significant change will occur in banking. Like most of their counterparts throughout East Asia, businesses in China are heavily dependent on bank financing, rather than on the issuance of marketable securities. Yet banking is a glaringly fragile component of the Chinese economy. A half-century of uncompetitive lending to state-owned industry has left a massive deadweight of nonperforming loans. And lately it has become fashionable to predict that China's nonperforming-loans problem will gradually eat away at the economy's performance, if not stall growth entirely.

While pessimists are right to be concerned, they ignore the potential upside from successful banking reforms. Indeed, we believe that China's banking sector has the potential to catalyze the next steps in the economy's ongoing transformation.

### **CHINA'S FINANCIAL SYSTEM**

Banking assets make up nearly 80 percent of the nation's financial-asset pie. The market capitalization of equities listed on China's



Shanghai and Shenzhen stock exchanges (setting aside Hong Kong, the only two in the country), account for just 15 percent of financial assets. And even this modest figure is misleadingly high, because two-thirds of China's listed shares are government-owned and thus not tradable. The percentage of



external funds raised by corporations issuing bonds is lower still, amounting to less than 1 percent of the total.

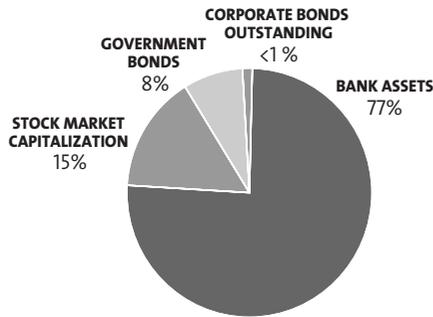
China's financial asset base is equivalent to 244 percent of GDP; the figure for the United States is roughly the same, at 236 percent. Yet the composition of the bases differs in tell-

ing ways. America's financial infrastructure is dominated by securities markets. Firms in the United States have a variety of choices for raising external capital – issuing stocks or bonds, or borrowing from banks. Thus, when one source of funds is impaired, other options remain. In the face of a banking crisis,

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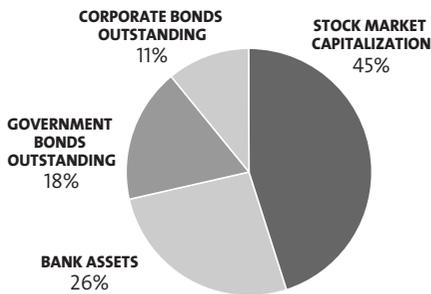
### SIZE AND COMPOSITION OF CHINA'S FINANCIAL SYSTEM – 2002

TOTAL = \$3.1 TRILLION



### SIZE AND COMPOSITION OF THE UNITED STATES' FINANCIAL SYSTEM – 2002

TOTAL = \$24.7 TRILLION



for example, firms could still obtain investment funds through the securities markets. Stockholders and bondholders, moreover, provide not only capital but also a valuable source of discipline. Their investment decisions help ensure that only firms with productive investment projects receive funding, and use the invested funds as intended.

Beijing recognizes the value of such financial diversity. To that end, it established the mainland's two stock exchanges back in 1990-1991, and since then the exchanges have facilitated the conversion of state-owned enterprises into stock companies. Public trading of

such privatized enterprises has enabled firms to mobilize valuable capital for restructuring. Trading in company shares has also created pressure to make corporate activities more transparent and to make corporate officers more responsive to stockholders' interests.

Later reforms have brought China's financial infrastructure still closer to that of the market economies. Among the recent notable initiatives is the Qualified Foreign Institutional Investor program, introduced in late 2002. Under that program, foreign institutions receive a foreign-exchange quota to be applied to securities investments. As of Jan. 2004, the State Administration of Foreign Exchange granted foreign-exchange quotas, totaling \$1.7 billion, to 10 of them. This is a modest beginning. But at least six additional overseas institutions have applied for new qualified foreign institutional investor licenses, and several existing license holders are applying for quota increases. UBS, for example, exhausted its \$300 million limit and has obtained permission for increasing it to \$600 million. The program's success has already led to talk of a Qualified Domestic Institutional Investor program, which would allow China's own institutions to invest in overseas capital markets and build closer ties to foreign enterprises.

The country is also emerging from a state-decreed moratorium on corporate bond issues that followed a spate of defaults by state-owned enterprises during the late 1980s. As the drive for financial liberalization was gaining steam in 1999, the moratorium was eased, and since then the market for new corporate debt has revived modestly. Although this market remains very small, it has the potential to expand if easing continues. One area for further liberalization is the regulated ceiling on interest rates for corporate debt, irrespective of the issuer's credit

quality. Another is the requirement that individual bond issues be approved by an arm of the State Council, the top executive organ in China.

#### **SIZE MATTERS: CHINA'S BIG FOUR**

The dominance of banks over capital markets in China is a fact of life. Accordingly, the pace of financial reform in China will depend on the nature and timing of bank reform.

Indeed, the effects of that dominance and the critical importance of reform are compounded by concentration within banking. There are 36,611 banking institutions in China. The vast majority (98 percent) operate as mutual institutions known as rural credit cooperatives, which dot China's 25,000 townships. Despite their numbers, though, the cooperatives account for only 10 percent of total bank assets. The real money is in China's four enormous state-owned banks. The Big Four hold 59 percent of all bank assets and operate a nationwide branch network. Given the dominance of banking assets in the financial system as a whole, this means that the Big Four account for about half of the financial assets of the nation. China thus does not merely have a financial infrastructure dominated by banks, but rather one dominated by just four banks.

The story of how the Big Four grew pre-eminent is important to understanding the recent changes to the system and the direction in which reforms are heading. The state-owned banks were born from China's first stage of financial reforms, orchestrated by Deng Xiaoping in 1979. After the 1949 revolution, the Communist government gradually closed China's patchwork of commercial banks, replacing them with a single People's Bank of China. Thereafter, the bank played a dual role as both a central bank and commer-



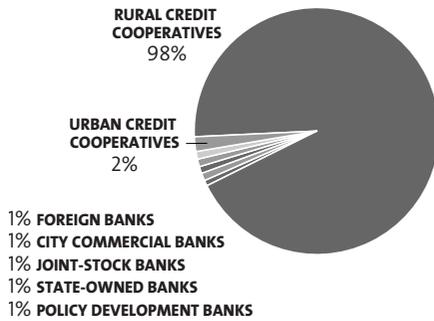
cial bank. It wielded monopoly power, disbursing investment and operating funds to state enterprises according to government fiat.

Deng's reforms brought the first break in the People's Bank of China monopoly, first spinning off the Agricultural Bank of China and then the Bank of China. For the Agricultural Bank the spinoff was really a rebirth, as it had operated independently before being merged with the People's Bank of China in 1957. The Bank of China was created by carving out the People's Bank of China's foreign-exchange division. Within a matter of years, the State Council decided to reconstitute the People's Bank of China to serve solely as the

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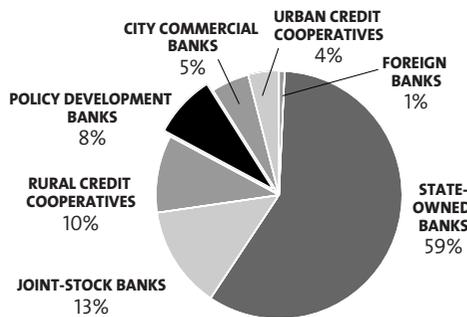
### NUMBER AND TYPE OF BANKING INSTITUTIONS IN CHINA - 2002

TOTAL = 36,611 BANKS



### TOTAL AND COMPOSITION OF BANK ASSETS IN CHINA - 2002

TOTAL = \$2.7 TRILLION



nation's central bank. It transferred the bank's remaining commercial banking functions, along with certain other banking functions, from the Ministry of Finance to two special-purpose banks: the China Construction Bank (formed in 1983) and the Industrial and Commercial Bank of China (1984). Thus the People's Bank of China was oriented toward functioning as a genuine central bank, and China's two major state-owned commercial banks were turned into four.

The dominance of the Big Four in China's financial system today can easily leave the

impression that they are a monolith, a hold-over from the days of central planning. In fact, they represent the first major effort to harness market forces to discipline banking practices. The fundamental problem left unsolved has been the state-owned banks' ongoing lending to inefficient, financially unsound state-owned enterprises. This bureaucratic-industrial lock has impeded the development of a credit culture – an appreciation for balancing risk and return considerations – in reaching lending decisions.

Despite the obstacles posed by the legacy of China's bureaucratized banking, Beijing has persisted with liberalization. In 1994, the Big Four were recast as commercial banks and three new policy-development banks were established: the China Agricultural Development Bank, the China Development Bank, and the China Import and Export Bank. The policy banks were specifically created to divorce the state-owned banks from responsibility for lending dictated from above, enabling them to act more like true commercial banks. However, while the policy banks do issue bonds (\$109 billion outstanding as of year-end 2002) to support lending, most of these bonds are purchased by banks – particularly by the Big Four.

In 1995 there was another major reform, the adoption of the Law of the People's Bank of China and the Commercial Banking Law of China. The former solidified the People's Bank of China's status as China's central bank and made it the chief regulator of the banking system. The latter brought the Big Four a step closer to operating like commercial banking enterprises by giving them greater autonomy. It also introduced prudential standards and regulations for the industry. The greatest contribution of this round of reform was to promote a market-driven banking system and, more generally, to advance the rule of law –

## Key Events in the Development of China's Banking System

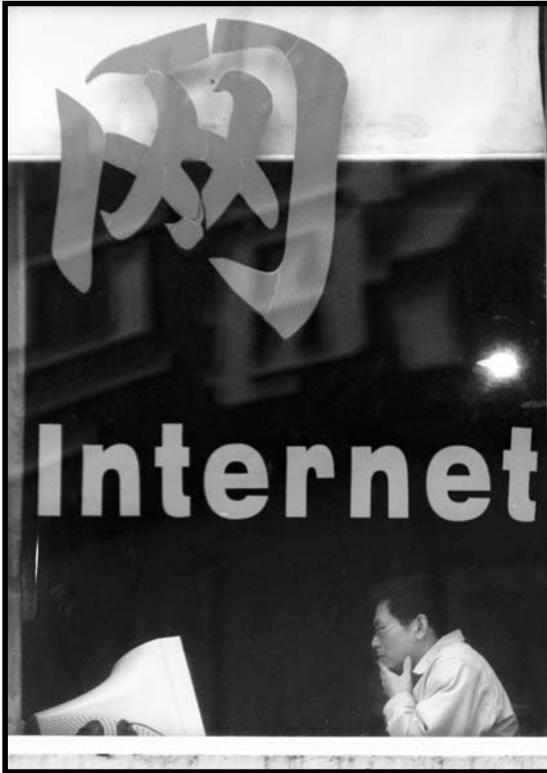
- 1948** People's Bank of China established.
- 1951** Renminbi issued as new currency.
- 1978** Vice Premier Deng Xiaoping begins the process of transforming China from a centrally planned to a socialist market economy.
- 1979** The People's Bank of China's banking monopoly ends with the formation of the first two state-owned banks of the Big Four: the Agricultural Bank of China and the Bank of China.
- 1980** China resumes its membership in the World Bank and returns to the International Monetary Fund.
- 1983-4** The next-two state-owned banks of the Big Four are created: the China Construction Bank and the Industrial and Commercial Bank of China.
- 1985** China approves establishment of the first foreign branch bank office in China since 1949.
- 1990** Shanghai Securities Exchange established.
- 1991** Shenzhen Securities Exchange established.
- 1992** China Securities Regulatory Commission established.
- 1994** The Big Four are recast as commercial banks; three new policy-development banks are established: the China Agricultural Development Bank, China Development Bank, and China Import and Export Bank.
- 1995** National People's Congress passes the Law of the People's Bank of China, codifying the People's Bank of China as China's central bank.  
National People's Congress passes the Commercial Banking Law, enabling the Big Four to become genuine commercial banks; the law also segregates the business operations of banks, securities firms and insurance companies.
- 1996** China Minshen Banking Corp., the nation's first publicly traded private bank, established.
- 1998** China Insurance Regulatory Commission established to take over regulation of the insurance industry from the People's Bank of China; the  
China Securities Regulatory Commission takes over supervisory responsibility of securities market regulation from the People's Bank of China.  
Big Four infused with \$33 billion of capital.
- 1999** China's first bankruptcy of a major financial institution: Citic.  
Four asset-management companies established to offload \$169 billion in nonperforming loans from the Big Four: China Xinda, China Oriental, China Great Wall, and China Huarong.
- 2001** China becomes a member of the World Trade Organization; commits to opening up its financial services industry to foreign banks on equal terms by 2006.  
HSBC Holdings becomes the first foreign bank to buy a stake in a mainland Chinese bank.
- 2003** Law of the People's Bank of China and the Commercial Banking Law of China amended; Law on the Supervision of the Banking Industry passed; the China Banking Regulatory Commission legalized and the People's Bank of China further empowered as the nation's central bank.  
State Council approves Reform Measures for Rural Credit Cooperatives, thereby promulgating reforms on supervision, ownership, policies and operations.  
\$45 billion injected into the China Construction Bank and the Bank of China, two of the Big Four considered to be the least burdened by nonperforming loans.  
Measures for the administration of equity investment made by overseas financial institutions in Chinese-funded financial institutions take effect on Dec. 31. The amount of equity investment allowed to be made by foreign financial institutions in Chinese financial institutions is increased to a maximum of 20%.
- 2004** Three major new financial laws implemented: Law of the People's Bank of China (amended), Administrative Measures on the Supervision of the Banking Industry, and Commercial Banking Law of China (amended).

both crucial components in liberalizing China's economy overall.

In the aftermath of the 1997 Asian financial crisis and fears it might spread to China, Beijing made further reform of the banking system a strategic priority. Originally, the People's Bank of China had been responsi-

ble for banking, securities and insurance. In 1998, supervision of the latter two sectors was transferred to the China Securities Regulatory Commission and the China Insurance Regulatory Commission, respectively.

Coincident with these moves, the central government publicly owned up to the banking



system's grossly unhealthy balance sheet, injecting \$33 billion of capital into the Big Four. Shortly thereafter, it took the added step of establishing four asset-management companies, one for each of the banks. The companies eased pressure from the banking system by absorbing \$169 billion in nonperforming loans. By the end of 2003 they had disposed of \$61.5 billion in bad loans, recovering some \$12 billion. Although this represents a recovery rate of only 20 percent, it nevertheless was a significant step toward bolstering the nation's fragile banking system. The Big Four have formally acknowledged that more than one-fifth of their loans are nonperforming, a figure that translates to some \$250 billion in bad debt. Unofficial estimates have put the figure as high as \$470 billion.

If one assumes a recovery rate of 30 percent for the disposal of these assets, the scope of the liabilities problem at the Big Four rang-

es from \$177 billion to \$329 billion, or 15 percent to 27 percent of GDP. The alarming scale of China's nonperforming loan problem (which is even larger if other types of lenders are included) explains why the banking system is both China's core financial asset base and the Achilles' heel of its booming economy.

#### **ONGOING REFORM**

Just last year the government created the China Banking Regulatory Commission, one of many initiatives narrowing the focus of the People's Bank of China so that it can better serve as the central bank. The Commission's creation completes the transfer of the People's Bank of China's all-encompassing regulatory powers over the financial-services industry, reflecting the function-based approach China is taking toward financial-services regulation. The People's Bank of China is now structured to concentrate on monetary policy, avoiding the potential for conflict with the role of overseer of the commercial banks.

At the end of 2003, the government injected another \$45 billion into the big banks, with equal portions going to the China Construction Bank and the Bank of China. These are the two major lenders least burdened by nonperforming loans, and they were selected in a pilot program to test the viability of transforming the state-owned banks into internationally competitive joint-stockholding banks. Both banks are expected to go public by 2005, and already have important alliances with foreign banks in place.

The capital infusion came from China's awesome foreign exchange reserves which, even after the transfer, stood at \$403 billion, thanks to China's cumulative trade surpluses. Rather than exchanging bad loans for bonds, as was done previously, the latest capital infusions have come as pure cash transfers. This has increased the banks' capital-to-asset ratios,

giving them incentives to make more-prudent loans, which in turn should help reduce their nonperforming-loan ratios. Some \$40 billion and \$35 billion have reportedly been earmarked for the Industrial & Commercial Bank of China and the Agricultural Bank of China, respectively – the Big Four banks most burdened by uncollectible debt.

room for expanding into non-banking businesses in securities and insurance. This holds out the promise for increased profitability and greater risk diversification.

#### **WHAT MUST BE DONE**

While there is certainly good reason to believe that China is making progress in getting its

**With economic growth near 10 percent, loans that have been directed to especially frothy sectors like real estate could further burden an already troubled banking sector when the cycle turns downward.**

In addition to the capital injections, the National People's Congress passed three banking laws that took effect in February. One solidifies the People's Bank of China's responsibility for making monetary policy, guarding against financial risk, ensuring financial stability and combating money laundering – as well as confirming that it will no longer regulate financial institutions.

The second law, the Law on the Supervision of the Banking Industry, complements the first by assigning the China Banking Regulatory Commission's responsibility for regulating all banks and other depository institutions. This law also introduces some of the international norms for banking supervision, designed to steer banks towards better risk management. Yet another law frees the Big Four of obligations to grant loans for projects approved by the State Council. It also gives banks authority for activities taken for granted in advanced economies: trading government bonds, dealing in foreign exchange, and offering payment card services. Although banks are prohibited from investing in non-banking financial institutions, the laws leave

financial house in order, criticisms of banking reforms remain. These typically boil down to claims that deregulation and efforts at addressing the nonperforming loans are insufficient to deal with the sheer magnitude of the problems. For example, the use of the nation's swelling pool of foreign reserves to offset nonperforming loans is seen as both a ploy for delaying the banks' day of reckoning and a way to ease pressure on China to appreciate its currency. Moreover, with economic growth near 10 percent, loans that have been directed to especially frothy sectors like real estate could further burden an already troubled banking sector when the cycle turns downward.

While there may be some truth here, other considerations suggest that the ongoing banking reforms will have a lasting impact. The value of the latest round of recapitalization is indeed dwarfed by the magnitude of nonperforming loans. Yet the Big Four still have ample reason to put the capital infusions to good use as they prepare for competition with foreign banks. Exchange-rate considerations may well have influenced the decision

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to use foreign reserves to fund the capital infusions. But arguments that the exchange-rate policy is dictating the agenda for banking reform are unconvincing.

The more legitimate concern is potential overheating in the economy. Rapid growth in money supply and credit may be leading to overinvestment – and excess capacity – in some industries. Both credit and money grew by more than 20 percent in the first half of 2003, the most since 1998. Here again, however, the government seems to be responding appropriately. For example, it has hobbled liquidity creation by increasing the percentage of deposits banks must hold on reserve. As a consequence, bank loans increased by only \$9.9 billion from October to November 2003, a dramatic contrast to the average monthly increase of \$33.2 billion during the first three quarters of 2003. Nevertheless, if growth in money and credit is not checked, it will undoubtedly add to the precariousness of China's troubled banking sector.

### **THE BIG PICTURE**

During the past quarter-century, China has taken major steps to convert a centrally planned economy into a market-oriented one. This has included spinning off the commercial banking operations of the People's Bank of China into separate commercial banks, improving financial supervisory authority, generally strengthening the rule of law in the financial system, and taking related actions to foster a modern credit culture. The nearly \$250 billion the government has pumped into the Big Four demonstrates that Beijing is doing more than just talking about bank reform. While by no means guaranteed to stay on course, the momentum and trajectory of China's banking reforms do suggest that nonperforming loans will eventually be

reduced to levels manageable by the banks themselves.

Furthermore, China's increasing integration with the global financial system has increased the sense of urgency for resolving nonperforming loan problems. As of late 2003, there were 62 foreign banks from 19 countries with 211 representative offices in the People's Republic. Currently, these banks account for a mere 1.4 percent of total banking assets. But once China's financial sector is opened to foreign banks on more equal terms, the proportion of assets held by foreign institutions surely will increase.

China has a national saving rate of around 40 percent of GDP – a remarkably high level. Most of the savings is in banks, which held \$1.25 trillion in household deposits at the end of 2003. The magnitude of these assets, combined with the opportunities implied by China's economic mass, continued growth and rising personal income levels, means that foreign financial institutions will continue to make China a major target.

The resulting competition in the banking sector should eventually mean that Chinese households and businesses benefit from more competitive interest rates on loans and deposits and a wider range of financial products and services. There are encouraging signs that this is already underway: since the beginning of 2004, the People's Bank of China has allowed banks greater leeway to raise their lending rates to reflect actual risk.

To be sure, banking reform is a work in progress; its final contours are still being determined. But so far, the leadership's demonstrated commitment, combined with the inexorable pressures associated with opening up to foreign competition, suggest that what so far has been the weakest link in the world's hottest economy may soon be one of its strongest. **M**