

***Banking Reform in China: Gradually Strengthening Pillar or
Fragile Reed?****

By: John P. Bonin

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**BANKING REFORM IN CHINA:
GRADUALLY STRENGTHENING PILLAR
Or FRAGILE REED? ***

John P. Bonin

Professor of Economics
Wesleyan University
Middletown, CT

and

Research Fellow
William Davidson Institute
University of Michigan School of Business
Ann Arbor, MI

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Non-Technical Summary

China began the structural reform of its banking system in 1978 with the creation of state-owned specialty banks (SOSBs) from the monobank structure. Over time, these SOSBs grew to be among the largest fifty banks in the world. However, as owner, the government dictated the terms of lending so that these large four SOSBs, together having about an 80% market share in China, were financing state-owned enterprises (SOEs). From 1978 to 1996, the ratio of household deposits to GDP rose from 6% to 57% and the ratio of bank loans to GDP grew from 50% to 90%. During this same period, the ratio of government revenues to GDP fell dramatically from 35% to 11%. The four SOSBs had taken financial responsibility for the government policy including the support of loss-making SOEs, which constituted about half of all SOEs by the end of the period. Two decades of policy lending have left the SOSBs burdened with bad debt; the continuing determination of interest rates centrally has resulted in razor thin spreads and left SOSBs insolvent if their assets are evaluated by international standards.

Unlike the other Asian economies, the structural deficiencies of the Chinese banking system have not been exposed by a financial crisis. Rather, the government has continued with controlled, gradual banking reform. Standard international loan classification will be mandated for all four SOSBs. This will help to identify the extent of the bad loan problem; foreign estimates indicate that at least 25% of the loans made by SOSBs must be written off entirely. To prevent the SOSBs from losing the household deposit base that supports their loan portfolios, the government has delayed development of the financial sector. Because China has a deeper, more bank-dominated financial sector than any transition economy, the cost of recapitalizing the banking sector will be high, probably between 25% to 35% of GDP. However further delay is damaging to China's future growth. Recognizing the need to deal with the insolvency of the SOSBs, the government is setting up bad debt agencies to which the bad loans are to be transferred.

From the experiences of the Central European transition economies, we conclude that China's banking reform is not sufficient to resolve the root cause of bad loans. The Czech experience with a hospital bank indicates that transferring loans but leaving clients with the banks invites continuing soft lending. The Chinese government's growth initiative

clearly intends for the SOSBs to fund SOEs. For SOSBs to become more independent and pursue lending on a commercial basis only, more radical measures are needed. We suggest that undesirable clients as well as bad loans should be transferred to hospital banks that will be responsible for restructuring or closing down SOEs. These banks should be capitalized fully as a window of opportunity currently allows China to absorb the requisite government debt. Over time, these banks will become investment banks or venture capitalists and further the development of Chinese capital markets. To develop independent SOSBs, we suggest a gradual privatization strategy in which small blocks of shares are sold on domestic markets and stock options are used to create incentives for bank management to promote efficient banking activities. By moving more aggressively on banking reform, China can build the foundations of sustainable growth for the future.

Abstract

Two decades of policy lending created a large bad debt burden in the loan portfolios of the four large state-owned specialty banks that together dominate all aspects of banking in China. The government has recognized the need to restructure these insolvent banks by setting up bad debt agencies with a narrow purpose to work out or sell bad debt. This reform does not sever the link between the bank and the client so that soft lending will continue. Drawing on the experiences of fast track transition economies, we make two emendations to the Chinese banking reform program. First, establish hospital banks to take both the bad loans and the undesirable clients. In working to restructure some of these SOEs, the hospital banks will develop the skills of investment bankers and venture capitalists. Second, begin the gradual divestiture of the state from the large banks by selling small blocks of shares on the domestic market and using stock options to create proper incentives for bank management. This reform package would jump start the stalled development of capital markets in China and strengthen its dominant banking sector.

JEL Codes: G21, P34, P52

Key words: bad loans, banking reform, Chinese banking, policy lending,
banking in transition economies

1. Introduction: Financial Sector Fragility in Emerging-Market Economies

As the recent experiences in the emerging market economies in Mexico and Southeast Asia indicate, capital markets can be extremely volatile especially when they are open to international transactions. The ensuing currency crisis caused by a rapid outflow of foreign funds spread quickly and deeply into the real sectors of these economies. The result was an immediate and forced recognition of both structural and behavioral problems in their banking sectors. Hence, the currency crisis in these economies was the trigger to initiate banking sector reform.

China has been protected from such a currency crisis. Lardy (1998a) argues that the absence of capital account convertibility, the medium to long term structure of China's external debt, the large percentage of foreign capital inflows in the form of foreign direct investment, China's trade and current account surpluses, and its large stock of foreign reserves all combine to make an Asian or Mexican-style crisis extremely unlikely in China. Naughton (1997) concludes that China will not catch the "Thai disease" because it has relatively little exposure to private debt denominated in foreign currency and because the interactions between the volatility in domestic financial markets and foreign currency markets are limited. However, such protection is a mixed blessing because China's banking sector is in need of significant reform. Without the discipline of international markets to expose the weaknesses of the domestic banking sector, as occurred in Southeast Asia and Mexico, the impetus for reform rests solely with policymakers in China. In this paper, we consider the prospects for banking reform in China based on the decade-long experiences of the fast-track transition economies countries in Central Europe (CE), namely, the Czech Republic, Hungary, and Poland.

Uneven development is a legacy of the planning period in all transition economies. Most pronounced was the relative backwardness of the financial sector in all planned economies. At the beginning of the transition, segments of the real sector were on a par with those in mature industrial economies but modern banking and finance were virtually non-existent. In the planned economy, money served as a unit of account and played only a limited role as a medium of exchange. The passivity of money was supported by a banking sector in which the mono-central bank was a record-keeping entity for transactions between production units. In most planned economies, a state savings bank with an extensive branch network was responsible for collecting household deposits. Intermediation between savers and borrowers occurred within the state banking sphere basically through a system of directed credits to state-owned enterprises (SOEs) for both investment needs and budget allocations for working capital necessary to meet the output plan. Credit evaluation and risk management was irrelevant; hence, these skills were never developed.

In CE as in all transition economies, the first step in banking reform was structural and involved the creation of a two-tier system with commercial and retail activities carved out from the old mono-central bank. The new Central Bank was charged with pursuing monetary and exchange rate policy; it was also given the responsibility of supervising and monitoring the nascent commercial banking sector. The second tier consisted of the newly created commercial banks and was to be the crucial pillar supporting the development of the domestic banking sector. These banks, which were created from the legacies of the old system, were set up as joint stock companies initially with 100% state ownership. To promote competition, entry requirements for *de novo*

domestic banks were not stringent and many small new banks were born. Restrictions on foreign entry into banking varied across the countries with Hungary having the most open policy and Czechoslovakia the most restrictive. For these small open economies, competition and development would hinge on foreign participation in bank privatization.

Three essential functions of a modern banking system are payments settlements and recordkeeping, efficient intermediation between savers and investors, and the provision of the appropriate systemwide liquidity using indirect monetary policy instruments. Although the first and the last are clearly important, this paper focuses on efficient intermediation as the key to continual, sustainable growth in China. Financial intermediation involves matching the funds from savers with needs of investors. In the process of intermediation, banks are involved in various financial activities: agglomeration of funds for large projects, selection of investment projects to be financed, monitoring the performance and liquidity of clients, the maturity conversion to provide longer-term financing for investment in fixed capital, and the diversification, pooling and pricing of risk. To perform these tasks effectively, banks collect information. The argument that banks are crucial to the payments system and depositories of important financial information persuaded policymakers in the CE countries to preserve the old structure in a new form so that informational capital would not be destroyed. However, separating the functional from the dysfunctional aspects of the old structure in a market-oriented system turned out to be a daunting task.

From almost a decade of banking reform in the three fast track CE countries, several general lessons can be drawn. First, creating independently operating commercial banks from the formerly state-owned banks is a necessary condition for a market-oriented

banking sector. Second, excessive entry of small undercapitalized domestic banks led to systemic instability rather than competition. Third, the implementation of effective banking regulation and prudential supervision took longer than expected. Effective regulation obliges the state to commit to an arms-length only relationship with banks and also to support the development of both the legislative infrastructure and human capital necessary for proper supervision. Fourth, the legacy of bad loans that rendered many, if not all, of the state-owned banks insolvent at inception must be dealt with coherently and comprehensively. Policymakers must acknowledge the informational problem that the full extent of the inherited stock of bad debt is difficult to determine in the turbulence of the transition. More importantly, policy must address the flow problem of accumulating new bad debt by considering the incentives of the decision-makers in a relational activity like banking.

In the next section, the salient features of the Chinese banking sector are presented based on the comparative perspective of CE. In Section III, two interrelated problems for China's banking reform, i.e., the independence of commercial banks from the government and the bad loans problem, are considered and policies are discussed using the experiences of the CE countries. Section IV concludes with an evaluation of the current Chinese government's proposal for dealing with bad loans and puts forth an alternative.

2. China's Banking Sector: A Comparative Perspective

China's banking sector is significantly more controlled than banking sectors in CE. In the fast track transition economies, directed credits are virtually non-existent, interest rates are market-determined, and state ownership of banks has been reduced. In

China, policy lending is prevalent, interest rates are set centrally, and the major banks are fully state-owned. Although the structure of China's banking sector is segmented as was those in CE, the organizational divisions are different. Unlike CE banking sectors, China has no separate state savings bank. Furthermore, the two-tier system was created in two steps. In the first step, the Chinese monobank was divided into four state-owned specialty banks in 1978. The largest of the four, the People's Bank of China (PBC), was responsible for industry and commerce. The Bank of China (BoC) specialized in foreign exchange transactions. The Agricultural Bank of China (ABC) and the People's Construction Bank of China (CBC) were responsible for agriculture and fixed asset investment, respectively. In 1984, the Industrial and Commercial Bank of China (ICBC) was created to specialize in urban banking and received the commercial portfolio of the PBC, which itself then became a separate central bank left to pursue monetary policy.

These four state-owned specialty banks (SOSBs) are large by international standards when assets are used to measure size.¹ The largest of the four, ICBC, has fifty percent more assets than the second largest, the BoC; these two were ranked fifth and 24th among all banks in the world at the end of 1996. The CBC ranked 31st and the smallest of the four, ABC, ranked 47th. By contrast, only one of the Polish banks ranks amongst the 100 largest banks in **Europe** and this is a consolidated financial group. All four SOSBs are national banks that form the core of the second tier; in 1993, these four accounted for 81.7% of all loanable funds in China (Xu, 1998). Another difference from CE is that China's banking law does not grant a universal banking license to commercial banks but follows the U.S. system in which investment and commercial banking activities

are separated. Most importantly, these large and dominant SOSBs are primary deposit-taking banks with commercial licenses implying that household deposits are used directly as a source of funds for commercial loans in China. By this characteristic, they resemble the state savings banks in CE that were granted universal licenses in the new banking acts.

The remainder of the national banking sector consists of two medium-sized banks created in the mid-1980s, the Bank of Communications and CITIC Industrial Bank,² three smaller national banks opened in the 1990s, Everbright, Huaxia, and China Minsheng Bank,³ and three policy banks created in 1994, the Long-term Development and Credit Bank, the Agricultural Development Bank, and the Import-Export Bank. The policy banks are not allowed to take household deposits but, unlike SOSBs, they may hold equity stakes in companies. Therefore, according to their license, they resemble investment banks. These banks were created for the purpose of separating policy lending from commercial lending and leaving the latter to the four dominant SOSBs. The fringe of the banking sector includes regional commercial and housing banks.

In addition to banks, the financial sector in China consists of numerous non-bank financial institutions (NBFIs), e.g., urban and rural credit cooperatives, trust and investment companies (TICs), and finance companies. NBFIs provide a broad range of lending but, with the exception of the cooperatives, do not take household deposits. In 1993, their market shares in loanable funds were rural cooperatives: 8.1%, urban

¹ This section is based partly on Chapter 3 of Lardy 1998b.

² The former, about one-quarter as large as the smallest of the dominant four, is exempt from the state credit plan and the latter, about one-quarter as large as the former, is involved with an industrial group.

cooperatives: 2.8%, TICs: 5.9% and finance companies: 0.4% (Xu, 1998).⁴ The dominance of the big four SOSBs in banking, more narrowly defined and before the creation of the policy banks, is evidenced by an aggregate loanable funds market share in 1993 of only 1.1% by all other commercial banks. The structure of China's banking sector resembles most closely that of the Czech Republic in which the four largest banks, all with universal licenses, held 69% of the (non-government) loans and 80% of the deposits at the end of 1995. In China at the same time, the big four SOSBs accounted for 78% of the loans and 72% of all deposit collected (Fry, 1998).

Since the creation of the two-tier system in China, the financial sector has deepened rapidly by conventional measures.⁵ From 1978 to 1996, household deposits to GDP rose from 6% to 57%, M2 to GDP rose from 32% to 112%, and bank loans to GDP rose from 50% to 90%. By the latter measure, China has a deeper financial system than any of the three CE countries as credit to the non-financial sector as a percentage of GDP was 20% in Poland, 23% in Hungary, and 53% in the Czech Republic in 1995 (OECD, 1997, p.81). At the same time that this remarkable financial deepening was taking place, the ratio of government revenues to GDP was declining dramatically from 35% in 1978 to 11% in 1996. Furthermore, the banking sector's increasing role in financing the economy is evidenced by the ratio of incremental bank credit to combined annual fiscal revenues. This ratio rose from about 0.15 in 1979 to a number larger than one for the first time in 1992 and then to a remarkable 1.39 in 1996. Not only is its rapid growth

³ The first two of these banks required reorganization resulting in ownership changes while the third is a private shareholding bank owned by non-state companies and the first bank in China to engage an international auditor.

⁴ The market share of TICs was affected significantly by a subsequent drop in the real estate market.

⁵ The data on China are taken from Naughton (1997) and Lardy (1998b).

extraordinary but this ratio is now unusually large compared with other countries. The corresponding ratios are 0.15 in the U.S., 0.55 in the U.K., and 0.81 in Japan with Japan as a clear outlier among industrial countries.

China's banking sector, and in particular the four dominant SOSBs, have become the primary vehicle for both funding and directing economic growth. Much of the lending by the big four SOSBs is on-lending to SOEs based on directed credits from the central bank.⁶ Up until 1993, about 75% of the assets of the PBC consisted of loans to the banking sector for policy lending. In 1993, SOSBs received over RMB 960 billion or about 97% of the total central bank lending to all financial institutions. These loans financed about one-third of the lending of the SOSBs. Earlier, in 1991, policy lending by the SOSBs as a group was estimated at about 42% of total lending with approximately four-fifths of this financed by central bank lending and one-fifth by deposits. By 1996, a policy of tight credit reduced the stock of central bank loans to financial institutions to about 50% of the assets of the PBC. The distribution of these loans also changed with the creation of the new policy banks as the magnitude of central bank financing to SOSBs had fallen to RMB 680 billion by 1995 due to the rechanneling of some policy lending.

Nonetheless, exposure of the SOSBs to SOEs remained high as 83% of all loans from the big four were to SOEs and 90% of all lending for fixed investment by ICBC was to SOEs at the end of 1995. SOEs borrow from banks to support virtually all of their short-term needs as 95.6% of working capital and 99.8% of inventories are financed in this manner. The capital structure of SOEs is highly leveraged as debt to book value, defined as depreciated fixed capital plus inventories, was 73% at this time. About 25% of

SOSB lending is long term, defined as over one year in maturity. Since approximately one-half of SOEs are loss-making, the credit risk faced by the SOSBs from policy lending remained significant even after the creation of the policy banks. On the liability side, 60% of the deposits in SOSBs are from households and 32% from enterprises. However, virtually all of the enterprise deposits are borrowed so that an equivalent entry appears on the asset side of the banks' balance sheets. Of total household deposits, about 20% were sight deposits earning a fixed low nominal interest rate of 3.15% while inflation was in double digits in 1994 and 1995. Lardy estimates that the implicit subsidy from households to banks on these sight deposits alone in 1995 was RMB 74 billion or over 1% of GDP. Clearly, household deposits were still supporting policy lending to SOEs even after the creation of policy banks in China.

The central bank's policy of indexing nominal interest rates on long-term household deposits of over three years resulted in non-negative real rates for all but seven quarters since 1986 (Naughton, 1997, p.12). However, the shorter term loans on working capital by banks yielded negative real returns for five of the ten years from 1986 to 1996. Leaving aside maturity mismatch, these broadly negative spreads affected significantly the capital adequacy of the banks. Profitability of the SOSBs was also affected adversely by the spread of more than 1% between lending rates charged by the PBC and deposit rates paid on bank reserves. Centrally determined interest rates in China led to at best razor-thin spreads overall and negative returns on certain maturities even without taking account of the credit risk of the asset portfolio.

⁶ This section is based on Lardy (1998b) and Naughton (1997).

Directed credits have impacted adversely and significantly the credit risk faced by SOSBs. The default risk on these policy loans is difficult to determine because the loan classification scheme was not according to international standards and accurate auditing procedures were not in place. For 1995, Naughton estimates a figure for non-performing loans (NPLs) in the banking system as a whole at 21% of all loans or about 18% of GDP. Lardy reports that 22% of the loans in the portfolios of the SOSBs were NPLs in 1995 and that these banks had less than 1% coverage in loan-loss reserves. Recently, the central bank reported that 20% of the SOSBs' loans are NPLs while foreign estimates indicate that at least 25% of their loan books must be written off entirely (Asiamoney, 1999). If the latter estimate is correct, over RMB 1.5 trillion or about \$190 billion in value must be subtracted from the assets of the four SOSBs. This figure amounts to about 22.5% of GDP. By any reasonable standards, the SOSBs would be insolvent if they were to mark their loan portfolio to market.

Basically, the last twenty years in China have witnessed a rapid build up of bad loans financed directly by household deposits at now-insolvent SOSBs. High rates of household savings held hostage in the banking sector without any meaningful financial alternatives have funded the state's industrial policy. In 1995, household saving was 70% of total domestic saving; 77% of this was held as bank deposits with 14% in cash and only 9% in other assets. The trigger that can expose the weakness of the Chinese banking sector is the rapid withdrawal of household deposits from the large SOSBs. The fear of this domestic trigger has led policymakers to postpone the further development of the equity and bond markets to focus on banking reform. The stock of bad loans in China is

the result of twenty years of policy-directed flows. Dealing with both the stock and flow issues of bad loans has become a priority of financial policy in China.

3. Dealing with Bad Loans: What Have We Learned from Central Europe?

The experiences of the fast-track CE countries with bank insolvency and bad loans provide a list of more don'ts than do's.⁷ Of these three countries, the Czech Republic has a financial structure most resembling that of China with a ratio of credit to GDP at 53% and market shares of the big four banks of about 70% for loans and 80% for deposits. Furthermore, at the beginning of the banking reform in 1990 in then Czechoslovakia, all of the working capital of SOEs was funded by short-term, low-interest, revolving bank credit referred to as TOZ loans. A "hospital" bank, Konsolidacni Banka (KnB), was created for restructuring these loans on commercial terms. All such loans were transferred along with a comparable amount of enterprise deposits from the other banks. In several stages, other loans classified as bad were transferred from the largest Czech banks to KnB for work out and the parent banks were recapitalized.

Although considered appropriate at the time, the Czech solution failed to insure the strength of the domestic banking system. Three of the four large Czech banks participated in the voucher privatization program that left bank governance still in the hands of the state.⁸ Universal banking regulations allowed banks to take significant equity holdings in companies; voucher privatization facilitated such equity ownership.

⁷ For a more detailed discussion of the bad loan problem in CE, see Ábel and Bonin (1994) and Bonin, Mizsei, Székely, and Wachtel (1998).

⁸ The foreign trade bank did not participate in voucher privatization partly because it was owned jointly by the Czech and Slovak Republics. For more details on bank privatization in CE, see Bonin, Mizsei, Székely, and Wachtel (1998), chapter 2.

Investment funds were created by the participating banks to acquire shares in companies, some of which were their own clients. One of the big four, Ivesticni a postovni banka (IPB), moved aggressively into both corporate holdings and retail banking by setting up sixteen subsidiary investment funds. IPB paid a premium on household deposits that it collected through the postal system to fund its investment activities. IPB's solvency deteriorated and Nomura Securities, an investment bank from Japan, took a controlling stake in exchange for filling the hole on the balance sheet that resulted from these activities.

Recently, the Czech banking system was exposed to a mini-Asian crisis and the full extent of its bad loans problem was recognized. Neither the creation of a separate hospital bank for credit obligations extended on non-market terms nor several rounds of cleaning up the banks' balance sheets make the big four Czech banks strong financial pillars. What went wrong? Simply put, the foundations for a strong market-oriented banking sector were not present. First, the big banks did not achieve independence from the government as the state retained majority or near majority stakes in them after voucher privatization. Second, the incentive (flow) problem was not solved as the banks not only retained their clients but they became even more involved with some of them as owners. Hence, the potential arose for a conflict of interest between the bank as equity holder and as debt holder. When the mini-currency crisis hit, Czech firms became distressed and the banks' balance sheets suffered. Interestingly, the Czech government's protectionist policy had allowed domestic banks to maintain high spreads and, hence, earn reasonable profit margins. Even in this environment in which banks could self-

capitalize, the bad loans problem was not resolved because soft lending practices were continued.

By contrast, Hungary pursued a policy of privatizing state banks by selling controlling shares to strategic foreign investors as rapidly as possible. Such sales required recapitalization of the banks to make the combination of current net worth and franchise value attractive to a foreign investor. This strategy earned Hungary the dubious reputation at the World Bank as the country most oblivious to the moral hazard of multiple recapitalizations of its domestic banks. However, the quality of the portfolio of any bank in the turbulent environment of a transition economy is extremely difficult to evaluate. In all three CE countries, the evolution of the stock of bad loans was due partly to the gradual learning and recognition of the quality of existing relationships (the stock issue) and partly to continuing bad lending practice (the flow problem). The continual recapitalization of Hungarian state-owned banks was ultimately successful because it was followed closely by privatization to independent, foreign owners leaving Hungary with the strongest banking sector in the region.

The Hungarian experience points to the importance of achieving independent governance both from the state and from undesirable clients. The latter is important for the incentive problem because banking is inherently a relational activity. Of more importance than inherited bad loans to the forward-looking operations of the bank are inherited bad clients. This point is often overlooked when the bad loans problem is divided into its stock and flow components. The Hungarian bank with the most exposure to loss-making industrial clients was Magyar Hitel Bank (MHB). Prior to searching for a strategic foreign investor but after recapitalization, MHB's loan portfolio was divided

into good and bad assets. The bad loans along with these clients' deposits were separated from the good part of MHB and a department was set up to work with these clients in an attempt to recover some portion of the bad loans. Only the good bank was privatized; this transaction was structured to attract a strategic foreign investor who would increase the bank's capital. Shortly after purchasing a 90% stake in MHB, ABN Amro merged it with its own Hungarian branch subsidiary. MHB now bears the name of the Dutch parent and is a financially sound foreign-owned bank.

The Polish experience indicates the inappropriateness of combining the resolution of bad loans with making the banks responsible for enterprise restructuring. The World Bank supported a program of bank-led enterprise restructuring based on the notion that the major bank creditor had sufficient information about their clients either to promote restructuring or to decide to liquidate large SOEs. Financial restructuring dominated bankruptcy as the preferred option of banks for their clients. More than 50% of the value of the bad loans were renegotiated and less than 30% of the clients, holding only 12.5% of the value of the loans, were forced to liquidate their assets (Gray and Holle, 1996). The main instrument used to restructure these loans was debt-equity swaps; this option was used in almost 60% of the cases and chosen disproportionately by the weaker banks. Hence, weak banks with no expertise in restructuring large companies wound up taking ownership stakes in their weak clients. Furthermore, new bank credit was provided to ailing enterprises in about a third of the cases surveyed by Gray and Holle (1996). As in the Czech Republic, Poland's program strengthened, rather than severed, the ties between banks and their undesirable clients. The Polish program provided breathing room for the

SOEs to postpone painful restructuring and emphasized the importance of banks divesting themselves of their non-viable clients.

How can the experiences in the CE countries be used by policymakers who are interested in promoting banking reform in China? Obviously, it is unreasonable to expect China to follow Hungary's example and sell majority stakes in its SOSBs to strategic foreign investors. If resolving the bad loans problem and promoting independent, sound commercial lending decisions are taken as the medium-term objectives of Chinese banking reform, several lessons can be drawn. The Czech experience indicates that transferring bad loans to a special hospital bank does not solve the incentive problem because it leaves the client attached to the original bank. Experience in Poland indicates that, while banks may have the information to deal with problem clients, they do not often have the expertise and incentives to do so properly. Banking is fundamentally a relational activity. The Hungarian experience with the good-bank/bad-bank solution illustrates the wisdom in separating bad clients from banks that are being restructured and recapitalized. This is an important first step for China in its reform of the banking sector.

IV. China's Banking Reform: An Evaluation and a Modest Proposal

China has not been completely immune from the effects of the Asian crisis. Depressed export markets and low domestic demand have combined to generate deflation. The retail price index fell by 3.3% year on year as of September 1998 and the consumer price index fell by 1.5% during the same period (Pu and Zhang, 1999). Deflation increases the cost of deposits to banks as even the low nominal interest rate on sight deposits is a positive real rate of over 3%. Hence, what had been an implicit tax on

household deposits in inflationary periods is now a net outflow from banks. Deflation has also led monetary authorities to cut lending rates twice within the year with real rates maintained at about 6% to 7% (Pu and Zhang, 1999). The resulting shrinkage in the spread has affected adversely the capital adequacy of Chinese banks. In March, Standard and Poor's lowered the ratings for three of the SOSBs, BoC, CBC, and ICBC, to BBB-, the lowest investment grade, and rated the outlook for these banks as negative (*The New York Times*, March 2, 1999). Clearly, the recapitalization of the big four banks is necessary if they are to take on an independent status from the state.

The Chinese banking reform program is aimed at resolving the bad loan problem at the SOSBs leaving them free to pursue business on a commercial basis. The structural aspect is the consolidation of the central bank network by creating nine districts to replace the regional offices. The intent is to reduce the influence of regional authorities in bank lending. The regulatory change is the requirement that banks adopt the standard loan classification scheme used internationally consisting of five categories: pass, special mention, substandard, doubtful, and loss. The intent is to recognize more accurately the extent of the bad loan problem. The institutional component is the creation of the Xinda Asset Management Company (AMC), which is modeled on the Resolution Trust Company (RTC) set up to resolve the bad loans from the portfolios of savings and loan associations in the U.S. Non-performing loans (NPLs) will be transferred from the one of the four SOSBs, CBC, to this AMC. The plan is to create similar AMCs for the other three SOSBs this year. The intent is to solve the bad loan problem by removing NPLs from the balance sheets of the SOSBs and placing them with the AMCs for workout and recovery.

The Xinda AMC will purchase the NPLs from CBC at face value; thus CBC will be recapitalized fully. Xinda AMC is expected to collect what it can or repackage the loans and sell them at discounted value on secondary markets. Bankers expect that foreign investors will be invited to buy the repackaged assets. The instrument used to capitalize AMCs will be government bonds guaranteed by the Ministry of Finance. Total lending by the four SOSBs amounted to RMB 6.3 trillion in September 1998. If the AMCs issued bonds equal to 35% of this portfolio at a nominal interest rate of 5%, the interest servicing cost would add 1.4% to the fiscal deficit (*Asiamoney*, 1999, p.21). China's estimated budget deficit for 1999 is about 2% of GDP (*The Economist*, March 13, 1999) so that the interest costs of capitalizing AMC would bring the deficit to almost 3.5% of GDP. This is extremely high by Chinese historic standards and above levels generally considered prudent and sustainable by the international financial community.

The cost of bailing out the SOSBs is not the only issue of concern with the reform. The RTC was established in the U.S. to deal with loans made by financial institutions that had been shut down or merged with other banks. Hence, the flow issue was not relevant. In contrast, the Chinese SOSBs will continue to deal with clients whose loans have been transferred to the AMC. Without shedding clients who are still not viable in the market economy, the SOSBs remain susceptible to making new bad loans. Hence, the proposed reform does not solve the flow aspect of the bad loan problem.

Furthermore, as long as interest rates are centrally determined, the SOSBs can not price lending risk appropriately even when they have good information about their clients. The reform does not leave the SOSBs independent enough from state policy or from troubled clients; thus, government officials can not expect the SOSBs to take full responsibility for

the financial outcomes of new lending. Hence, the proposed reform suffers from moral hazard due to the lack of a credible commitment to no future government bailouts of the SOSBs.

From a regulatory perspective, the reform depends on legislation to promote proper recognition of problem loans. The experiences in Hungary and the Czech Republic make clear that legislation is not sufficient. Attention must be paid to the incentives of bank decision-makers if the actual quality of the loan portfolios is to be revealed. Since banking is a relational activity, bank officers will protect a client with whom they wish to continue to do business. At the end of last year, the PBC inspected fifty branches of SOSBs having a large increase in bad loans. Dozens of managers, including two senior officials at Beijing branches of ICBC, were dismissed for incompetency and mismanagement (*Financial Times*, March 22, 1999). The intent was to change the behavior of managers who had built local fiefdoms and felt secure in their positions because it was rare to be sacked for incompetence. Furthermore, these bank managers were able to maintain good relations with local government authorities because of their support of local SOEs. Although penalties are an important component of supervision, the information necessary to ferret out such improper behavior is difficult to obtain, especially when coalitions form in whose self-interest it is to keep the information hidden.

Our modest proposal for enhancing the scope of the Chinese reform is focused on promoting independence for the SOSBs and developing effective supervision given the scarce resources available for regulation. The first recommendation is to designate a review period during which the SOSBs can decide which of their clients they wish to

shed. According to Lardy (1998b, p.118), banks keep on their books loans to borrowers who have already been liquidated. For these loans, the transfers of NPLs to an AMC are sufficient because no continuing relation exists between the bank and a client. For other NPLs, the borrower is an operating, but loss-making, SOE. The SOSB should be given the option of shedding such a client. The review period should not be overly long to avoid inappropriate incentives for current lending. The loans to clients so designated should be transferred to the AMC along with their banking business and their deposits.

This policy achieves the objective of making SOSBs independent from undesirable clients and addresses the flow problem. SOSBs use their knowledge to determine which of their clients is viable and then they are held accountable for loans to the clients whom they choose to retain. The AMCs gain some leverage over the businesses whose loans they are attempting to recover and become more like hospital banks than loan collection agencies. Two advantages over the Chinese reform are obtained by this proposal. First, the relation between the bank officer and the client that fostered soft lending practices in the past is severed, as the company now must work with a new bank. Second, the AMCs are not temporary collection agencies created only to work out bad loans; rather they are new financial institutions given the immediate task of restructuring SOEs and supporting financially the resulting businesses. Recruitment of talented people to the AMCs will be easier if they are viewed as ongoing financial institutions rather than as collection agencies that will close shop after resolving the existing NPLs.⁹

⁹ A similar institutional issue existed for the Treuhandanstalt, a agency established to privatize SOEs in the former GDR. The staff members used their experiences in Germany to set up a consulting agency to advice privatizations in other transition economies.

Given the nature of the clients to be transferred, the AMCs will be insolvent when established. To promote the independence of the AMCs from the state, they must be capitalized completely and with good assets. Hungary's experience with its multiple recapitalizations of banks indicates that using government securities that are not sufficiently liquid and do not return a market rate leaves banks insolvent and without the correct incentives (Ábel and Bonin, 1994). Hence, the financial instruments used to capitalize the AMCs should bear a flexible interest rate that will reflect future market conditions not a nominal rate fixed at the low current rates. Otherwise, subsequent recapitalizations of the AMCs will be required and their independence from the state will be suspect.

Estimates of the cost of recapitalizing China's banking sector indicate that it is large compared with the costs in the CE countries. Lardy (1998b) calculates that, in 1996, a hypothetical recapitalization would amount to 35% of GDP in China whereas Hungary's multiple recapitalizations added up to less than 10% of GDP. However, China had a ratio of domestic debt to GDP of 6.3% in 1996 so that bank recapitalization would have increased this figure to about 42% whereas Hungary's stock of domestic debt to GDP was over 90% after its bank recapitalizations. Perhaps more pertinent to China's situation, Japan's domestic debt to GDP ratio exceeded 100% by the end of 1997. A window of opportunity exists for China to implement a credible once-off recapitalization of the banking sector.

Our suggestion of shedding clients leaves the SOSBs downsized somewhat but now solvent. These four will continue to be the dominant banks in China in terms of both lending decisions and deposit-taking. Without the old loss-making SOEs as clients, they

must be induced to seek new business and develop new products especially in retail banking. The AMCs should be sufficiently independent from the state to develop their own niche over time. Given the experience of AMCs with loan workout and debt sales on secondary markets, these financial institutions could become investment banks or venture capitalists. This scenario leaves the already established policy banks as the vehicles by which the government should support its industrial policy. In this manner, the cost of industrial policy will become transparent, as the future holes in the balance sheets of the policy banks will be filled either with new government securities or by raising capital on the market.

As a complementary policy, the development of sound banking regulation and effective prudential supervision is necessary to impose the proper incentive structure on the SOSBs. Effective regulatory systems throughout the world use market incentives to induce the desired behavior (Bonin, Mizsei, Székely, and Wachtel, 1998, Chapter 4). China's regulatory reform does not pay sufficient attention to incentives. The key to a self-enforcing regulatory system is: first, to make the franchise value of the banks depend on efficient intermediation, and then, to link the compensation of decision-makers to the franchise value of the bank. The franchise value of a bank is the discounted value of the future stream of returns to banking activity. Future returns should depend on providing high-quality services and products to both retail and commercial clients, meeting the short-term liquidity needs of profitable commercial clients, and arranging long-term funding for economically rational investment projects. Furthermore, prudent regulation should penalize excessive risk-taking and make any form of lending on non-commercial grounds prohibitively costly. Under these conditions, the franchise value of a bank will be

based on efficient intermediation. If the monetary rewards of the decision-makers are then tied to franchise value, banks will be operated properly and efficiently.

In developed market economies, the standard way to link compensation to franchise value is through stock options. By beginning the process of privatizing SOSBs, the authorities could use this instrument to generate proper incentives. Given the structure of the Chinese banking sector, the first stage of privatization would not involve a strategic foreign investor. Rather several tranches in which small blocks of shares are sold over time on the domestic stock exchanges would result in broad domestic ownership of SOSBs, comparable to the ownership structure found in state savings banks in CE. Given the value of the SOSBs, the capacity of the domestic markets will limit significantly the pace of divestiture of state-held shares. Foreign portfolio investment might be encouraged to speed up the privatization process at some point in time. Nevertheless, the state will retain a majority stake in the SOSBs for the foreseeable future. Hence, the government must take a passive role only in bank governance and allow both market discipline and incentives to provide the correct motivation for management. When the SOSBs have been transformed into strong commercial banks having solid household deposit bases, further divestiture and more extensive privatization strategies can be considered. As a final recommendation, we offer the less-than-modest proposal that the Chinese government begin the process of privatizing SOSBs with small blocks of domestic offerings initially so that it may use stock options to motivate properly bank management.

Taken together, these recommendations comprise a package that is designed to allow the state to withdraw responsibly from governing the SOSBs and permit these

banks to develop into independent and efficient banks. At the same time, the state must assume its proper roles of bank regulator and prudent supervisor of the banking system but from an arms-length position only. This is a difficult tightrope to walk for policymakers. In no one of the three CE countries discussed was this orchestrated successfully by the government. In Hungary, foreign penetration was the driving force of market discipline that spurred the rapid development of the banking sector. In China, the reform will be orchestrated from above. However, China is not face with the extreme time pressure that the CE countries felt due to pending EU accession. Hence, the government has the opportunity to make the Chinese banking sector a strong pillar for its financial markets. However, the window will not stay open forever and the cost of any further delay in terms of the growth-deterring effects of capital misallocation makes proactive policy a priority.

Unfortunately, current Chinese policy seems to have taken a step backward from pursuing an independent and market-type banking sector. At the National People's Congress in March, Zhu Ronghi called for an attack on "the unprecedented and grim" economic environment and reminded state banks of their "political" responsibilities to lend to money-losing enterprises (*The Economist*, March 13, 1999). The government's overriding concern of promoting stronger aggregate growth places major responsibility for funding investment again with the SOSBs. Some see these pronouncements as thinly veiled exhortations to return to directed lending and central planning arrangements. If the government does co-opt the SOSBs into its growth initiative, progress toward bank independence will be reversed. Moreover, further development of financial markets will be stalled for fear of the flight of household deposits from SOSBs. Such a policy is based

on the mistaken notion that growth can be sustained with an extensive investment strategy in China. The Chinese economy has developed to a point where intensive growth strategies are necessary. Efficient allocation of capital, not simply more of it, is required and the SOSBs must be allowed sufficient independence to do their part as the dominant players in Chinese financial markets.

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