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Reforming China's Banking System

Since the late 1970s, China has undertaken economic reforms that have liberalized agricultural production, allowed the growth of a dynamic private sector, and gradually opened the economy to international trade and foreign direct investment. As a result, China stands as one of the fastest growing economies in the world. Yet, Chinese policymakers face continuous pressure to improve economic performance. Some analysts estimate that China needs to maintain annual growth rates even higher than the 9.5% average achieved in 1978–2000 in order to modernize the economy and create jobs for ten million workers that enter the labor force each year. Growth is constrained by the financial sector, which functions below potential because it supports unprofitable state-owned enterprises (SOEs).

Chinese authorities have attempted to ease this constraint with policies that give greater play to market forces and encourage banks to engage in commercial banking, shifting away from their traditional role as suppliers of financing to SOEs. SOEs also are being restructured to improve their financial condition. This *Economic Letter* discusses how the legacy of a planned economic system continues to affect economic and financial performance, as well as some of the constraints policymakers face in attempting to implement reforms.

Lagging SOEs

Before China began economic reforms, its economic activity was dominated by SOEs, which geared production to meet development goals and which automatically received credit from the banking sector according to a national development plan. But once liberalization began, it became apparent that SOEs could not keep up with the needs of the evolving market economy. An analysis by Heytens and Karacadag (2001) reveals that SOEs are about 60% as efficient (as measured by value added) or profitable (as measured by operating profits to assets) as foreign-funded enterprises. Their low profitability leaves SOEs financially vulnerable. For example, interest coverage (the operating profit potentially available to cover interest expenses) in SOEs is as low as one-third that observed in major industrial countries. Firm-level data for listed enterprises suggest that Chinese enterprises cannot generate enough cash flow to pay interest on about 20 to 30% of their total debt. A moderate rise in interest rates or a moderate drop in sales could cause 40% to 60% of the debts of all firms to become unserviceable.

Liberalization and lagging SOE performance have allowed private enterprises to grow rapidly to meet domestic and foreign demand for Chinese goods. Firms with access to foreign financing and managerial expertise have done particularly well. As a result, the share of output attributable to SOEs fell from 38% in 1994 to 26% in 1999, while the combined shares of individual-owned, shareholding, and foreign-funded enterprises rose from 24% to 41% over the same period. (Locally owned collectives account for the remainder.) The SOEs also now account for a smaller share of employment—from 66% in 1994 to 51% in 2000.

Burdened banks

Banks in China traditionally met government policy goals by financing the operations of SOEs, regardless of their profitability or risk. While bank exposure to SOEs has tended to decline over time, SOEs still accounted for over one-half of outstanding bank credit in 2000. Out of the more than 40,000 financial institutions in China, the most exposed are four state commercial banks (SCBs), which accounted for 86% of the assets of the banking sector. Exposure to poor-performing SOEs has had a major impact on bank performance. According to official estimates, even after a large amount of loans were taken off bank books, nonperforming loans (NPLs) at the end of 2001 were $213 billion, or about 25% of total loans (Dai 2002). This figure could be much higher if fully adjusted to reflect international definitions for NPLs. For example, the Bank of China's 1999 NPLs were found to be 2.6 times as high

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using international criteria as they were using the traditional Chinese definitions (Lardy 2001).

Bank vulnerability is accentuated by pressures on NPLs to increase. SOEs cannot very easily reduce their costs (for example, due to impediments to laying off workers), which limits their competitiveness and profitability, as well as their ability to service their debts. At the same time, because of their continuing importance and the fact that they employ millions of workers, it is very difficult to cut off SOEs from financing. SCBs thus face pressures to roll over SOE loans, even when SOEs have defaulted on their debts, which reduces funding for more worthwhile investment projects.

Reforming the financial system

Chinese authorities have taken a number of steps to strengthen the banking sector to ensure that the financial sector will be able to support continued rapid rates of growth.

Strengthening bank balance sheets. The government has borrowed heavily to recapitalize banks and take NPLs off their books. In 1998, it issued $32 billion in bonds to recapitalize the banking sector. In 1999–2000, bonds were issued by four asset management companies (one for each SCB) to absorb approximately $170 billion of bad loans (Lardy 2001). Chinese commercial banks are now adopting balance sheet criteria that reflect international practices; for example, as recommended under the 1988 Basle Accord, risk-based capital ratios of 8% are being maintained, although there is concern among some analysts that the Basle criteria understate the riskiness of assets held. Loan-loss provisions are now to reflect asset quality, and since the beginning of 2001, they may be as high as 100% compared to 1% of loan balances previously. Financial statement definitions are also gradually being brought in line with international standards.

Using commercial lending criteria. According to legislation and rules adopted in the mid-1990s, banks now must base lending on commercial criteria. Policy banks also have been established to free SCBs from lending to SOEs to meet government goals. Starting in 2000, credit to SOEs with overdue bank loans was cut off in several provinces; this policy is to be adopted gradually throughout China. To reduce risk exposure, loans must be made against collateral, banks must assess borrower creditworthiness, and loans to a single borrower must not exceed 10% of bank capital. To shield banks from political pressure, individuals and nonbank organizations may not interfere in bank operations. Commercial banks may not give unsecured loans to related parties or provide secured loans on preferential terms.

Strengthening SOE finances and management. To prevent rising NPLs, the government is restructuring SOEs. Large SOEs are encouraged to adopt commercial practices, while small ones are being privatized. As part of this process, nearly 26 million workers were separated from SOEs in 1998–2001 (17 million were rehired, and 3 million retired). SOEs also must limit spending and no longer can assume that banks will automatically provide financing. According to a senior government official, nearly $10 billion will be spent in 2002 to close or merge unprofitable SOEs (China Online 2002). In 2001, 460 SOEs were shut down, and $6 billion in NPLs were written off.

Improving governance. More Chinese firms and banks are listing their shares, exposing them to some market discipline. The top 100 firms listed in China's stock exchanges have some state ownership (*Fortune* 2002). At present only three Chinese banks are listed—Pudong Development Bank, Shenzhen Development Bank, and Minsheng Bank—but recent press reports indicate that the Bank of China plans a listing and China's largest SCB, the Industrial and Commercial Bank of China, may follow in the future. Banks also are required to introduce governing boards and are to be audited by an approved accounting firm.

Fiscal constraints

Policymakers face numerous obstacles in restructuring the economy and the financial sector. One concern is whether China has the resources to fund the restructuring of banks and SOEs, to develop a social safety net, and to meet development goals. While official figures indicate that China's public debt was about 13% of GDP in 2000, private estimates suggest that the debt may be much higher if other implicit or explicit government liabilities are counted. The public debt has been growing in recent years because of pressures to increase expenditures and to meet revenue shortfalls.

Expenditures have risen to stimulate the economy in response to the recent global economic slowdown, to absorb the bad loans in the banking system, and to expand the social safety net (unemployment insurance and pensions) as a way to facilitate SOE restructuring. Recent data highlight the magnitude of the task. For example, unemployment insurance covered 103.5 million people by the end of 2001, out of a total labor force exceeding 750 million. (*People's Daily* 2001). By comparison, the U.S. labor force was 142 million in 2001.

At the same time, government revenue as a share of GDP has fallen, from 35% of GDP in 1978 to 11% in 1995, in part because liberalization and a shift to a tax system has eroded revenues traditionally obtained from SOEs. As a result of recent tax reforms, the share rose to 15% in 2000.

In response to fiscal pressures, ongoing reforms seek to broaden the tax base and reduce distortions in the tax system. Efforts are also being made to draw on private sector resources by raising funds in domestic or international capital markets and encouraging foreign investment. Press reports indicate that foreign investors are teaming up with asset management companies to raise the yield on NPL workouts from the estimated 9 cents on the dollar obtained in 2000. Foreign investment is also being encouraged in order to improve management and help restructure SOEs, which would enhance their overall competitiveness and their ability to service their debts.

The impact of WTO

Another concern is whether China's accession to the World Trade Organization (WTO) in December 2001 will adversely affect the viability of the financial sector. China has committed to eliminating non-tariff barriers and to reducing tariffs significantly, as well as to opening a number of sectors to foreign investment, including the financial sector.

The impact of liberalizing foreign entry in the domestic banking sector will not be felt for some time. Foreign banks initially will be allowed only to provide foreign currency services to Chinese clients. They may provide local currency services to Chinese enterprises within two years of accession and the full range of banking services to all Chinese clients within five years of accession. Foreign bank entry will put pressure on domestic bank profits, but it also will boost the efficiency of domestic banks.

WTO accession will also affect banks through its impact on manufacturing and services. In the medium- to long-run, WTO will benefit the economy (and banks) by contributing to the anticipated doubling of China's share of world exports by 2005, compared to 1995 (Ianchovichina and Martin 2001). By opening domestic import markets, WTO accession is also expected to boost growth by increasing efficiency. In the short run, however, WTO accession poses significant risks, as many SOEs are not in a position to compete effectively with foreign firms. There is also concern that increased imports of U.S. farm products will adversely affect small scale farming in China and depress Chinese farmer incomes, which could increase social tensions.

Conclusions

China is pursuing wide-ranging reforms to maintain the rates of growth needed to employ its expanding labor force. In pursuing these reforms, policymakers need to overcome a number of formidable obstacles we have discussed above, as well as strike a difficult balance. On the one hand, the timing and sequencing of reforms must be carefully managed to minimize the potential for costly distortions or economic disruption. On the other hand, reforms must achieve enough momentum and be sufficiently complete to provide the intended benefits.

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